

VICTORIA

Auditor General
Victoria

**Report of the
Auditor-General on
the Finances of the
State of Victoria,
2001-02**

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The Hon. B.A. Chamberlain MLC
President
Legislative Council
Parliament House
MELBOURNE

The Hon. A. Andrianopoulos MLA
Speaker
Legislative Assembly
Parliament House
MELBOURNE

Sir

Under the provisions of section 16A of the *Audit Act* 1994, I transmit my *Report on the Finances of the State of Victoria, 2001-02*.

Yours faithfully

A handwritten signature in black ink, appearing to read 'J.W. Cameron', with a large, sweeping flourish at the end.

J.W. CAMERON
Auditor-General

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Part 1

Executive summary

OVERVIEW

This report outlines the results of the audit of the *Annual Financial Report* for the State of Victoria for the year ended 30 June 2002. The *Annual Financial Report* presents the financial position of the State of Victoria and the General Government (Budget) Sector, and the results of their operations and cash flows. A clear audit opinion was provided on the 2001-02 *Annual Financial Report*.

My analysis of the State's overall condition shows that it remains strong. However, there are a number of vulnerabilities and emerging pressures which require careful management.

The operating surpluses achieved by the Government in recent years have been supported by strong economic activity and, therefore, any downturn in the economic cycle and further expenditure pressures, including wage growth, will inevitably impact on the Government's capacity to maintain existing program levels.

In particular, the strong property market has positively contributed to the State's operating result. The unpredictability of the property market presents a risk to future State revenues. The higher level of financial assets held has also increased the vulnerability of State revenues to movements in equity markets due to both domestic and international factors which are largely outside its control or influence.

The strategic challenge for the Government remains to ensure that the key risks to the State's finances are clearly identified and taken into account in its ongoing financial planning and management.

SUMMARY OF MAJOR FINDINGS**OPERATING RESULT AND FINANCIAL CONDITION****Page 19**

- The State achieved an operating surplus of \$607 million in 2001-02, some \$396 million lower than the result achieved in 2000-01.

Paras 3.5 to 3.6

- State revenues increased by \$1.1 billion, underpinned by higher Commonwealth grants and favourable property market conditions positively impacting on taxation revenues, offset to an extent by lower investment revenue resulting from the downturn in global equity markets.

Para. 3.7

- These increased revenues in the year were offset by a \$1.5 billion increase in expenditure. The increase was mainly in the areas of superannuation costs (mainly reflecting the impact of the downturn in the world equity markets on investment values which impact on the net liabilities of the superannuation funds and the cost to the State), wages and related costs, and grants and transfer payments. These cost increases were partly offset by reduced borrowing costs, and supplies and services (mainly reflecting lower claims expenses of the State's statutory insurance schemes).

Para. 3.8

- The financial position of the State continues to remain sound, with net assets of \$49.4 billion, an increase of \$5.2 billion since the prior year.

Paras 3.10 to 3.11

- The State's overall financial condition continues to remain strong. However, there are a number of emerging pressures and vulnerabilities which require careful management.

Paras 3.22 to 3.24

- The Government has achieved its short-term financial objectives and is progressing towards the achievement of its broadly stated longer-term financial objectives.

Paras 3.29 to 3.31

- The General Government Sector achieved an operating surplus of \$273 million for 2001-02, which was \$235 million below the original budget forecast and \$943 million below the result achieved in the previous year.

Paras 3.14 to 3.15

REVENUE**Page 35**

- The operating revenues of the State in 2001-02 totalled \$30.6 billion, some \$1.1 billion (3.8 per cent) higher than 2000-01.

Para. 4.1

- Investment income reduced by \$999 million from the previous year mainly resulting from the effect of the downward valuation of investments emanating from a deterioration in world equity markets.

Paras 4.48 to 4.53

- The strong property market in the year has positively impacted on the level of taxation revenues raised, with stamp duty collections on property transfers \$601 million higher than in 2000-01.

Paras 4.11 to 4.13

- During 2001-02, revenues from gambling activities amounted to \$1.4 billion, an increase of \$94 million on the previous year, and represented 15.6 per cent of total taxation revenue.

Paras 4.14 to 4.15

- In 2001-02, fines revenue from the Traffic Camera Office totalled \$138.6 million, an increase of \$54.5 million over the previous year.

Paras 4.34 to 4.37

- Revenue from fines and regulatory fees is expected to increase substantially by around \$129.6 million (30 per cent) in 2002-03, attributed to the full effect of a number of government initiatives introduced as part of an effort to reduce Victoria's road toll, including the purchase and installation of new and converted digital red light and speed detection cameras at key intersections and on the City Link.

Paras 4.38 to 4.40

EXPENDITURE**Page 53**

- The operating expenses of the State totalled \$30 billion during 2001-02, some \$1.5 billion (5.3 per cent) higher than in the previous financial year.
Paras 5.1 to 5.3
- Costs associated with employee entitlements comprising salaries, wages and on-costs, amounted to \$9.4 billion in 2001-02, an increase of 8.9 per cent or \$768 million on the previous financial year.
Para. 5.5
- The net additional cost of major public sector industrial settlements and additional permanent staffing decisions by the Government in recent years is estimated to have cost \$962 million in 2001-02 (an increase of \$471 million from the previous financial year), and is expected to increase to around \$1.47 billion for 2003-04. This does not include any related increases to the State's unfunded superannuation liabilities.
Para. 5.10
- Given the significant impact of the public sector industrial settlements and staffing decisions on the State's finances, it will be important that their implementation is carefully managed and monitored to mitigate against the risk of further cost increases.
Para. 5.11
- In an interim agreement entered into in March 2002, the public transport franchisees and the Government agreed to settle a number of disputes in return for 2 core settlement payments totalling \$68.8 million, together with annual payments of \$2.8 million over the period of the arrangements. However, 45 claims remained unresolved and are to be examined by a Government taskforce.
Paras 5.52 to 5.56
- In May 2002, the Public Transport Corporation and OneLink settled all outstanding claims relating to the automated ticketing system. The agreed terms of settlement included a payment of \$65 million by the State; introduction of a new performance regime for OneLink at a cost to the State of up to \$2.5 million over the remaining term of the contract; and a capping of the financial risk of vandalism to the State through an annual payment of \$3 million to Onelink.
Paras 5.63 to 5.69
- The total costs incurred by the State in relation to the Formula One and Motor Cycle Grand Prix events for the 2001-02 financial year amounted to \$16.2 million, compared with \$13.1 million in 2000-01.
Para. 5.76
- The net operating costs to the State associated with the staging of the Grand Prix events since their inception is approximately \$74.5 million. The increasing annual costs incurred by the State from the staging of the events reinforce the need for the Australian Grand Prix Corporation to continually assess its financial planning to ensure that the net costs to the State are minimised.
Paras 5.77 to 5.80

EXPENDITURE - *continued***Page 53**

- The net cost to the State of attaining (in 1998) the right to stage the 2006 Commonwealth Games in Melbourne was \$6.1 million. In addition, the State had provided further funding of \$49.6 million to 30 June 2002 to the organising committee company in relation to planning the Games. Further to this contribution, Victorian Government departments incurred related expenditures of \$2.5 million in 2001-02.

Para. 5.88

- A revised whole-of-government budget for the 2006 Commonwealth Games had not been finalised at the date of preparation of this report. However, we were advised that it would be completed in time for consideration as part of the Government's 2003-04 budget cycle, taking into account a review of the original budget and experience of the Sydney 2000 Olympic Games and the Manchester 2002 Commonwealth Games.

Para. 5.87

- The State's direct and indirect financial support for the Melbourne Cricket Ground redevelopment includes:
 - a guarantee of a loan of \$360 million provided to the Melbourne Cricket Club (MCC);
 - a grant of \$77 million to the MCC, and a further contribution to meet the cost of the construction of the temporary athletics track;
 - various indemnities to the MCC and a financial guarantee to the MCG Trust; and
 - certain compensation payments to the MCC, the Australian Football League (AFL) and the Victorian Cricket Association/Australian Cricket Board.

Paras 5.94 to 5.96

- To comply with the Government's guidelines relating to the operation of the Community Support Fund which provide that it should not be used to fund mainstream recurrent programs, the continuance of certain programs will require reconsideration of either the source of funding or revisions of these guidelines.

Paras 5.115 to 5.118

- A Community Support Fund grant of \$4.25 million was provided to a local government council in contravention of established guidelines.

Paras 5.119 to 5.123

ASSETS**Page 85**

- The State's assets mainly comprise physical assets, receivables, cash and investments which had an aggregate value of \$97.1 billion as at 30 June 2002 - an increase of around \$1.7 billion on the previous year.

Paras 6.1 to 6.2

- Based on the most recent valuation reports provided by investment fund managers, between 30 June 2002 and 30 September 2002 the further downturn in investment markets (post-balance date) reduced the value of the State's financial assets by around \$461 million and further increased the value of the State's unfunded superannuation liability by approximately \$384 million.

Paras 6.13 to 6.15

- Of the \$1 575 million allocated towards the Growing Victorian infrastructure reserve, \$1 363 million has been committed to various infrastructure projects. As at 30 June 2002, around \$209 million had been expended on approved projects.

Paras 6.51 to 6.52

- Given that the majority of current timetabled train services for the rail lines associated with the regional fast rail project are not express (in particular peak hour services), the concentration of the feasibility analysis of the costs and benefits of the project predominantly on express journey times could be considered narrowly focused.

Paras 6.56 to 6.61

- It was originally expected by the Government that the regional fast rail project would be delivered through a combination of public and private sector financing and would achieve certain targeted savings in journey times. Due to value-for-money considerations, the final arrangements do not involve private sector financing and are expected to deliver savings in journey times lower than those originally anticipated. The current estimated cost of this project is \$556 million in nominal terms.

Para. 6.76

LIABILITIES, COMMITMENTS AND CONTINGENCIES**Page 109**

- The liabilities of the State totalled \$47.7 billion at 30 June 2002, a decrease of \$3.5 billion on the previous year.

Para. 7.1

- The decrease in liabilities was mainly due to reductions in payables of \$4.1 billion (mainly due to the maturity of derivatives in the year) and interest-bearing liabilities of \$1.8 billion, partially offset by an increase in unfunded superannuation liabilities of \$1.5 billion and outstanding insurance claims of \$491 million.

Paras 7.1 to 7.2

- The substantial deterioration in the State's unfunded superannuation liability in the year was largely attributable to:

- negative investment returns of 5.03 per cent for the State Superannuation Fund and 2.98 per cent for the Emergency Services Superannuation Scheme primarily attributable to the downturn in world equity markets;
- changes to actuarial assumptions, including an increase in the assumed proportion of members opting to resign between ages 54 and 55; and
- higher than projected member salary increases.

Paras 7.7 to 7.13

- In relation to the Spencer Street Station redevelopment, the project developer assumes the key risks and costs associated with the commercial aspects of the development, including the risk of cost overruns and construction delays, and the risks associated with occupancy utilisation of the commercial facilities.

Paras 7.103 to 7.108

- Our initial assessment of the Spencer Street Station redevelopment project indicates that the arrangements associated with the transport interchange facility will need to be reported in future financial reports as a liability of the State, with the corresponding asset also reported.

Paras 7.124 to 7.125

- A detailed review by my Office of the arrangements associated with the Seal Rocks development was suspended in July 2000 due to the commencement of an arbitration process. Due to the prolonged period of arbitration and the recent litigation initiated in relation to this project, it has not been possible to recommence our review and report to Parliament on this issue. Our review will proceed once the current legal proceedings are completed.

Paras 7.154 to 7.160

- Additional claims with a value of \$134.4 million have been lodged for contract variations on the 4 major road construction contracts associated with the Geelong Road project.

Paras 7.161 to 7.165

**REVIEW OF THE GOVERNMENT'S
ESTIMATED FINANCIAL STATEMENTS**

Page 147

- In each of the past 3 years, the impact of property price increases and the sustained strength of the property market on the State's Budget Estimates have been underestimated. It should, however, be acknowledged that the difficulty of forecasting conveyancing duty is not confined to Victoria.

Paras 8.14 to 8.17

- The inherent difficulties in forecasting conveyancing duty, as well as the absence of timely, cost-effective data and a comprehensive model will continue to impede the Government's ability to produce accurate forecasts for this revenue item. Accordingly, to mitigate this risk, the forecasting methodology and data availability issues should be addressed as a matter of priority.

Paras 8.18 to 8.22

Part 2

Opinion on the Government's Annual Financial Report

AUDIT OF THE GOVERNMENT'S ANNUAL FINANCIAL REPORT

2.1 A key obligation of the Government, under the *Financial Management Act 1994*, is to report on the State's operations in an Annual Financial Report. The Report represents the consolidated financial report for the State of Victoria which must be audited by the Auditor-General and presented to the Parliament each year. Under the Act, the Government's Annual Financial Report must present fairly the financial position of the State and the Victorian General Government (Budget) Sector at the end of the financial year and the results of their operations and their cash flows for the year, together with the transactions of the Public Account, which comprise the Consolidated Fund and Trust Fund.

2.2 Consistent with the financial reporting requirements of the *Financial Management Act 1994*, the Minister for Finance has determined that the Annual Financial Report be presented in accordance with the relevant Australian Accounting Standards.

2.3 Table 2A outlines the key elements of the State of Victoria as a reporting entity.

TABLE 2A
STATE OF VICTORIA REPORTING ENTITY (a)

<i>General government sector (b)</i>	<i>Public non-financial corporations (c)</i>	<i>Public financial corporations (d)</i>
<p><i>Includes -</i></p> <ul style="list-style-type: none"> • All government departments; • Other administrative units, such as the Office of the Chief Commissioner of Police and the Office of Public Employment; and • Other entities that provide services that are mainly non-market in nature, for the collective consumption of the community. 	<p><i>Includes -</i></p> <ul style="list-style-type: none"> • Water sector authorities; • Australian Grand Prix Corporation; • Public Transport Corporation; • Urban Land Corporation; and • Alpine Resort Management Boards. 	<p><i>Includes -</i></p> <ul style="list-style-type: none"> • Transport Accident Commission; • Treasury Corporation of Victoria; • Victorian Funds Management Corporation; • Victorian WorkCover Authority; and • State Trustees Ltd.

(a) A full list of Victorian public sector agencies is disclosed in note 36 to the Government's Annual Financial Report.

(b) The scope of the Budget sector for this reporting period has been expanded to incorporate a number of agencies and regulatory bodies that were formerly referred to as the general government non-budget sector agencies. The General Government Sector includes all government departments and other bodies engaged in providing services free of charge or at prices significantly below their cost of production.

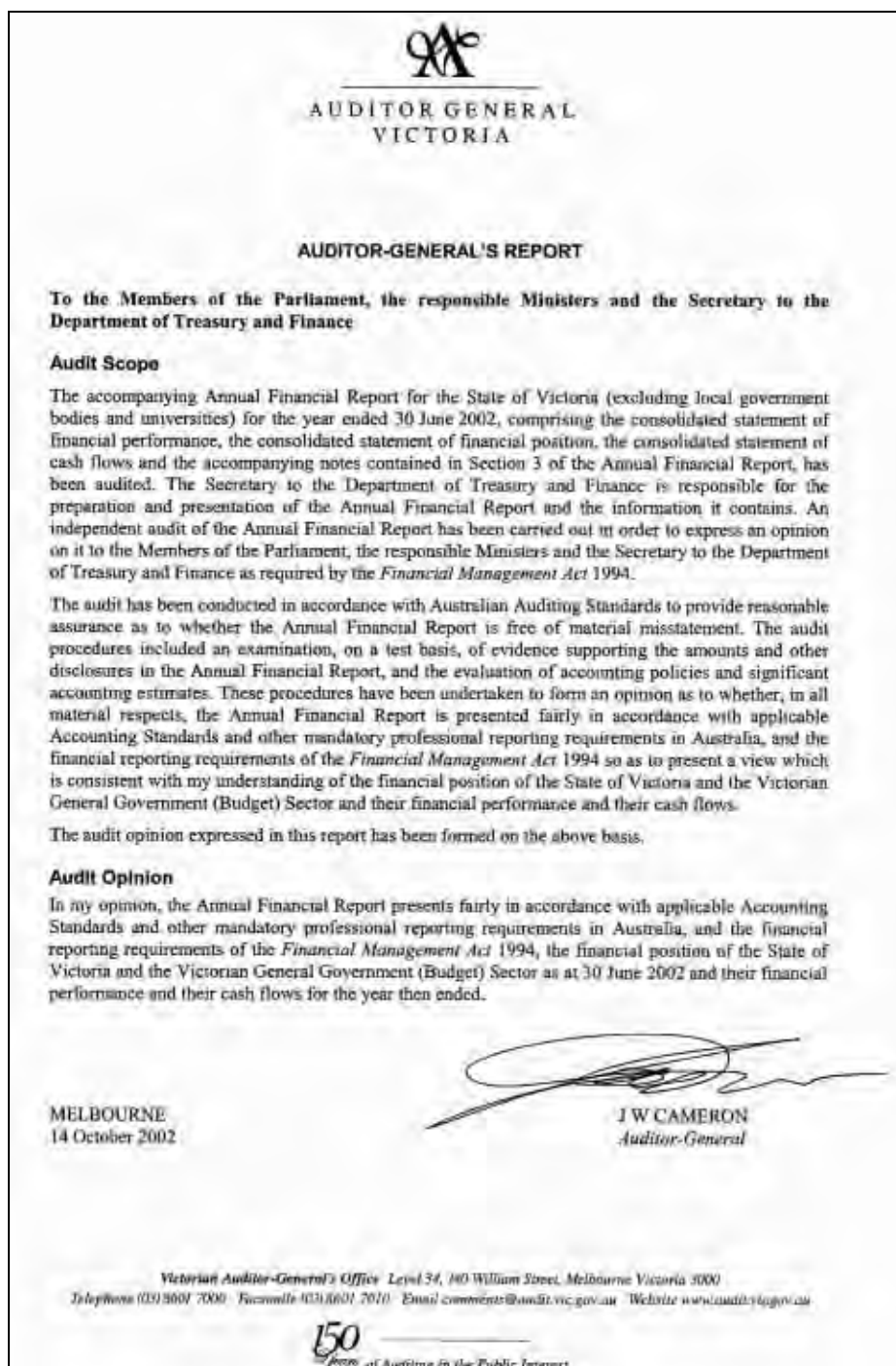
(c) Includes agencies which provide goods and services within a competitive market that is non-regulatory and non-financial in nature.

(d) Includes agencies which are government controlled and have the characteristics of performing a central borrowing function, accepting deposits, and the ability to incur liabilities and acquire financial assets in the market on their own account.

AUDIT OPINION ON THE ANNUAL FINANCIAL REPORT

2.4 The Government's Annual Financial Report for the financial year ended 30 June 2002 has been audited as required by the *Financial Management Act* 1994. The Annual Financial Report represents the consolidated financial report of the State of Victoria which includes around 320 public sector agencies, but excludes local government bodies and universities.

2.5 My audit opinion on the Annual Financial Report, issued on 14 October 2002, reads as follows:



Understanding the report of the Auditor-General on the Annual Financial Report

2.6 The purpose of an audit report on a financial report is to enhance the credibility of the information presented in relation to an entity's financial performance, financial position and cash flows and, in some cases, advise readers of problems in the financial report. The audit report is structured to clearly define the financial report being audited, explain the scope of the audit and present the auditor's opinion on the financial report.

2.7 In the context of the Report of the Auditor-General on the Annual Financial Report, it is important to recognise that the audit report relates only to the financial report and related notes contained in Section 3 of the Government's Annual Financial Report. It does not extend to the information presented in Sections 1, 2 and 4 of that Report or in the associated Appendices.

The extent or scope of the audit

2.8 The Report of the Auditor-General on the Annual Financial Report begins by listing the various components of the financial report covered by the audit opinion and highlights that the financial report is for the State of Victoria, excluding local government bodies and universities. The introductory paragraph concludes by confirming that the preparation and presentation of the financial report is the responsibility of the Department of Treasury and Finance and that my responsibility is to form and express an opinion on the financial report as required by the *Financial Management Act* 1994 to the Members of Parliament and the responsible Ministers.

2.9 In the next paragraph of the report, the nature and extent of the audit work is described. I indicate that my Office's audit work has been conducted in accordance with Australian Auditing Standards. These Standards provide detailed professional guidance that is required to be followed to ensure the appropriateness and quality of the audit work and the reliability of the audit opinion.

2.10 The report indicates that the audit procedures are performed to provide reasonable assurance about whether the financial report is presented fairly in accordance with the relevant financial reporting framework and is free of material misstatement. The audit provides a high, but not absolute, level of assurance. Absolute assurance in auditing is not attainable because of such factors as the use of judgements and estimates in the preparation of financial reports, the use of testing and sampling for gathering and evaluating evidence, the inherent limitations of internal control and the fact that much of the evidence available to the auditors is persuasive, rather than conclusive in nature.

2.11 An audit is not designed to detect all errors in the vast number of transactions that make up the financial statements, but the audit procedures are designed to ensure that the aggregate of any errors detected do not exceed a level above which the user of the financial statements would have their judgements affected by that level of error.

2.12 I explain in the audit report that the audit includes an evaluation of the appropriateness of the accounting policies used by the Government and an evaluation of the overall presentation of the financial report. As a basis for this evaluation, I use the applicable Accounting Standards and other mandatory professional reporting requirements in Australia and the financial reporting requirements of the *Financial Management Act 1994* that the Government is required to follow in preparing the financial report.

2.13 In addition, judgements are made in relation to the validity of significant accounting estimates included in the financial report. Many of the significant amounts detailed in the financial report, such as the valuation of certain assets, outstanding insurance claims liabilities, and the calculation of unfunded superannuation and other employee entitlement liabilities are based on estimates made by public sector entities. In order to determine whether misstatements exist in these estimates, a review of the validity of the assumptions and the completeness of the underlying data supporting the estimate is undertaken.

Impact of materiality and audit procedures on the audit opinion

2.14 The aggregate of all misstatements in the financial report are considered material if, in the light of surrounding circumstances, it is probable that the misstatements would change or influence the decision of a person who was relying on the financial report and who had reasonable knowledge of the Victorian public sector and its activities. If this were the case, I would include a reservation in the audit opinion.

2.15 Australian Auditing Standards require that the audit work provide “reasonable assurance” that any misstatements aggregating to more than a predetermined level of materiality will be revealed in the audit opinion. Before commencing the audit, a judgement is made based on the Government’s total revenues, expenditures, assets and liabilities as to what dollar magnitude (materiality) of misstatements in the financial statements would influence the decisions of users about the allocation of scarce resources or the discharge of accountability. That dollar amount is then used as a basis for determining the nature, extent and timing of the audit work required. Materiality also involves a qualitative aspect involving a judgement as to the nature of any error and whether any omission or misstatement has the potential to adversely affect decisions of users.

2.16 In planning the audit, a small amount of risk is accepted that the audit procedures may fail to detect whether the financial report is materially misstated. This minimal risk is accepted because of the judgements involved in determining the nature, timing and extent of audit procedures, evaluating the evidence obtained and also to enable the audit to be conducted in a cost-effective manner.

2.17 However, in order to reduce this risk to an acceptable level, detailed audit procedures are performed. These procedures include, for example, obtaining an understanding of and evaluating the internal control structure and, where considered necessary, testing significant internal controls and samples of transactions and account balances, performing tests of the reasonableness of amounts and confirming year-end balances with third parties.

Audit opinion

2.18 The opinion paragraph contains my audit conclusions on whether the Annual Financial Report presents fairly the financial position of the State of Victoria and the Victorian General Government (Budget) Sector and their financial performance, and their operations and cash flows in accordance with applicable Accounting Standards and other mandatory professional reporting requirements in Australia, and the financial reporting requirements of the *Financial Management Act* 1994. It is important to recognise that the audit opinion is not a statement of fact but an expression of my professional judgement.

2.19 My audit opinion on the Government's Annual Financial Report concludes that the financial information is presented fairly in accordance with the above reporting framework for the financial year ended 30 June 2002.

What the audit opinion does not provide

2.20 The audit opinion is not designed to consider whether the resources used by the Government were applied efficiently, economically or effectively. This aspect of our work is separate from that relating to the audit of the Government's Annual Financial Report.

2.21 Finally, our audit work on the Government's Annual Financial Report is not designed to, and the opinion does not, provide assurance that all the transactions of the Government are in compliance with laws and regulations, except for those that impact on the information presented in the Annual Financial Report. Through my audit of individual departments and agencies, cases of non-compliance with legislative and regulatory requirements may be identified in which case, if significant, these will be reported to the Parliament in separate reports.

Part 3

Operating result and financial condition

SUMMARY OF OPERATING RESULT AND FINANCIAL CONDITION

3.1 The Annual Financial Report for the State of Victoria discloses the financial outcomes for the 2001-02 financial year on 3 levels, namely:

- State of Victoria;
- Victorian General Government Sector; and
- The Public Account, comprising the Consolidated Fund and Trust Fund.

3.2 Comment follows on the outcomes of each of the levels of government operations.

State of Victoria

3.3 As indicated previously, the consolidated financial report for the State of Victoria includes around 320 public sector agencies, but does not include the local government sector, denominational hospitals and universities.

3.4 A summary of the operating result achieved by the State for the financial year and its financial position as at 30 June 2002, as disclosed in the Annual Financial Report, is presented in Table 3A.

TABLE 3A
STATE OF VICTORIA, OPERATING RESULT AND FINANCIAL POSITION
((\$billion))

<i>Item</i>	<i>2001-02</i>	<i>2000-01</i>
Operating result -		
Revenues	30.6	29.5
Expenses	30.0	28.5
Operating surplus for the year	0.6	1.0
Financial position -		
Assets -		
Physical assets	67.8	61.9
Cash and investments	21.5	21.3
Receivables	7.2	11.6
Other	0.6	0.6
Total assets	97.1	95.4
Liabilities -		
Interest-bearing liabilities	13.1	14.9
Unfunded superannuation	13.4	11.9
Employee entitlements	2.7	2.5
Payables	5.0	9.0
Other	13.5	12.9
Total liabilities	47.7	51.2
Net assets	49.4	44.2

Operating result

3.5 The operating result is a major indicator of the Government's financial performance as it identifies the extent to which the costs of service delivery to the public are covered by revenues of the State. This information, when assessed over a number of years, provides an important indicator of the financial impact and sustainability of the Government's financial strategies and policies.

3.6 The Consolidated Statement of Financial Performance discloses that the State achieved an operating surplus of \$607 million in 2001-02 - some \$396 million lower than the result achieved in 2000-01.

3.7 State revenues increased by \$1.1 billion, underpinned by higher Commonwealth Grants and favourable property market conditions positively impacting on taxation revenues, offset to an extent by lower investment revenue resulting from a downturn in global equity markets.

3.8 These increased revenues in the year were offset by a \$1.5 billion increase in expenditure. The increase was mainly in the areas of superannuation costs (mainly reflecting the impact of the downturn in the world equity markets on investment values which impact on the net liabilities of the superannuation funds and the cost to the State), wages and related costs, and grants and transfer payments. These increases were partly offset by reduced borrowing costs and supplies and services (mainly reflecting lower claims expenses of the State's statutory insurance schemes).

3.9 Table 3B outlines the contribution of each of the key factors to the reduction in the operating surplus compared with the previous year.

TABLE 3B
CHANGES IN FINANCIAL PERFORMANCE
(\$million)

<i>Item</i>	<i>2001-02</i>
Revenue changes	
Taxation	
Increased Conveyancing Duty	600
Other increases	253
Abolition of Financial Institutions Duty and Stamp Duty on Quoted Marketable Securities	(590)
Grants	
Mainly reflecting increases in GST, First Home Owners Scheme grants and Special Purpose Payments	1 510
Investment revenue	(999)
Other revenue	
Mainly due to the recognition of the State's interest in the Snowy Hydro Limited	348
	1 122
Less	
Expenditure changes	
Employee entitlements	
Increase mainly due to the settlement of major public sector industrial agreements	768
Superannuation	
Increase mainly as a result of negative returns from global equity markets and member salary increases	1 170
Grants and transfer payments	
Increase mainly relates to non-government schools and the First Home Owners Scheme payments	339
Supplies and services	
Decrease mainly attributable to a lower WorkCover and TAC claims expenses	(422)
Borrowing costs	(396)
Other expenditure	
Range of factors	59
	1 518
Change in Net Result	(396)

Financial position

3.10 The Consolidated Statement of Financial Position serves as an indicator of the Government's financial strength and discloses information on the level and composition of assets and liabilities held by the State as at 30 June 2002.

3.11 The financial position of the State from a whole-of-government perspective continues to remain sound, with net assets of \$49.4 billion - an increase of \$5.2 billion since the prior year. Table 3C outlines the key movements between the periods.

TABLE 3C
CHANGES IN FINANCIAL POSITION
(\\$million)

<i>Item</i>	<i>2001-02</i>
Asset changes	
Physical assets	
Revaluations in the year	4 592
Mainly additions	2 805
Depreciation in the year	(1 491)
Receivables	(4 372)
Other asset movements	202
	1 736
Liability changes	
Interest-bearing liabilities	
Reduced mainly due to a decrease in deposits by State Superannuation Fund with TCV and the retirement of debt	1 857
Payables	4 056
Unfunded superannuation	(1 553)
Increase largely due to a downturn in world equity markets	
Other liabilities	(897)
Increase mainly due to increased insurance claims liabilities	
	3 463
Change in Net Assets	5 199

General Government Sector

3.12 The General Government Sector consists of those entities that are financed mainly through taxes and other compulsory levies and provide public services, which are mainly non-market in nature, for the collective consumption of the community. The public sector agencies that comprise the General Government Sector mainly consist of agencies that receive more than 50 per cent of their funding from budget appropriations, and are outlined in note 36 of the Annual Financial Report.

3.13 A summary of the operating result achieved by the General Government Sector for the financial year and its financial position as at 30 June 2002, as disclosed in the Annual Financial Report, is presented in Table 3D.

TABLE 3D
VICTORIAN GENERAL GOVERNMENT SECTOR,
OPERATING RESULT AND FINANCIAL POSITION
(\$billion)

<i>Item</i>	<i>2001-02 Estimate</i>	2001-02 Actual	<i>2000-01 Actual (a)</i>
Operating result -			
Revenues	23.5	25.4	23.8
Expenses	23.0	25.1	22.6
Operating surplus for the year	0.5	0.3	1.2
Financial position -			
Assets -			
Physical assets	35.5	39.2	35.4
Cash and investments	4.5	5.5	4.2
Receivables	1.0	1.4	1.2
Other	0.4	0.4	0.4
Total assets	41.4	46.5	41.2
Liabilities -			
Interest-bearing liabilities	6.3	6.4	6.4
Unfunded superannuation	12.5	13.4	11.8
Employee entitlements	2.5	2.5	2.3
Payables	1.0	1.3	1.2
Other	0.8	1.1	0.9
Total liabilities	23.1	24.7	22.6
Net assets	18.3	21.8	18.6

(a) Comparatives adjusted to reflect changes in the reporting entity.

Operating result

3.14 The Consolidated Statement of Financial Performance discloses that the General Government Sector achieved an operating surplus of \$273 million for the 2001-02 financial year, a decrease of \$943 million from that achieved in the previous year. The key factors contributing to this outcome are similar to those impacting on the State's result as outlined previously.

3.15 The General Government Sector result for the year was \$235 million below the original budget forecast for the sector mainly due to higher salary and wages (\$480 million), superannuation costs (\$1 089 million), and supplies and services (\$144 million), partly offset by increased revenues from taxation (\$878 million) mostly associated with property transactions and higher Commonwealth Grants (\$563 million).

Financial position

3.16 The net assets of the General Government Sector were \$3.5 billion higher than initially forecast in the Budget Papers. The key factors contributing to this outcome were the revaluations of the physical assets (\$3 billion) which was not included in the Budget estimates and higher cash and investment balances (\$991 million) – offset by greater than anticipated unfunded superannuation liabilities (\$853 million).

The Public Account

3.17 The Public Account consists of the Consolidated Fund and the Trust Fund. The Consolidated Fund is the Government's main operating account into which all revenues of the Crown are required to be paid. Moneys forming part of this Fund are utilised by departments to carry out their activities under the authority of Parliamentary Appropriations.

3.18 The *Financial Management Act 1994* requires the presentation of certain information relating to the financial operations of the Public Account in the Annual Financial Report. Note 32 to the Annual Financial Report provides these required disclosures.

3.19 Table 3E outlines the Consolidated Fund cash result for the year (prior to borrowing transactions). It shows how the surplus of \$1.1 billion was achieved and compares with the \$845 million in the prior year.

TABLE 3E
CONSOLIDATED FUND CASH RESULT FOR THE FINANCIAL YEAR
(\$million)

Item	2001-02	2000-01	1999-00
Receipts -			
Operating activities	22 188	20 990	19 865
Investing and financing activities	134	375	218
Total receipts, excluding borrowing transactions	22 322	21 365	20 083
Less – Payments (operating and capital transactions)			
Special Appropriations	2 003	2 627	2 351
Annual Appropriations	19 192	17 893	15 842
Total payments, excluding borrowing transactions	21 195	20 520	18 193
Overall Consolidated Fund surplus for year, excluding borrowing transactions	1 127	845	1 890
Borrowing repayments	(a) -	(a) -	(269)
Cash surplus for the year	1 127	845	1 621

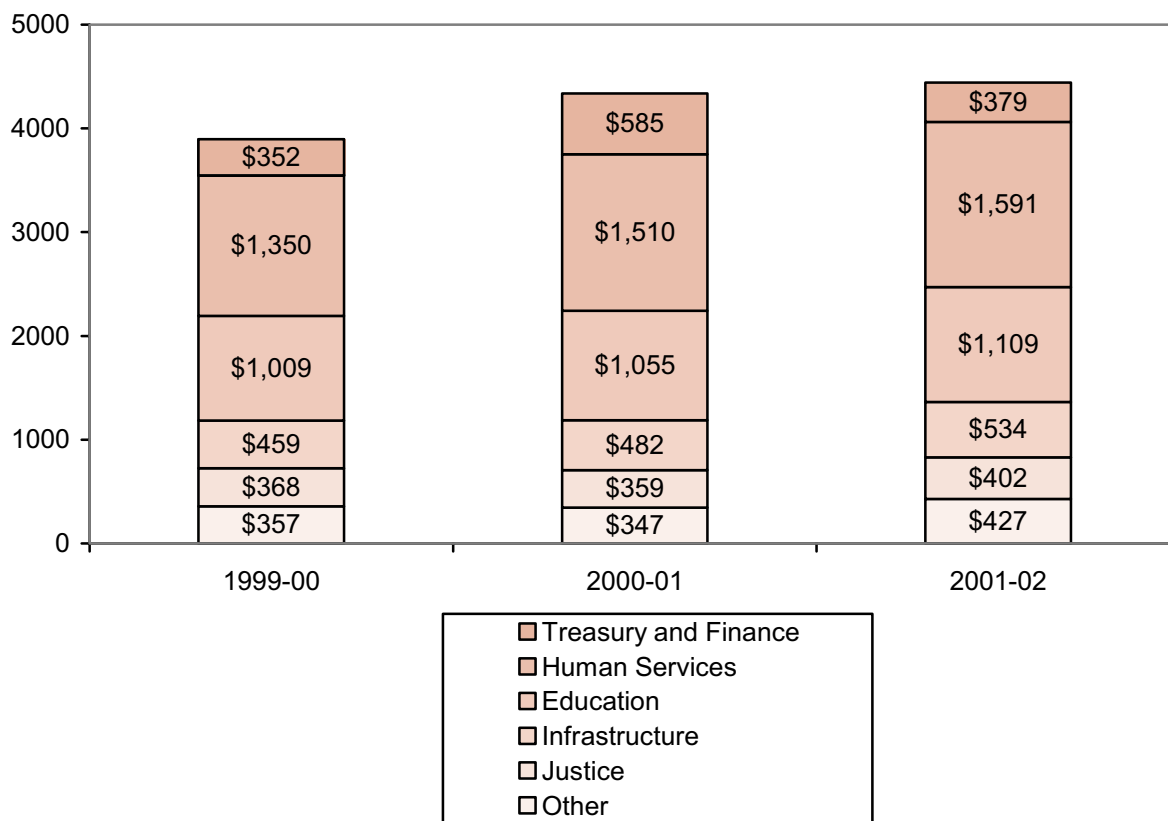
(a) Borrowing repayments during 2001-02 totalled \$638 000 (2000-01, \$520 000).

3.20 The improved result for the year was mainly due to higher revenues during the year from Commonwealth Government Grants and higher taxation receipts. The increase in receipts was largely offset by increases in departmental expenditures.

Major spending departments

3.21 The key departments accounting for parliamentary appropriations applied during the year were Human Services, Education and Training, Treasury and Finance, Infrastructure and Justice. Chart 3F below shows the gross appropriations applied on a per capita basis for these departments over the past 3 years.

**CHART 3F
GROSS APPROPRIATIONS ON A PER CAPITA BASIS
(\$)**



ANALYSIS OF THE STATE'S FINANCIAL CONDITION

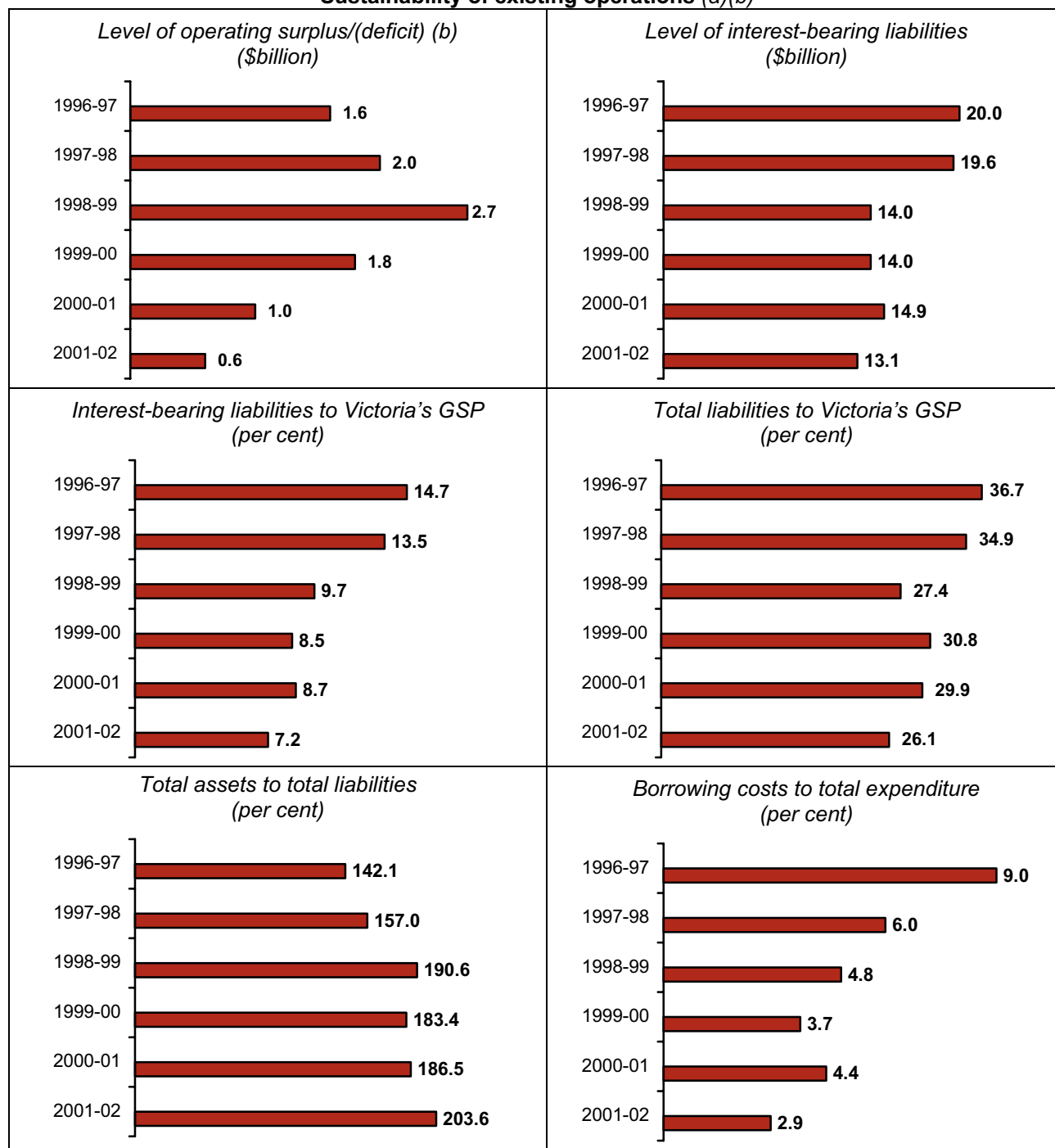
3.22 The financial condition of a government in essence is its financial health as measured by the sustainability, vulnerability and flexibility of its financial activities, looked at in the context of the overall economic and financial environment. These terms are defined as:

- **Sustainability** – indicating movements in the degree to which a government can maintain existing programs and operations, and meet existing creditor requirements without increasing the debt burden on taxpayers;
- **Flexibility** – indicating movements in the degree to which a government can increase its financial resources to respond to rising commitments, by either expanding its revenues or increasing its debt burden; and
- **Vulnerability** – indicating movements in the degree to which a government is dependent on, and therefore vulnerable to, sources of funding outside its direct control or influence.

3.23 The analysis of indicators associated with these attributes provide a useful insight into a government's finances. Table 3G presents the key indicators we have applied in assessing the State's financial health for the 6 year period, 1996-97 to 2001-02. Our analysis focuses on historical financial information and, accordingly, its scope does not extend to assessments of the effectiveness of government programs and their associated impacts on the State's revenues and expenditures.

**TABLE 3G
STATE OF VICTORIA,
INDICATORS OF FINANCIAL CONDITION**

Sustainability of existing operations (a)(b)

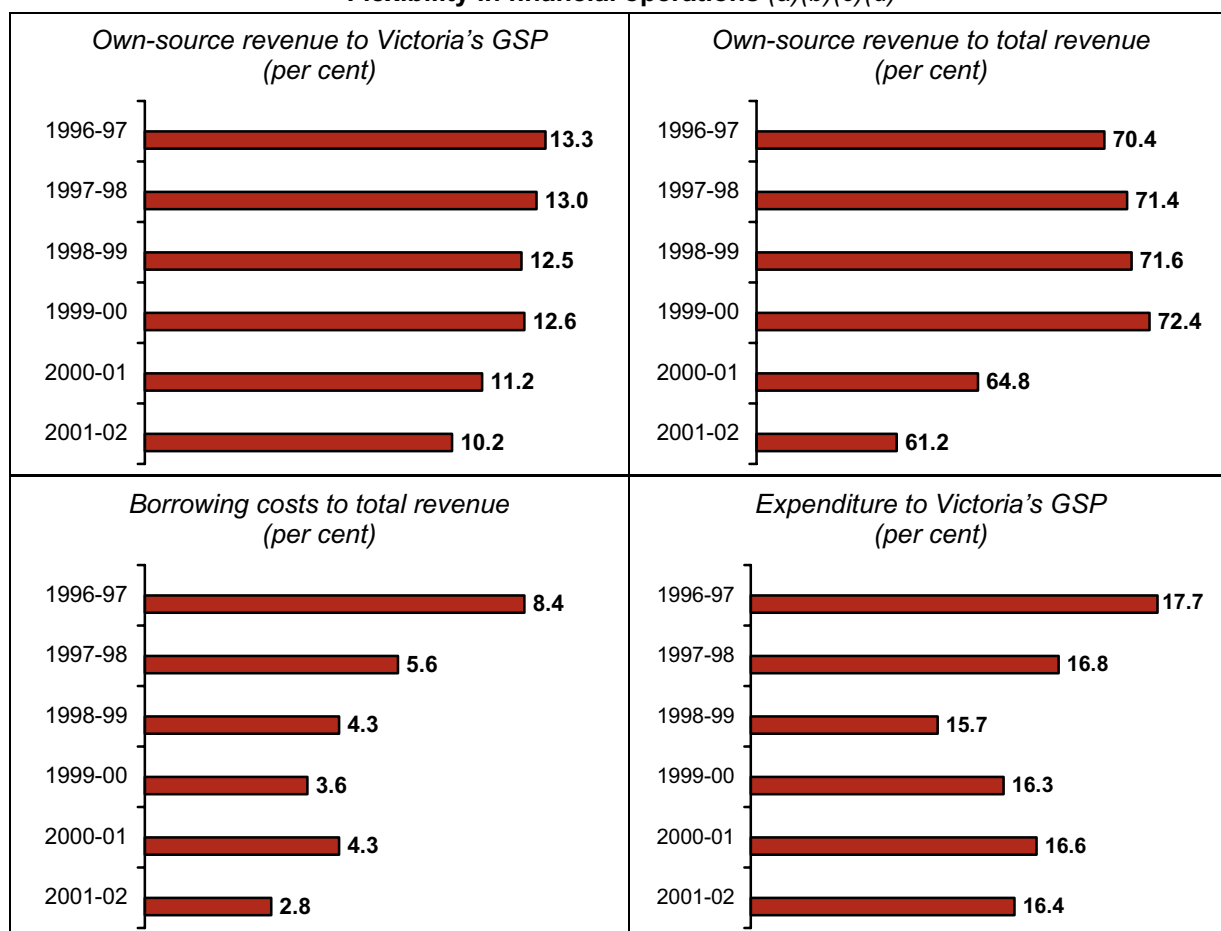


(a) A number of the indicators provide reference to Victoria's GSP. This reference relates to Victoria's Gross State Product, which is a measure of the size of the State economy and is sourced from statistics published by the Australian Bureau of Statistics for the financial years up to 2000-01, and estimates provided by the Department of Treasury and Finance for the 2001-02 financial year. The 1999-2000 figures are adjusted for accounting policy changes disclosing derivatives at their gross values. The figures are adjusted for final GSP estimates.

(b) Figures relating to periods prior to 2000-01 do not include abnormal items, which in the main relate to the impact of privatisations.

TABLE 3G
STATE OF VICTORIA,
INDICATORS OF FINANCIAL CONDITION - continued

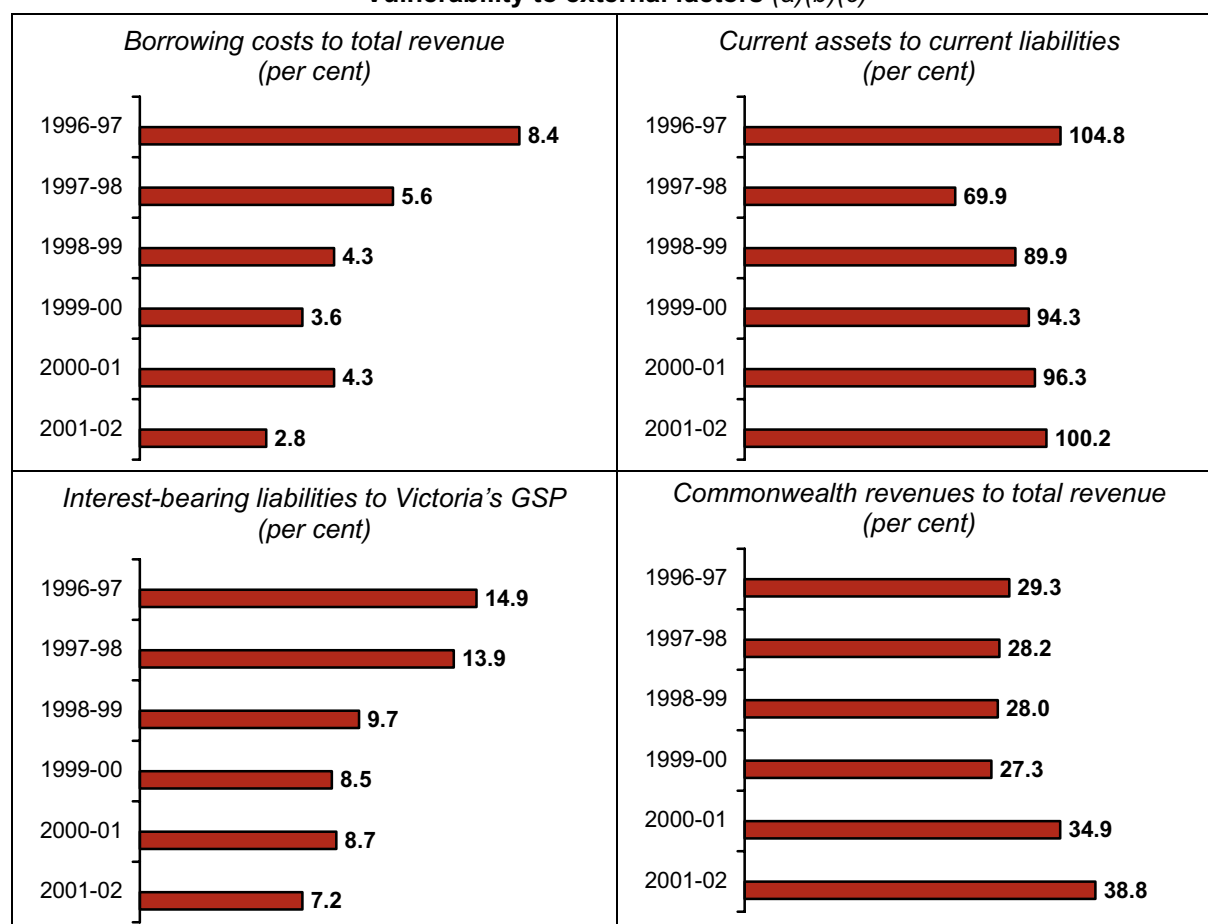
Flexibility in financial operations (a)(b)(c)(d)



- (a) A number of the indicators provide reference to Victoria's GSP. This reference relates to Victoria's Gross State Product, which is a measure of the size of the State economy and is sourced from statistics published by the Australian Bureau of Statistics for the financial years up to 2000-01, and estimates provided by the Department of Treasury and Finance for the 2001-02 financial year. The figures are adjusted for final GSP estimates.
- (b) Own-source revenue represents total revenue from ordinary activities, less total grants to the State.
- (c) Figures relating to periods prior to 2000-01 do not include abnormal items which, in the main, relate to the impact of privatisations.
- (d) Figures relating to 2000-01 reflect the impact of National Tax Reforms, which impacted on the level and composition of State revenues and expenditures. Therefore, care needs to be taken when analysing trends associated with these indicators.

TABLE 3G
STATE OF VICTORIA,
INDICATORS OF FINANCIAL CONDITION - continued

Vulnerability to external factors (a)(b)(c)



- (a) A number of the indicators provide reference to Victoria's GSP. This reference relates to Victoria's Gross State Product, which is a measure of the size of the State economy and is sourced from statistics published by the Australian Bureau of Statistics for the financial years up to 2000-2001 and estimates provided by the Department of Treasury and Finance for the 2001-02 financial year. The 1999-2000 figures are adjusted for accounting policy changes disclosing derivatives at their gross value. The figures are adjusted for final GSP estimates.
- (b) Figures relating to periods prior to 2000-01 do not include abnormal items which, in the main, relate to the impact of privatisations.
- (c) Figures subsequent to 2000-01 reflect the impact of National Tax Reforms, which impacted on the level and composition of State revenues and expenditures. Therefore, care needs to be taken when analysing trends associated with these indicators.

3.24 The information contained in the tables indicates that the State's overall financial condition continues to remain strong. However, there are a number of emerging pressures and vulnerabilities which require careful management. These are detailed below:

- **The Government's capacity to maintain existing programs and operations has been maintained.** The State's net asset position and the level of its liabilities relative to the size of the Victorian economy have improved. The servicing costs of total public debt have reduced, reflecting a decrease in the level of interest-bearing liabilities and relatively low interest rates. The annual operating surpluses have declined since 1998-99 indicating that the Government's capacity to undertake additional programs and initiatives without re-examining and re-prioritising existing programs has reduced. The significant operating surpluses achieved in recent years have been supported by strong economic activity and, therefore, any downturn in the economic cycle and further expenditure pressures will impact on the Government's capacity to maintain existing programs;
- **The Government's flexibility in responding to future opportunities requiring increased financial resources on balance has been maintained.** The State's own-source revenues have continued to decline since the introduction of the National Tax Reforms in 2000-01, resulting in a reduction in the State's taxation base which has been compensated by the Commonwealth Government's GST grants to the State. While the level of State expenditure substantially increased in the year, the growth rate in expenditure was less than the increase in the size of the Victorian economy; and
- **The State remains vulnerable to funding sources not directly within its control.** The State's reliance on Commonwealth Government grants has increased. However, under the National Taxation Reforms, the State during a transitional period is substantially protected against any adverse impacts on its budgetary position for the transitional period which is expected to extend to 2006-07. The State's working capital position continues to improve along with its borrowing levels. The higher level of financial assets has increased the vulnerability of the State revenues to movement in equity markets due to both domestic and international factors which are outside its control or influence. Over recent years, the strong property market has positively contributed to the State's operating results. The unpredictability of the property market presents a risk to future State revenue levels.

STATE'S CREDIT RATING

3.25 A further indicator that may be used to assess the State's financial condition and any movements therein, is its credit rating as assigned by the major international rating agencies. The State's credit rating is a key determinant of the level of borrowing costs that are payable by the State on its debt, and on financial market and investor assessments of the strength and stability of the State's finances.

3.26 In February 2002, Standard and Poor's re-affirmed the State's triple-A long-term rating and stated that *"The state sits comfortably within the 'AAA' rating category. Any change to the rating would require several years of much weaker financial outcomes than currently expected combined with government inaction in addressing the problem. Standard and Poor's views either of these scenarios as highly unlikely"*.

3.27 In March 2002, Moody's Investors Services also re-affirmed the State's Aaa rating for domestic currency debt and Aa2 rating for foreign currency debt. Moody's commented that *"Victoria has maintained a trend of sound fiscal performance, generating sizable surpluses after financing both operating and capital expenditures. These surpluses have resulted from the state's prudent fiscal practices, supported in recent years by strong economic growth. Surpluses have been used both for debt reduction and to set up a reserve for future capital spending"*.

3.28 In October 2002, Moody's Investors Services adjusted the State's foreign currency debt rating to Aaa based on it being tied to Australia's foreign currency rating.

PERFORMANCE AGAINST KEY GOVERNMENT OBJECTIVES

3.29 A significant element of the Government's financial management reforms as reflected in the *Financial Management (Financial Responsibility) Act 2000* is a requirement for the Government to provide a statement in the *Budget Papers* of its short-term and long-term financial objectives. Table 3H details the Government's objectives as presented in the 2001-02 *Budget Papers*.

**TABLE 3H
GOVERNMENT'S KEY FINANCIAL OBJECTIVES, 2001-02**

<i>Long-term</i>	<i>Short-term</i>
<ul style="list-style-type: none"> • Maintain a substantial budget sector operating surplus. • Provide capital works to enhance social and economic infrastructure throughout Victoria. • Provide improved service delivery to all Victorians. • Ensure competitive and fair taxes and charges to Victorian businesses and households. • Maintain State Government net financial liabilities at prudent levels. 	<ul style="list-style-type: none"> • Achieve an operating surplus of at least \$100 million in each year. • Establish a \$1 billion infrastructure reserve. • Provide expenditure priority on education, health and community safety. • Re-examine and improve Victoria's business taxation system. • Maintain a triple-A credit rating.

3.30 In the context of the Government's short-term objectives, it has:

- achieved a General Government Sector operating surplus of \$273 million for the 2001-02 financial year;
- set aside under its Growing Victoria initiative \$1.57 billion of financial assets for application towards the development of State infrastructure, of which \$1.34 billion was committed as at 30 June 2002;
- maintained a triple-A credit rating;
- implemented various measures aimed at reducing the level of taxation burden; and
- increased levels of appropriations applied over a 3 year period from 1999-2000 to 2001-02, including higher allocations for education and training (13 per cent), human services (22 per cent) and justice programs (12 per cent).

3.31 The Government has achieved its short-term financial objectives and is progressing towards the achievement of its broadly stated longer-term financial objectives.

RESPONSE provided by Minister for Finance

Summary of operating results and financial condition

Para 3.22

The chart depicting the operating result of the State over the period demonstrates the fluctuations which are inevitably experienced when attempting to measure sustainability for the whole of the State. The current year's result and the results for most other years, were impacted by a number of large volatile fluctuations and these have been documented in the Financial Report for the State of Victoria for each of those years. The overall conclusion of the Report is that existing programs and operations have been maintained and that the Government's short term objectives (Para 3.24) have been achieved. This includes the maintenance of a substantial budget sector operating surplus (paras 3.29 to 3.31). However, a more appropriate measure of sustainability would be to include an analysis of the underlying surplus position which excludes once-off transactions and the short-term effects of volatility in financial markets on investments and liabilities.

Part 4

Revenue

SUMMARY OF STATE REVENUES

4.1 The operating revenues of the State in the 2001-02 financial year totalled \$30.6 billion, some \$1.1 billion (3.8 per cent) higher than 2000-01.

4.2 The key factors contributing to the increase in State revenues were a higher level of grants received from the Commonwealth Government (\$1.5 billion); increased taxation collections (\$263 million); and the first time recognition of the State's interest in the Snowy Hydro Limited (\$236.6 million).

4.3 These increases were partially offset by a reduction in investment income (\$999 million) mainly resulting from the effect of the downward valuation of investments emanating from a deterioration in world equity markets.

4.4 Table 4A provides a summary of the State's operating revenues.

TABLE 4A
OPERATING REVENUES OF THE STATE
(billion)

<i>Revenue source</i>	2001-02	<i>2000-01</i>
Grant revenue	11.9	10.4
Taxation	8.8	8.5
Sale of goods and services	7.9	7.8
Investment income	0.4	1.4
Other	1.6	1.4
Operating revenue	30.6	29.5

Source: Annual Financial Report for the State of Victoria, 2001-02.

COMMONWEALTH GRANTS

4.5 Commonwealth grants include GST-sourced revenue received from the Commonwealth Government and other amounts received under specific purpose funding agreements such as the Australian Health Care Agreement. Commonwealth grants are also received for on-passing to other bodies, principally non-government schools and local government entities.

4.6 Under the National Tax Reforms, as from 1 July 2000 the Commonwealth Government terminated the provision, to the State, of general purpose financial assistance grants and franchise fee replacement revenues, while the State eliminated some of its own-source taxes. Under an Intergovernmental Agreement, any losses to the State resulting from the introduction of the National Tax Reforms are compensated via the Commonwealth Government's transitional assistance program.

4.7 In 2001-02, total Commonwealth grants paid to the State increased by \$1.5 billion, mainly as a result of higher GST revenue grants, increased specific purpose grants, in particular for road, health and education purposes, and additional funding received for the First Home Owners Scheme which is administered by the State on behalf of the Commonwealth.

Impact of the National Tax Reforms on State finances

4.8 Under the national taxation arrangements the Commonwealth Government provided an undertaking that the budgetary positions of the States and Territories would not be adversely affected by the reforms. To assist States and Territories, which would be adversely affected by the introduction of the reforms over several years, the Commonwealth undertook to provide budget balancing assistance payments. Victoria is forecast not be in a position of net budgetary gain from the National Tax Reforms until the 2007-08 financial year, with the position gradually improving thereafter. However, the Victorian Government estimates that, following a Commonwealth Government decision in March 2001, to cease the bi-annual indexation of petroleum excise, the State would be adversely affected by \$30 million in the 2002-03 financial year, increasing in the out-years. This situation arises as the Guaranteed Minimum Amount payable to the State under the national taxation arrangements will not include the impact of this indexation in the future.

4.9 Table 4B outlines the estimated impact on the State's finances of the National Tax Reforms over the period 2001-02 to 2004-05, based on forward estimates at the time of the 2002-03 budget.

TABLE 4B
IMPACT OF NATIONAL TAX REFORMS ON THE STATE
(\\$million)

	<i>Estimate</i> 2001-02	<i>Revised</i> <i>estimate</i> 2001-02	2001-02 <i>actual</i>	2002-03 <i>estimate</i>	2003-04 <i>estimate</i>	2004-05 <i>estimate</i>
GST revenue grants	5 933	5 689	5 593	6 154	6 472	6 736
Revenue forgone	(6 239)	(6 312)	(6 293)	(6 516)	(6 722)	(6 881)
Other revenue adjustments	94	(a) 77	(a) 77	106	121	137
Total revenue change	(212)	(546)	(623)	(256)	(129)	(8)
Net additional expenditure (b)	(261)	(385)	(354)	(210)	(276)	(276)
Net Impact	(473)	(931)	(977)	(466)	(405)	(284)
Net Commonwealth Guarantee Payments	473	931	977	436	361	225
Net impact on Victoria's budget	0	0	0	(c) (30)	(c) (44)	(c) (59)

(a) Includes 2000-01 budget balancing assistance adjustment.

(b) Relates to impact of additional expenditure obligations assumed by the State from the Commonwealth Government under the National Tax Reforms.

(c) Estimated impact of Commonwealth Government's decision to cease indexation of petroleum excise.

Source: Budget Statement 2001-02, Budget Statement 2002-03 and the Government's Annual Financial Report, 2001-02.

4.10 As shown in the table, the State's share of the GST revenue in 2001-02 was calculated to be \$5.6 billion, with a further \$977 million budget balancing assistance grant payable to the State for the year.

TAXATION REVENUES

4.11 Taxation revenue represents the second largest source of State revenues and comprises collection from a diverse range of activities, including payroll, property, motor vehicles and gambling transactions. **In 2001-02, taxation collections totalled \$8.8 billion, an increase of \$263 million on the previous year.** Table 4C summarises the major sources of taxation revenue over the past 3 financial years.

TABLE 4C
STATE TAXATION REVENUES
(\$billion)

<i>Taxation source</i>	2001-02 (a)	<i>2000-01 (b)</i>	<i>1999-2000</i>
Payroll tax	2.5	2.5	2.3
Financial and capital transactions	2.4	2.4	2.4
Gambling	1.4	1.3	1.5
Motor vehicle	1.0	1.0	0.9
Taxes on immovable property	0.6	0.6	0.5
Other	0.9	0.7	2.1
Total taxation revenue	8.8	8.5	9.7

(a) Includes the impact of the abolition of financial institutions duty and stamp duty of quoted marketable securities.

(b) Includes the impact of the abolition of revenue replacement payments and reduced gambling tax rates under the Intergovernmental Agreement associated with the National Tax Reforms.

Source: Department of Treasury and Finance.

4.12 Taxation revenue increased by \$263 million, mainly due to higher:

- stamp duty collections on property transfers (\$601 million);
- gambling taxes and fees mainly due to increases in the levy on electronic gaming machines and a growth in turnover (\$94 million);
- tax collections on insurance premiums resulting from increased insurance premium levels levied by the insurance industry (\$97 million); and
- motor vehicle fees and taxes (\$72 million).

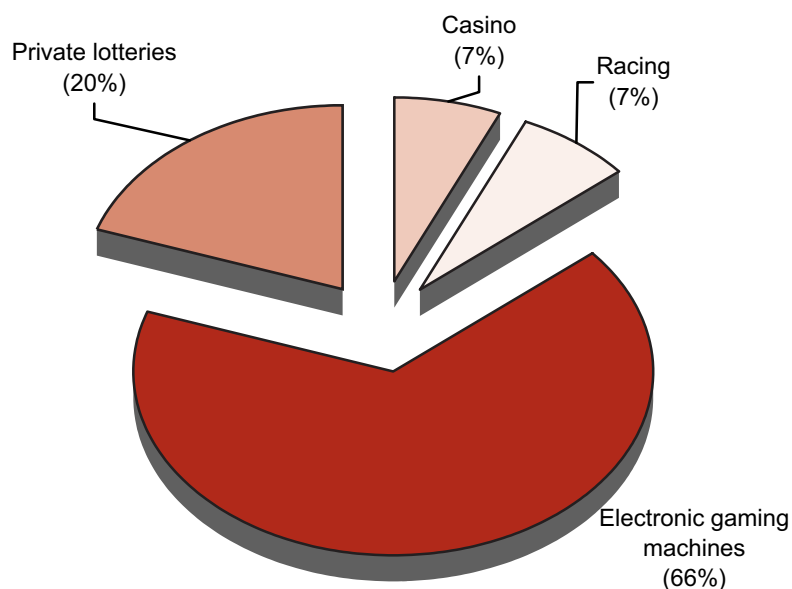
4.13 These increases were partially offset by reduced collections associated with the abolition during the year of a number of taxes associated with the National Tax Reforms.

Gambling taxes

4.14 Gambling taxes are levied by the State on electronic gaming machines (EGMs), private lotteries, casino operations and racing. **During 2001-02, State revenues from gambling activities amounted to \$1.4 billion, an increase of \$94 million on the previous year and represented 15.6 per cent of total taxation revenue in 2001-02.**

4.15 As illustrated by Chart 4D around 66 per cent of revenue from gambling activities was derived from EGMs. In 2001-02, the State collected \$900 million (2000-01, \$801 million) in taxation from 27 500 EGMs located at clubs and hotels. The increase in EGM taxation is a result of both the growth in turnover and the introduction from 2001-02 of the \$1 200 per machine health benefit levy which brought the total annual levy payable per machine to \$1 533.

CHART 4D
MAJOR GAMBLING REVENUE SOURCES, 2001-02
(per cent)



Source: Department of Treasury and Finance.

Crown contract resolution – Lyric Theatre development

4.16 In November 1993, Crown Ltd was granted a 40 year licence by the Government to operate the casino complex in Melbourne. An associated Management Agreement set out a number of design and financial obligations that would apply to Crown over the term of the licence. The Agreement and subsequent variations thereof included the requirement for Crown to construct at the casino complex a second hotel tower and the Lyric Theatre. In the event that these 2 construction projects were not completed by the agreed construction date of November 1999, Crown would be required to pay the State liquidated damages of \$50 000 per day.

4.17 Our previous reports to Parliament have outlined the circumstances surrounding the deferral of the construction of the second tower and the Lyric Theatre until November 2003 and the subsequent election by Crown in June 2000 not to proceed with the construction of the Lyric Theatre, on the grounds that there was no commercial, social or community need for the theatre at the casino complex. Crown requested approval to undertake an alternative capital project at the casino complex.



Progress of the construction of a second hotel tower at the casino complex.

4.18 In May 2002, following negotiations over a 12 month period, the Government and Crown reached **an agreement removing Crown’s obligation to construct the Lyric Theatre in exchange for an \$18 million payment to the State, payable in 6 instalments of \$3 million per annum, commencing in June 2002.** Under the administrative arrangements, payments are to be made into a government trust account specifically designated to be applied for the construction of cultural facilities in the Southbank arts precinct.

4.19 The deed of variation also required Crown to construct or procure an alternative project, with a value not less than the estimated cost of constructing the Lyric Theatre of \$42 million, and the nature and timing of the project to be at the sole discretion of Crown. The Minister for Gaming retains the right to approve the alternative project being included as part of the Melbourne casino complex.

4.20 An earlier deed of variation releasing Crown from its requirement to construct the Lyric Theatre and second hotel tower until November 2003 was equivalent to the waiver by the State of up to \$73 million in liquidated damages. Further, in exchange for the \$18 million to be received over a 6 year period, the Government waived its right to fines of \$50 000 per day for any delays in completion of construction beyond November 2003.

Extension of Tattersall's Lotteries licence

4.21 For many years, the conduct of lotteries in Victoria was regulated within the framework established under the *Tattersall Consultations Act* 1958. Within that framework, the Estate of the Late George Adams (Tattersall's) was granted a series of exclusive licences to conduct lotteries within Victoria for the period until June 2004.

4.22 In late 1997, the former Government commissioned a review of legislative restrictions on competition within the *Tattersall Consultations Act* 1958, in accordance with the requirements of National Competition Policy. The report arising from that review, which was issued in January 1998, recommended that the legislative monopoly over the conduct of lotteries held by Tattersall's be removed at the end of the current licence period. The recommendation was consistent with the later findings of the Commonwealth Government's Productivity Commission inquiry into Australia's gambling industries, released in December 1999, which concluded that, with the possible exception of casinos, restrictions on competition within the gambling industries had little justification.

4.23 In response to these findings, and in order to facilitate the establishment of a Statewide football tipping competition, the Government undertook to change the legislative framework governing the conduct of lotteries, by repealing the *Tattersall Consultations Act* 1958 and enacting the *Public Lotteries Act* 2001 which came into effect in July 2001. Concurrently, the Government endorsed the creation of a national competitive lotteries market commencing in 2007, which would coincide with the expiration of the lottery licences in New South Wales.

4.24 The *Public Lotteries Act* 2001 provided a framework for a competitive lotteries environment and specifically:

- guaranteed exclusivity of Tattersall's licensing arrangements until June 2004;
- provided for the extension of Tattersall's lottery licence to June 2007; and
- required Tattersall's to pay to the Government a premium payment, as agreed with the Minister for Gaming, in respect of the 3 year licence extension.

Determination of lotteries licence premium payment

4.25 During the 2000-01 financial year, Tattersall's reported lottery sales totalling \$1 032 million, of which \$574 million was distributed as prizes and \$306 million was paid to the Consolidated Fund in the form of lotteries turnover taxes. Tattersall's reported a margin of \$38 million on the lotteries, after statutory outgoings and commission, and a net profit after tax of \$3.9 million.

4.26 In December 2001, the Department of Treasury and Finance appointed consultants to undertake a review of the profitability of Tattersall's lottery operations. Subsequently, in April 2002, the Department commenced formal negotiations for a premium payment for a 3 year period, based on the results of the review and other external commercial advice.

4.27 Following various offers and counter-offers, a licensing agreement was completed in June 2002 between the Minister for Gaming and the Trustees of the Estate of the Late George Adams, providing Tattersall's with an exclusive licence to conduct lotteries until June 2007. Under the agreement, Tattersall's was required to:

- make a premium payment of \$3 million which was paid as a lump sum in June 2002;
- retain its head office in Victoria for the duration of the licence;
- implement a new lottery computer system; and
- agree on improved disclosures within its financial statements in order to ensure greater transparency in financial reporting.

4.28 The Department has indicated that its policy position on the calculation of any premium payment associated with the lotteries licensing arrangements after June 2007 is yet to be finalised.

“Mirror” State taxes on activities conducted at Commonwealth places

4.29 Our previous *Reports on the Finances of the State of Victoria* have commented on the impact of a High Court decision in November 1996, which gave rise to a degree of uncertainty regarding the validity of the imposition of State taxes on activities conducted at Commonwealth locations, including pay-roll tax, conveyance duty, lease duty, rental duty and land tax. The Commonwealth Government in April 1998 enacted the *Commonwealth (Mirror Taxes) Act 1998* with effect from October 1997.

4.30 The Act enables the levying of Commonwealth taxes which “mirror” the taxes imposed by the States in relation to Commonwealth places, designed to raise the same revenue on behalf of the States that was received prior to the ruling. In addition, the State introduced the *Commonwealth Places (Mirror Taxes Administration) Act 1999*, amending the State taxation legislation to facilitate the collection of these mirror taxes.

4.31 Under these arrangements, the State Revenue Office is to collect the Commonwealth taxes imposed under the applied State laws on the Commonwealth’s behalf, which then returns an equivalent amount to the State in the form of a statutory payment provided for under the Commonwealth legislation. The State will continue to have discretion over the taxation rates to be applied and will continue to oversee compliance with the legislation.

4.32 In February 2002, a bilateral agreement between the Commonwealth and the States to facilitate the collection and reporting of these mirror taxes was finalised. Under the terms of the agreement, revenue estimates are calculated on an agreed taxpayer survey methodology, which is communicated to the Commonwealth on a monthly basis. **In the 2001-02 financial year, around \$76 million was collected applying the survey methodology outlined in the bilateral agreement.**

4.33 These mirror taxes have been disclosed in the Government’s *Annual Financial Report* as part of State taxation revenues. Given that the revenue is raised under the authority of Commonwealth legislation, it remains our opinion that such receipts are more appropriately classified as grants from the Commonwealth, consistent with the principles supported by the November 1996 High Court decision.

FINES AND REGULATORY FEES

4.34 Revenue from fines and regulatory fees in 2001-02 totalled \$424.4 million, an overall increase of \$43.8 million or 11 per cent over the previous year. Fines are predominately generated from policing activities and outsourced traffic camera operations. Regulatory fees include various business licence fees, gambling supervision charges, environment protection fees, recreational fishing licences and boating fees.

4.35 Table 4E provides a summary of the actual fines and fees collected in 2000-01 and 2001-02 and the expected revenue over the 3 year period to 2004-05.

TABLE 4E
FINES AND REGULATORY FEES REVENUE
(*\$million*)

<i>Item</i>	<i>2000-01 Actual (a)</i>	<i>2001-02 Actual (a)</i>	<i>2002-03 Forecast (b)</i>	<i>2003-04 Forecast (b)</i>	<i>2004-05 Forecast (b)</i>
Fines	202.6	271.4	392.3	411.0	426.7
Regulatory fees	178.0	153.0	161.7	(c) 145.6	152.4
Total	380.6	424.4	554.0	556.6	579.1
Percentage change	<i>n.a.</i>	+11	+30	+0.5	+4

(a) Annual Financial Report for the State of Victoria, 2001-02 (General Government Sector).

(b) Source: Department of Treasury and Finance: Forward Estimates.

(c) The forecast decrease is mainly attributable to the first full year effect of the cessation of electricity franchise fees.

4.36 The table indicates that revenue from fines is trending upwards and is becoming an increasingly important source of funding for government operations.

Revenue from fines

4.37 Total revenue from fines in 2001-02 was \$271.4 million, representing an increase of \$68.8 million or 34 per cent over the amount collected from this source in 2000-01. A major component of fines revenue is generated from the infringements issued by the Traffic Camera Office (TCO). **In 2001-02, fines revenue from the TCO totalled \$138.6 million (2000-01, \$84.1 million), representing 51 per cent of all fines raised in the year (2000-01, 41 per cent).**

4.38 The substantial increase in fines revenue in the year is attributed to recent initiatives introduced by the Government as part of an effort to reduce Victoria's road toll. These initiatives included:

- an increase in the value of fines by 20 per cent;
- approval to increase the number of operational hours by private speed camera operators by up to 50 per cent;
- reduced speed limit in residential areas to 50 km/h; and
- purchase of additional booze buses for Victoria Police.



Speed camera in operation.

4.39 As indicated in the above table, revenue from fines and regulatory fees is expected to increase substantially from 2002-03 onwards, increasing by around \$129.6 million (30 per cent) in 2002-03 from the amount raised in 2001-02, and marginally thereafter. This expected increase in 2002-03 is attributed to the full effect of the abovementioned government initiatives and the purchase and installation of new and converted digital red light and speed detection cameras at key intersections and on the City Link.

4.40 The fines revenue projections have been largely based upon total anticipated traffic infringement numbers of 1.7 million per annum from 2002-03 to 2005-06. This represents an increase of 83 per cent over actual infringement notices issued in 2001-02 of 930 000. In addition, in 2002-03 the Government expects to process 540 000 City Link toll infringement notices.

Uncollected fines

4.41 The Department of Justice administers the majority of the State's fines revenue. The Enforcement Management Division (EMD) within the Department was formed in March 1994 through the amalgamation of the common operations of the Magistrates' Court function known as the PERIN Court and the Sheriff's Office of Victoria to provide an integrated fines management system.

4.42 The EMD is responsible for the administration and enforcement of all unpaid fines and criminal warrants issued to the Sheriff's Office by the PERIN Court and the Magistrates' Court. In November 1998, administrative support functions associated with the processing of revenue and debtors control previously the responsibility of EMD and the TCO were outsourced to LMT Australia Pty Ltd (LMT).

4.43 Following the introduction of accrual accounting in the Victorian Budget Sector in 1994, the Department developed criteria to enable a consistent approach to be applied to the write-off of bad debts for accounting purposes. The bad debt criteria, which is still applied to all uncollected fines owing to the State, requires all filed warrants held by the Sheriff's Office for greater than 12 months to be written-off as bad debts. A filed warrant is one where the defendant has left an address and the Sheriff's Office has been unable to identify the new address in the ensuing 12 months.

4.44 Bad debts were written-off for the first time in 1994-95 and have continually been written-off annually. It should be noted that the write-off of uncollected fines is for accounting purposes only, as all warrants remain enforceable by law. Table 4F quantifies outstanding fines written-off for accounting purposes since 1994-95.

TABLE 4F
UNCOLLECTED FINES AND COSTS PAYABLE TO THE STATE WRITTEN-OFF,
1 JULY 1995 TO 30 JUNE 2002
(*\$million*)

<i>Write-off</i>	1994-95	1995-96	1996-97	1997-98	1998-99	1999-2000	2000-01	2001-02
Fines	43.5	11.0	21.0	12.1	13.8	17.7	14.1	10.8
Warrant execution fees	41.6	7.4	63.1	0	0	0	0	0
Total	85.1	18.4	84.1	12.1	13.8	17.7	14.1	10.8
Bad debts recovered	0	1.1	2.4	1.4	0.7	0.7	0.8	0.6

Source: Department of Justice Annual Reports.

4.45 At 30 June 2002, the aggregate amount of uncollected fines owing to the State (in addition to those regarded as bad debts and written off) was \$367.9 million (30 June 2001, \$311.8 million).

TABLE 4G
OUTSTANDING FINES DEBT
(*\$million*)

	2001-02	2000-01
Outstanding debt	367.9	311.8
Provision for doubtful debts	266.3	187.6
Net fines debtors	101.6	124.2

Source: Department of Justice Annual Report, 2001-02.

4.46 In the 2001-02 financial year, based on the recommendation of consultants engaged by the Department, a revised method to more accurately estimate the cash collections and, therefore, the amount of the provision for doubtful debts in relation to outstanding fines was implemented by the Department. In addition, changes to legislation in the form of the *Magistrates' Courts (Infringements) Act 2000* came into effect in the year, under which a debt arising from a PERIN Court order which is over 5 years old ceases to be enforceable or recoverable.

4.47 The application of the Department's revised policy for calculating the provision for doubtful debts in 2001-02 combined with PERIN Court debts over 5 years old no longer being recoverable, resulted in an increase of around \$79 million in the provision for doubtful debts associated with these outstanding fines.

INVESTMENT INCOME

4.48 Investment revenue comprises dividends, interest, investment gains, royalties, rental and other miscellaneous revenue. **In 2001-02, investment income totalled \$429 million, a decrease of \$999 million from the previous year, largely attributable to the effect of the downward valuation of investments emanating from the deterioration in international equity markets during the year.**

4.49 Investment holdings by the Department of Treasury and Finance, Treasury Corporation of Victoria, Transport Accident Commission and the Victorian WorkCover Authority, made up around 93 per cent of the State's total investments. Further commentary on the State's investment holding is provided in the *Assets* part of this report.

4.50 The investment performance of these agencies in the 2001-02 financial year is illustrated in Table 4H. The investment returns for each agency varies as a result of the different investment objectives, strategies and portfolio asset mix adopted to meet the respective agencies short-term and long-term operational requirements, which include the matching of asset and liability profiles.

**TABLE 4H
KEY AGENCIES' INVESTMENT PERFORMANCE,
2001-02**

<i>Agency (c)</i>	<i>Average return in 2001-02 (a)</i>	<i>Investment holdings at 30 June 2002</i>
	(%)	(\$m)
Department of Treasury and Finance <i>(b) (d)</i>	5.95	2 438
Treasury Corporation of Victoria <i>(c)(d)</i>	5.15	5 970
Transport Accident Commission <i>(b)</i>	(2.87)	5 224
Victorian WorkCover Authority <i>(b)</i>	(3.81)	4 935

(a) Average investment returns before fees. Care needs to be taken when interpreting the returns achieved, given the different investment objectives and portfolio profiles of the respective agencies.

(b) *Source:* Victorian Funds Management Corporation.

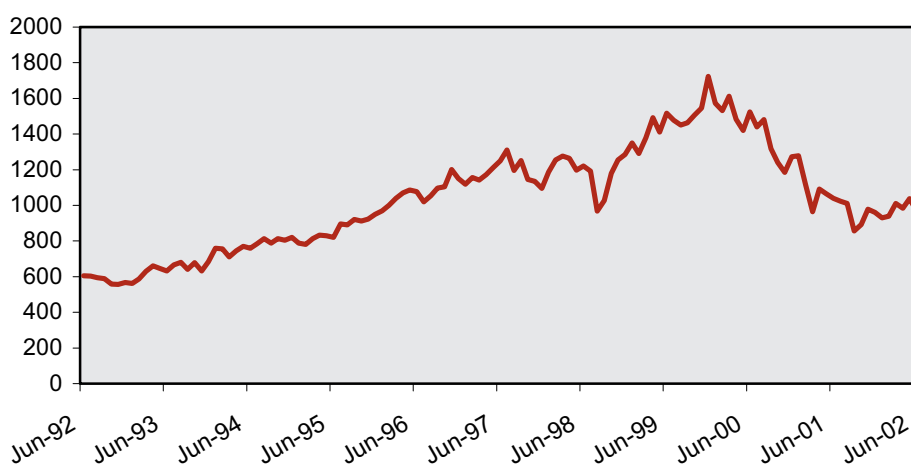
(c) *Source:* Agency's financial report. Includes the investment returns of \$2.3 billion of funds deposited by the budget sector, public sector agencies, a portion of public sector superannuation funds and the budget sector trust funds.

(d) These entities do not invest in equity instruments due to the nature of their investment and financing requirements.

4.51 Negative investment returns were experienced in 2001-02 by entities with a substantial allocation of equity investments in their asset portfolio, namely the Transport Accident Commission and the Victorian WorkCover Authority. The downturn in returns from equity investments is attributable to the downturn in global equity markets, and the impact of unfavourable movements of the Australian dollar against overseas currencies (adversely impacting on agencies with unhedged funds, such as the Victorian WorkCover Authority). However, over the past 5 years, unhedged funds benefited from favourable movements in the Australian dollar against overseas currencies and outperformed hedged funds. Overall, over the past 5 years the Transport Accident Commission and the Victorian WorkCover Authority which hold substantial equity investments have averaged returns of 5.59 per cent and 7.84 per cent, respectively.

4.52 The performance of the international equity market as measured by the index benchmark (MSCI World Accumulation Index ex-Australia) is illustrated in Chart 4I.

CHART 4I
MOVEMENT IN THE MSCI WORLD ACCUMULATION INDEX EX-AUSTRALIA
(\$Australia)



Source: Victorian Funds Management Corporation.

4.53 As illustrated in the chart, investment performance from international equities has decreased significantly since June 2000.

Gas Supply agreement

4.54 Our May 1997 *Report on Ministerial Portfolios* commented on the gas industry reforms implemented by the Government at that time. Under the reforms, GASCOR Pty Ltd, a corporatised government business enterprise operating exclusively as a gas trading company, purchases natural gas from ESSO/BHPP for resale to 3 private participant gas retailers.

4.55 Under the initial contractual arrangements with the 3 private retailers, GASCOR had an entitlement to a specified annual volume of gas under 2 pricing mechanisms. One of the pricing mechanisms covered all lower usage domestic, commercial and industrial customers while the other covered larger commercial and industrial customers. Under the existing supply arrangements, GASCOR purchased gas below the market rate from suppliers and on-sold the gas to lower usage customers at a substantially higher rate, thereby achieving a substantial operating surplus.

4.56 As from 1 September 2001, GASCOR was required to purchase the entire gas volume at the market price charged to larger commercial customers (which was substantially higher than the amount previously charged to lower use customers).

4.57 Table 4J shows the operating surpluses achieved by GASCOR in 2000-01 and 2001-02 and the expected result for 2002-03.

TABLE 4J
GASCOR OPERATING RESULT
(*\$million*)

<i>Category</i>	<i>2000-2001 Actual (a)</i>	<i>2001-02 Actual (a)</i>	<i>2002-03 Forecast (b)</i>
Gas sales	1 065	1 066	797
Operating surplus	316	124	34
State tax equivalent payment/public authority dividend	352	103	69

(a) *Source:* GASCOR 2001-02 Financial Statements.

(b) *Source:* Department of Treasury and Finance.

4.58 As the table illustrates, GASCOR's operating surplus decreased by \$192 million or 60 per cent in 2001-02 compared with the previous year, as a result of the changes to the gas purchasing and contestability arrangements, and is expected to decline by a further \$90 million or 73 per cent in 2002-03. This, in turn, has a similar impact on the State's operating result.

RESPONSE provided by Minister for Finance**“Mirror” State taxes***Para 4.33*

The State is responsible for all administration and collection costs of these taxes. At the point of collection, they are indistinguishable from all other State taxes and, in fact, exist only by virtue of the State taxes they ‘mirror’. The nature of the Commonwealth legislation requires that it appropriate the mirror taxes back to the States – hence the need for a bilateral agreement on the reporting of the collection of these taxes to the Commonwealth. It also recognises a nominal transfer to the Commonwealth in this regard, and the ‘return’ of the taxes to the States. At no stage does this include the transfer of cash between the Commonwealth and the States.

Potentially, mirror taxes can include any tax currently levied by State governments and in fact reflect a wide variety of taxes, particularly those paid by retailers occupying premises on Commonwealth properties.

The recognition of mirror taxes as being in substance State taxes has been agreed by all State governments, the Australian Bureau of Statistics and the Commonwealth Grants Commission. As indicated by the survey results for 2001-02, the approximately \$76 million is not material in the context of the \$8.9 billion in total general government taxation for the year.

Gas supply agreement*Para 4.58*

As indicated by the footnote to table 4J, the expected decline in the Gascor operating result for 2002-03 has been sourced from the Department of Treasury and Finance.

The table illustrates that, in 2001-02, Gascor's profitability decreased due to the scheduled conclusion of the profitable gas volume tranche under the supply contract with Esso/BHP-Billiton on 31 August 2001. As the wind-down of this gas allocation arrangement was anticipated, the impact on the Budget Sector operating result was reflected in the Budget papers.

Part 5

Expenditure

SUMMARY OF STATE OPERATING EXPENSES

5.1 The operating expenses of the State totalled \$30 billion during 2001-02, some \$1.5 billion (5.3 per cent) higher than in the previous year. The key factors contributing to this increased expenditure included:

- Superannuation (\$1.2 billion) – mainly reflecting the impact of a deterioration in the value of superannuation investments, in particular, international equities, which impact on the net liabilities of the superannuation funds and the cost to the State;
- Employee entitlements (\$768 million) – mainly reflecting the impact of settlements in the past 2 years of major industrial agreements across the public sector; and
- Grants and other transfer payments (\$339 million) – mainly reflecting increases in grants to non-government schools and grants associated with the First Home Owners Scheme.

5.2 The above increases were to some extent offset by a decrease in supplies and services expenditure (\$422 million) largely attributable to a reduction in claim expenses associated with the Victorian WorkCover Authority and the Transport Accident Commission, and a reduction in borrowing costs (\$396 million), mainly due to lower interest rates and a restructuring of the State's debt portfolio.

5.3 Table 5A provides a summary of operating expenses for the year.

TABLE 5A
STATE OPERATING EXPENSES
((\$billion))

<i>Item</i>	2001-02	<i>2000-01</i>
Supplies and services	12.2	12.6
Employee entitlements	9.4	8.6
Grants and other transfer payments	3.2	2.9
Superannuation	2.6	1.5
Depreciation and amortisation	1.5	1.3
Interest and other financing costs	0.9	1.3
Other expenses	0.2	0.3
Operating expenses	30.0	28.5

Source: Annual Financial Report for the State of Victoria, 2001-02.

5.4 An analysis of State expenditure trends over the past 5 years, as illustrated in Table 5B, indicates that there has been a 2.5 per cent increase in government expenditure in real terms between 2000-01 and 2001-02, representing a 1.3 per cent increase on a per capita basis. These outcomes have been influenced by the factors outlined in the preceding paragraphs.

TABLE 5B
EXPENDITURE TRENDS (a)

Year	Total amount (nominal value)	Total amount (real value)	Percentage movement in real terms	Per capita (nominal value)	Per capita (real value)	Percentage movement in real terms
	(\$m)	(\$m)	(%)	(\$)	(\$)	(%)
1997-98	23 632	23 632	n.a	5 563	5 563	n.a
1998-99	23 794	23 577	(0.2)	5 054	5 008	(10.0)
1999-00	26 189	25 282	7.2	5 494	5 304	5.9
2000-01	28 470	26 688	5.6	5 896	5 527	4.2
2001-02	29 999	27 355	2.5	6 139	5 598	1.3

(a) Consumer price index data sourced from Australian Bureau of Statistics publications, with 1997-98 used as the base year. CPI for 2000-01 excludes impact of GST estimated at 3 per cent. Population growth data sourced from the *Budget Papers, 2001-02*. Expenditure data (nominal value) sourced from Annual Financial Reports for the State of Victoria.

EMPLOYEE ENTITLEMENT COSTS – IMPACT OF RECENT INDUSTRIAL OUTCOMES

5.5 Costs associated with employee entitlements comprising salaries, wages and on-costs, amounted to \$9.4 billion in 2001-02 and represented 31 per cent of total public sector expenditure. The level of these costs increased by 8.9 per cent or \$768 million since the previous financial year. Table 5C illustrates employee entitlement trends over a 5 year period.

TABLE 5C
EMPLOYEE ENTITLEMENT COSTS

Year ended 30 June	Employee entitlements	Movement from the previous year
	(\$billion)	(per cent)
1998	7.77	0.6
1999	7.86	1.2
2000	7.99	1.6
2001	8.65	8.3
2002	9.42	8.9

Source: Annual Financial Reports for the State of Victoria.

5.6 The significance of this cost driver on the State's expenditure outcomes was highlighted by the Government in its 2002-03 *Budget Papers* which identified that a one per cent rise in the level of wages for all Budget Sector employees would cost approximately \$135 million in the first year.

5.7 Our November 2001 *Report on the Finances of the State of Victoria* outlined the impact on State expenditures of major public sector industrial settlements and additional permanent staffing decisions during 2000-01. It was then estimated that the impact of those settlements and staffing decisions would be to increase expenditure levels by around \$491 million in 2000-01, increasing to around \$979 million for 2003-04.

5.8 In 2001-02, the Government concluded 2 additional major public sector industrial agreements with administrative staff under the Community and Public Sector Union (CPSU) and the Victorian Police Association. The settlement of these agreements represents the conclusion of industrial agreement negotiations by the Government for the major Victorian public sector groups until 2003-04 and beyond.

5.9 This report does not seek to comment on salary and wage equity issues or delivery service requirements, however, it details the additional costs that are estimated to be incurred as a result of the industrial relation settlements.

5.10 As outlined in Table 5D, the net additional cost of major public sector industrial settlements and additional permanent staffing decisions in recent years is estimated at \$962 million in 2001-02 (an increase of \$471 million from the previous financial year), and is expected to increase to around \$1.47 billion for 2003-04. This does not include any associated increases to the State's unfunded superannuation liabilities.

TABLE 5D
ESTIMATED COST OUTCOMES OF MAJOR PUBLIC SECTOR INDUSTRIAL AGREEMENTS
AND POLICY INITIATIVES RESULTING IN ADDITIONAL STAFF (a)
(\$'000)

<i>Salaries and on-costs</i>	<i>2000-01</i>	<i>2001-02</i>	<i>2002-03</i>	<i>2003-04</i>
Agreements cost -				
Health sector employees (b)	215 508	398 113	473 648	525 091
Government school teachers	84 056	188 229	259 626	297 546
TAFE teachers/non-teachers (c)	18 407	41 336	53 952	59 518
Portfolio-wide CPSU/non-AWA (d)	71 269	125 326	172 207	171 731
Sworn police officers	-	56 970	97 480	125 300
Total estimated cost of major agreements	389 240	809 974	1 056 913	1 179 186
Less redirections of existing funding towards new agreements -				
Health sector	9 950	9 380	7 210	7 300
Government school teachers	23 900	65 400	65 400	65 400
Sworn police officers	-	0	0	2 000
Total redirections of existing funding	33 850	74 780	72 610	74 700
Total net cost to the State of new agreements excluding impact of policy decisions (e)	355 390	735 194	984 303	1 104 486
Major policy decisions – Additional permanent staff -				
Health sector; (2001-02 Budget Initiative) 400 additional staff recruited in 2000-01, and demand management strategy (additional 750 staff)	16 000	66 000	66 000	66 000
Government school staffing (2000-01 Budget initiative) 2 000 additional staff (f)	120 000	120 000	120 000	120 000
Government school staffing (2002-03 Budget initiatives) (g)	-	4 600	55 800	96 500
Police; (2000-01 Budget Initiative) 800 additional staff recruited (h)	-	36 640	43 380	44 280
Health sector; (2002-03 Budget Initiative) estimated additional 750 staff (i)	-	0	45 000	45 000
Total estimated cost of policy decisions	136 000	227 240	330 180	371 780
Total net cost including additional staff (e)	491 390	962 434	1 314 483	1 476 266

(a) Data extracted from estimates provided by Department of Treasury and Finance, Department of Human Services, Department of Education and Training, and Victoria Police. Data covers new major agreements entered into from the 2000-01 financial year and policy initiatives announced subsequent to and including the 2000-01 Budget for each of the key sectors.

(b) Excludes non government agencies – safety net adjustment and non-government parity – 9 agencies' costs estimated at \$12 million in 2001-02 classified as grants and transfer payments.

(c) As at 30 June 2002, the major TAFE agreements have been concluded.

(d) Excludes the 0.5 per cent productivity one-off payments to be made over the life of the agreement and self-funded by departments but includes the 2000 VPS Agreement.

(e) The total cost does not include the impact on unfunded superannuation liability.

(f) Includes recruitment of approximately 2 000 permanent staff that were to be funded as part of a \$637 million policy initiative. Based on average salary levels including on-costs, the cost is estimated by audit at \$120 million per annum.

(g) Includes the impact of a number of 2002-03 budget initiatives which involve the employment of additional teachers.

(h) Additional 800 police staff recruited by April 2002 ahead of initial target of 30 June 2003.

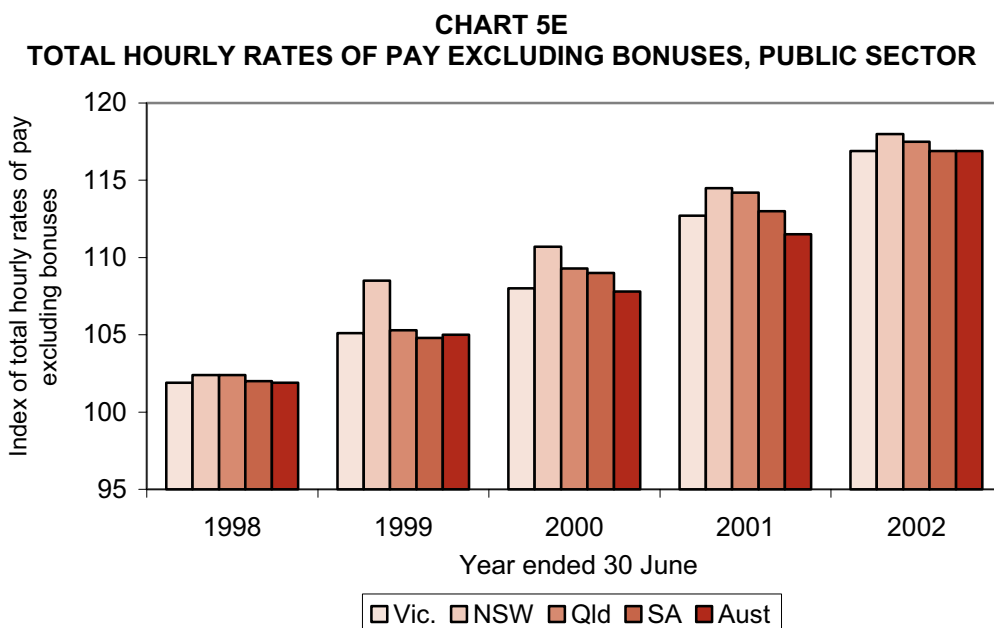
(i) The 2002-03 *Budget Papers* announced additional funding for the Hospital Demand Management Strategy, with a portion of this funding (\$45 million), forecast to result in the employment of additional staff.

5.11 Given the significant impact of these industrial settlements and staffing decisions on the State's finances, it will be important that their implementation is carefully managed and monitored to mitigate against the risk of further cost increases.

5.12 As indicated in the above table, part of the estimated cost of the new industrial agreements is to be internally funded from the redirection of existing departmental resources of around \$74 million per annum. The majority of the redirected resources occurs in the Department of Education and Training (DE&T). For the 2001-02 year, DE&T has advised that it achieved its required redirection savings target on a pro-rata basis with a portion of the internal redirection (\$37.4 million), achieved through changes to the school global budget process to reflect government policy requirements and the new Victorian Government Schools Agreement 2001.

Labour cost indicators

5.13 A commonly used labour cost indicator is the Wage Cost Index – Total Hourly Rates of Pay Excluding Bonuses. As illustrated in Chart 5E, this indicator, which relates to the Australian public sector highlights that, for the year ended 30 June 2002, wage rate growth in Victoria was on par with the Australian average but below the wage rate growth for New South Wales and Queensland. However, the percentage change increase in Victoria of 3.7 per cent from the corresponding quarter of the previous year was the highest of the jurisdictions shown in the chart and above the Australian average percentage change for the period of 3.2 per cent.



Settlement outcomes –Sworn police officers

5.14 In November 2001, the Government entered into an industrial agreement with the Victorian Police Association, covering around 10 300 sworn police officers, protective services officers and recruits. The agreement, operative from December 2001 until December 2004, provides for salary increases to commence from 1 August 2001. It is the intention of the parties that the agreement shall operate until December 2005 but the parties can extend the agreement for a further 12 months period, underpinned by a 4 per cent salary increase.



Police graduating from the Police Academy.

5.15 The agreement incorporates a new career structure, introducing new classifications and creating additional incremental progressions within existing classifications. The agreement also provides for classification band increases in each year of the operational life of the agreement and makes changes to various allowances including meals, accommodation and working conditions.

5.16 Taking into account the revised classification bands under the new agreement and competent performance over the 5 years covered by the agreement (until December 2005), the salary increases will range from 24 to 43 per cent, without taking into account promotions that may take place over the period. **Including the revised classification bands and incremental progressions, this equates to average annual pay rises of between 4.8 per cent to 8.6 per cent per annum over the life of the agreement, which is substantially in excess of the Government's target of 3 per cent growth rate per annum.**

5.17 The agreement resulted in an increase in employee entitlements expenditure of \$56.9 million in 2001-02, increasing to \$123.3 million by 2003-04. In the 2006-07 financial year, if the agreement is extended, the cost is expected to increase to \$217.8 million per annum.

Settlement outcomes – Administrative staff under the Community and Public Sector Union

5.18 Further to the settlements reached in 2000-01 which were outlined in our November 2001 *Report on the Finances of the State of Victoria*, Heads of Agreement were reached in October 2001 in settlement of the Community and Public Sector Union's Public Service Enterprise Agreement claims. The principles outlined in the Heads of Agreement were subsequently incorporated into the Victorian Public Service (Non-Executive Staff) Agreement 2001. This Agreement covers the period from May 2002 to November 2003. The total costs of the agreement amount to approximately \$61 million in 2001-02, increasing to \$108 million per annum thereafter.

5.19 Overall, the Agreement provides for a 4 per cent salary increase from 1 July 2001 and a further 4 per cent from 1 July 2002 for all staff assessed as meeting expectations in their annual performance assessments. Further, non-recurrent productivity improvement lump sum payments equivalent to 0.5 per cent of salary are made in 3 stages over the life of the Agreement, to be self-funded by the respective government agencies. An agreement was also reached to undertake a review of the current career structure, to be considered as part of the negotiations for the next agreement.

Settlement outcomes – health sector

5.20 In addition to the settlement of the Australian Nursing Federation and Health Services Union reached in 2000-01, a number of other awards were settled in 2001-02, including awards covering disability services nurses, radiation therapists, departmental nurses and employees covered by the Psychiatric, Disabilities and Alcohol and Drug Award. The Government further announced in the 2002-03 *Budget Papers*, additional funding of \$129 million under the Hospital Demand Management initiative to the Department of Human Services (DHS) in 2002-03, increasing to \$150 million per annum thereafter. DHS anticipates that of this funding, \$45 million will result in the employment of an additional 750 nursing staff throughout the public hospital system.

5.21 The resolution of various health sector work issues arising from decisions taken in 2000-01 by the Australian Industrial Relations Commission (AIRC); other settlements reached in 2001-02; and a number of budget initiatives in 2002-03 resulted in a further increase of employee entitlements expenditure of \$23.4 million in the 2001-02 financial year, increasing to \$83.4 million by 2003-04.

5.22 Finally, a number of AIRC decisions to May 2001 between the Health Services Union of Australia and 9 charitable organisations raised the disability sector pay rates to the level paid to comparable public sector employees. These AIRC decisions have increased the costs to DHS by \$12 million in 2001-02, increasing to \$12.7 million by 2003-04. As DHS is not the employer of staff in the non-government organisations, these costs although resulting from the outcomes of public sector staff agreement outcomes are not reflected as employee entitlements but as grant payments in the annual financial report of DHS and in the Government's Annual Financial Report. Accordingly, these costs have not been included in Table 5D.

Settlement outcomes – education and TAFE sectors

5.23 In addition to earlier policy decisions, the Government announced in the 2002-03 Budget that additional funding is to be provided commencing from 2001-02 for a number of initiatives, including to meet higher than expected enrolments in Prep to Year 2 in government primary schools. These initiatives are expected to result in the employment of additional staff.

5.24 As outlined in our November 2001 report, in February 2000, the Government agreed to a TAFE Enterprise Bargaining Framework under which TAFE institutes would be supplemented for salary increases up to a specified cap. This Framework enabled the TAFE institutes to further bargain at an institute level, however, institutes would not be funded for salary increases above the specified cap. The Framework provided for budget supplementation for teacher salary increases of 13.6 per cent and 11 per cent for non-teaching TAFE staff over a 3 year period.

5.25 In 2001-02, all outstanding TAFE agreements were finalised, resulting in further budget supplementations of \$2.6 million in 2001-02, rising to \$4.1 million in 2003-04.

Impact of wage settlements on unfunded superannuation liability

5.26 The actuary of each of the public sector superannuation funds estimates the unfunded liabilities position of the respective funds based on various assumptions, including salary inflation rates. The actuaries of the State Superannuation Fund and Emergency Services Superannuation Fund have assumed annual growth rates ranging from 4 per cent to 5 per cent for member salaries. Increases above this level would, therefore, adversely impact on the reported value of unfunded liabilities.

5.27 An analysis undertaken by the actuary of the State Superannuation Fund in January 2002, quantified the reasons for movements in the unfunded liability between 30 June 2000 to 30 June 2001. A key reason identified was that the average salary increases of around 4.9 per cent for fund members were higher than the assumed rate of 4 per cent. **The increase in the superannuation liability attributable to salary increases was \$387 million, of which \$72.5 million was related to salary increases above the 4 per cent assumed rate of salary growth.**

5.28 The impact on the State Superannuation Fund's liability as at 30 June 2002 of salary increases during 2001-02, based on advice provided by the Government Superannuation Office, was to increase the value of these liabilities by \$463 million, of which \$73.5 million was attributable to salary increases above the 4 per cent annual rate of salary growth.

5.29 Sworn police officers form part of the Emergency Services Superannuation Scheme (ESSS). ESSS reported a surplus position of \$274.8 million as at 30 June 2001. This position deteriorated to a deficit of \$70 million as at 30 June 2002. **ESSS estimates that approximately 17 per cent (\$40 million) of the deterioration for the Victoria Police component was attributable to salary increases (including promotions) being substantially above the actuarial assumption of 5 per cent salary growth per annum for the 2001-02 financial year.**

SUPPLIES AND SERVICES EXPENDITURE

5.30 Supplies and services expenditure consists of costs incurred from the purchase of goods and the provision of services, including payments made under outsourcing arrangements, insurance-related claims, operating lease payments and maintenance expenses. **In 2001-02, supplies and services expenditure totalled \$12.2 billion, a decrease of \$422 million from the previous year. The lower level of expenditure in the year was mainly attributable to a reduction in the claims expense of the Victorian WorkCover Authority and the Transport Accident Commission, as detailed later in this report.**

5.31 Commentary follows on a number of the more significant transactions impacting on the expenditure outcomes achieved in the 2001-02 financial year and in forward years.

Special Power Payment

5.32 In December 2001, the Government approved a one-off \$118 million Special Power Payment to certain electricity retailers to mitigate the impact of price increases on the electricity bills of non-metropolitan customers. The payment was provided to ensure consistency between the rate of increase in the average power bills paid by non-metropolitan customers and that of metropolitan customers in the same tariff category and consuming the same volumes of electricity. The variance in power bills was attributed to the different overall cost structures faced by retailers operating in outer suburban, regional and rural areas, compared with those operating in metropolitan areas.

5.33 The introduction of the rebate has coincided with the introduction of customer choice of electricity retail company. The Special Power Payment will result in a rebate on each power bill customers receive over a 12 month period commencing from 1 April 2002. A decision on electricity prices and rebates in 2003 is expected to be made by the Government in late 2002 following the completion of an assessment by the Essential Services Commission of structural issues, prices and the effectiveness of competition.

5.34 A condition imposed by the Government for the availability of the price support in 2001-02, was that the Special Power Payment of \$118 million be fully expensed in its books by 30 June 2002, to satisfy the Government's Budget strategy. To achieve this financial objective, VENCORP, a public sector entity, has agreed to act as Trustee to administer the Special Power Payment Scheme.

5.35 Of the \$118 million funding provided by the Government for this Scheme in 2001-02, only \$12 million has been disbursed to the electricity retailers to fund the rebate to customers, with \$106 million held by VENCORP in its capacity as Trustee pending its disbursement in 2002-03.

Public transport franchise developments

5.36 Public/private sector partnering arrangements now represent a major form and focus of government procurement within Victoria and across Australia. Based on the value of future financial commitments, the largest partnering arrangement in Victoria is the public transport passenger rail franchise arrangements.

5.37 Our previous reports to the Parliament have commented on the complex rail privatisation and franchising arrangements established in mid-1999. Under these arrangements, the then 5 public passenger transport businesses were awarded to 3 separate franchisees for periods ranging from 10 to 15 years. The 3 successful franchisees were companies with previous experience in the provision of public transport infrastructure and services within Australia and overseas, via interposed entities established specifically for the Victorian franchise arrangements.

5.38 In summary, the State retained ownership of the infrastructure associated with the public transport train and tram network, except for the rolling stock, and transferred the responsibility for the day-to-day management and operation of the network to the franchisees, including its ongoing maintenance in accordance with established standards, over the contracted term of each franchise. To ensure the maintenance of appropriate operating capacity, the franchisees agreed to procure and commission a specified number of new rolling stock units and to perform various works such as the refurbishment of the existing units and the upgrade of the infrastructure.

5.39 As the projected revenues from the sale of fares were forecast to be insufficient to operate the public transport businesses, particularly in the initial stages of the franchise period, the State agreed to provide a number of subsidies to the franchisees, with these subsidies reducing in value over the franchise period as the financial viability of the businesses improved. The aggregate cost in present value terms to the State for the delivery of these services by the franchisees over a 15 year period, consisting of fixed and variable payments, was estimated at \$2.8 billion (1999 dollars).

5.40 As a result of entering into these arrangements, the Government expected savings of \$161 million per annum, representing total savings in real terms of \$1.76 billion over the period of the franchising arrangement, when compared with the public sector benchmark cost developed by the Department of Treasury and Finance. A key underlying assumption of the public sector benchmark was annual patronage growth rates of between 2.1 per cent and 2.7 per cent under government ownership, compared with the franchisees projected growth rates of around 3.6 per cent per annum for the franchise period.

5.41 The benchmark was based on pre-existing levels of service and efficiency, and included an annual capital asset charge equivalent to 15 per cent of the written-down replacement cost of the non-current physical assets employed compared with 8 per cent generally imposed on general government sector agencies at the time.

Allocation of Risk, Contract Disputes and Performance Review

5.42 In 1999, the Government established the position of Director of Public Transport (the Director) within the Department of Infrastructure to oversee the operation of the public transport businesses and enable the ongoing monitoring and administration of the contractual arrangements associated with the delivery of public transport by the franchisees.

5.43 Under the established arrangements, **the franchisees accepted a number of key commercial risks, including the failure to achieve the projected levels of growth in fare revenue and movements in the rate of fare evasion. The franchisees' financial viability was dependent on the achievement of these growth targets and operating in line with the projected costs for the delivery of services and the procurement of rolling stock.**

5.44 The State retained certain defined risks, including increased subsidy payments resulting from changes in the CPI; the provision of additional funding associated with any changes in the scope of operations or amendments to fare regulations as approved by the Director; and a requirement to compensate the franchisees for any loss resulting from any changes in Victorian law.

5.45 In October 2001, as required under the franchise agreements, the franchisees submitted to the Director business plans and associated budgets covering the 3 calendar years 2002 to 2004. The business plans highlighted that the franchisees faced financial difficulties in running the public transport system.

5.46 In November 2001, the franchisees jointly presented a 6 point plan to the Director, centred around changes to the revenue allocation methodology and resolving outstanding contractual disputes. During subsequent negotiations, agreement was reached to resolve certain longstanding claims arising since the commencement of the franchise operations and the Director also committed to formally review other issues raised in the 6 point plan.

5.47 In January 2002, the Government established a Franchisee Review Task Force (the Task Force) consisting of senior staff from the Departments of Treasury and Finance, and Infrastructure, to review the performance of the franchising arrangement and to recommend to the Government what changes, if any, should be made to the existing arrangements.

5.48 To assist the Task Force, the Director re-appointed the original external financial advisers involved in the franchise selection process to conduct a review of the 3 year business plan for each of the franchisees. The review involved discussions with franchisee senior management, examination of the original bids and the franchisees' management accounts up to September 2001, and a review of profit and loss, cash flow and balance sheet forecasts for the years ending 31 December 2002, 2003 and 2004 for each of the franchisees.

5.49 In February 2002, only 28 months after the franchise agreement became operational, 141 claims and disputes were formally submitted by the franchisees to the Government.

5.50 In March 2002, the financial advisers confirmed to the Task Force that the franchisees had underperformed in comparison with original bid forecasts.

5.51 The key factor identified in the underperformance has been the significantly lower than forecast growth in the revenue pool and patronage growth across the network. While the franchisees attributed this reduced revenue to fare evasion and ticketing system problems, the financial advisers reported to the Task Force that the main reason appeared to be due to the aggressive patronage growth projections of the original bids and lower than forecast cost savings.

Interim agreement to disputes

5.52 In an interim agreement entered into in March 2002, the franchisees and the Director agreed to settle a number of disputes in return for 2 core settlement payments. **The first part of the settlement involved an up front payment of \$41.6 million together with annual payments of \$2.8 million over the period of the arrangements to the franchisees to settle 65 claims and disputes.** These claims related to a broad range of issues including inconsistencies between forecast and actual employee entitlements payable to the franchisees and deferred maintenance of the rolling stock that was subject to the original sale of assets agreements.

5.53 The settlement deed also identified a list of **45 outstanding claims which remained unresolved and are to be examined by the Franchise Review Taskforce.** These include claims relating to the financial impact on franchisees of the Regional Fast Rail Project, Spencer Street Station Redevelopment and issues regarding the operating performance incentive regime which aims to influence franchisee operational performance against specified targets. Other claims related to the imposition of charges for car parking at stations, free travel arrangements for senior citizen week, losses associated with the current automated ticketing system, franchisees' obligations in respect of employee entitlements at the end of the franchise period and streamlining of future force majeure claims.

5.54 The second part of the settlement involved a payment of \$27.2 million paid to the franchisees in 4 equal instalments from March 2002 to June 2002 as an initial passenger growth incentive payment to the franchisees operating the metropolitan network. The passenger growth incentive payments were made by the Director to each franchisee for additional revenue collected in excess of a specified threshold, which is based on the fare revenue generated in the 1998-99 financial year. The parties acknowledged a need to review the passenger growth incentive arrangements as part of the franchisee review process.

5.55 All the payments by the State under the deed of settlement were conditional upon receipt of additional franchise performance bonds increasing from \$105 million to \$210 million. However, the performance bonds revert back to the \$105 million level after 30 June 2003. These performance bonds are in addition to the \$60 million of performance bonds previously provided to ensure compliance with the franchise obligations to bring into regular service new committed rolling stock.

5.56 As part of the interim agreement, the parties acknowledged that the adverse impacts on the franchisees of, among other things, the introduction of the GST and unforeseen increases in both insurance premiums and the cost of traction power will also be considered as part of the franchisee review, notwithstanding that these risks were assumed by the franchisees under the terms of the original franchise agreements.

Ongoing monitoring of risks

5.57 Under the franchise agreements, the franchisees are required, among other things, to provide the Director with quarterly financial reports covering:

- the profit and loss, cash flow and balance sheet of each franchisee entity;
- a sufficient level of commentary to explain material variations from forecasts; and
- additional information, as required, e.g. forecast cash flows, level of indebtedness and employee numbers.

5.58 Notwithstanding these requirements that have operated since the commencement of the franchise period in September 1999, the external financial consultants review commissioned by the Director of Public Transport in December 2001 was the first detailed review of the financial performance and position of the franchisees undertaken on behalf of the State.

5.59 In the event of a contractual termination event materialising, including insolvency, the existing franchise agreements and related agreements provide the Government with the rights to gain control over all of the franchisees' assets and personnel that may be needed to secure the continued operation of the transport services. The Government has developed detailed contingency plans associated with the State's response to an insolvency or termination event, including the consideration of options for the future running of the public transport system (subsequent to termination) such as reverting back to full public ownership, contract re-negotiation and re-tendering.

5.60 The Government is currently holding discussions with the franchisees on a number of complex issues, the outcome of which will inform future government decisions regarding the operation of the public transport system.

OneLink - automated ticketing system

5.61 In May 1994, the Public Transport Commission (PTC) entered into arrangements with OneLink Transit System Pty Ltd (OneLink) to provide an automated ticketing system (ATS) and fare collection services for the metropolitan public transport system, over a period of 10 years ending in 2007. The Service Contract specified the broad requirements for the ATS but allowed for the subsequent finalisation of functional specifications. The software and equipment associated with the ATS was to be owned and operated by OneLink. Under the terms of the Service Contract, the Treasurer of Victoria guaranteed the payment obligations of the PTC to OneLink.

5.62 At the completion of the contract in March 2007, the Government has the option to extend the period of the contract for a further 5 years, terminate the contract and acquire the ATS system for a nominal sum, or terminate the contract and require OneLink to remove the system. In the event that OneLink elects not to remove the system, ownership of the ATS system will be transferred to the PTC.

Settlement of contractual claims

5.63 Our previous *Reports on the Finances of the State of Victoria* have commented on arrangements established between the PTC and OneLink relating to the administration of various damages claims between the parties. Under the arrangement, both parties agreed to waive certain rights and obligations with respect to the ATS agreement. However, OneLink retained the right to claim for variations to specifications lodged during the period May 1994 to March 1997, but these rights were suspended until after the commissioning of the pilot stage of the ATS.

5.64 In April 2000, Onelink lodged “scope creep” claims against the State, with a potential cost of up to \$338 million. Further general claims have also been lodged by OneLink with a value of \$24.5 million, including costs associated with vandalism.

5.65 The PTC established a team that included external legal, financial and engineering advisers to review the claims. Following protracted negotiations over a 2 year period, in May 2002 the PTC and OneLink agreed to settle all outstanding claims on the negotiated terms and conditions as set out in a Settlement Deed and Heads of Agreement. The agreed settlement includes:

- a payment of \$65 million by the State to OneLink, covering costs associated with “scope creep” and other general claims;
- introduction of a new performance regime for OneLink with associated incentives and penalties estimated to cost the State up to \$2.5 million over the remaining term of the contract;
- a capping of the financial risk of vandalism to the State through an annual payment of \$3 million to Onelink over the remaining term of the contract; and

- establishment of a revised default “trigger” regime under the contract for non-performance and an undertaking by OneLink to co-operate in the transition to a new ticketing system at the conclusion of the contract in 2007.

5.66 Consistent with the terms of the settlement, a payment of \$25 million associated with “scope creep” and general claims was made by the State in the 2001-02 financial year, upon the execution of the Heads of Agreement. The agreed Service Contract amendments must be executed and come into effect in accordance with the Heads of Agreement, by no later than 30 November 2002. At this time, a further payment of \$20 million is to be made, with an additional \$5 million contingent on a successful performance trial. The balance of the \$15 million of the financial settlement is to be made over the course of the remaining period of the contract and tied to proven performance improvements. The Treasurer was required to re-affirm the existing Treasurer’s guarantee, including the obligations reached under the settlement deed.

5.67 As indicated above, the terms of the settlement provides for further changes to the Service Contract, with OneLink agreeing to the inclusion of a new performance regime, incorporating *Customer Defined Availability (CDA)* measures. The new performance regime imposes higher standards on OneLink to ensure that more ticketing machines are fully operational at any point in time. It represents an average machine availability (across all machine types) of 99 per cent. This compares with the machine availability rate estimated to be between 80 per cent to 90 per cent in 2002, and an estimated machine availability rate of 72 per cent for 2001.

5.68 In the past 3 years, the PTC and OneLink have shared the costs of vandalism, estimated between \$6 million to \$7 million per annum. As part of the settlement, the PTC will be required to pay \$3 million per annum to OneLink and that company is to assume responsibility for payment of vandalism costs and operational machine failures (capped at a defined number of maximum instances).



An automated ticketing machine installed on a suburban tram.

5.69 In relation to the future operation of the automated ticketing system, it is proposed that the rights and obligations of the PTC under the Service Contract are to be ultimately assigned to the Revenue Clearing House Pty Ltd (RCH). The shareholders of RCH are the franchisees of the passenger transport businesses and the Secretary to the Department of Infrastructure, on behalf of the private bus operators. In the meantime, the PTC and RCH have entered into interim arrangements that continue until such time that the Service Contract is formally assigned to RCH. **As at the date of preparation of this report, formal assignment of the ATS agreement to RCH had not occurred. However, the settlement of outstanding claims between the PTC and OneLink is expected to assist in finalising the assignment of the rights and obligations of the PTC under the Service Contract.**

Major events strategy

5.70 The Government has in place a major events strategy, which underpins its objective of attracting and retaining major national and international sporting and other events to strengthen the State's sport, recreation and tourism base. The strategy incorporates an assessment framework and a funding limit up to \$35 million per year in financial support for the staging of major sporting and tourism events, excluding the Melbourne 2006 Commonwealth Games.

5.71 In 2000-01, the Government estimated that the consolidated economic impact on the State of hosting ongoing major events was \$277.3 million per annum. In relation to the one-off international events (excluding the Melbourne 2006 Commonwealth Games), the total economic benefit was estimated to be \$99.8 million.

5.72 Comment follows on the major international ongoing events hosted by the State since 1996, namely the grand prix events and a significant upcoming event, the Melbourne 2006 Commonwealth Games.

Australian Grand Prix events

5.73 The Australian Grand Prix Corporation has staged the Melbourne Formula One Grand Prix from 1996 and the Australian Motor Cycle Grand Prix from 1997. Furthermore, the Corporation is contracted to stage the Australian Formula One Grand Prix in Melbourne until 2010 and the Australian Motor Cycle Grand Prix at Philip Island until 2006.

Economic impact assessment of Grand Prix events

5.74 Our previous reports have commented upon economic impact studies commissioned by the Government with respect to the 2 Grand Prix events. The most recent studies were conducted in 1997 for the Australian Motorcycle Grand Prix event and in 2000 for the Australian Formula One Grand Prix.

5.75 Overall, the economic impact studies concluded that the 2000 Formula One Grand Prix increased the Victorian Gross State Product by \$130.7 million and resulted in additional taxation receipts for the State Government of \$9.8 million. The Motor Cycle Grand Prix event conducted in 1997 was estimated to have contributed \$54 million to the Victorian Gross State Product and \$3.7 million in additional taxation receipts. The Corporation has advised that a review will be conducted for the 2002 Motor Cycle Grand Prix event.

Financial outcomes of Grand Prix events

5.76 Table 5F illustrates that the total costs incurred by the State in relation to the Formula One and Motor Cycle Grand Prix events for the 2001-02 financial year amounted to \$16.2 million, compared with \$13.1 million in 2000-01.

TABLE 5F
COSTS INCURRED BY THE STATE TO STAGE OF THE FORMULA ONE GRAND PRIX
AND MOTOR CYCLE GRAND PRIX
(\$million)

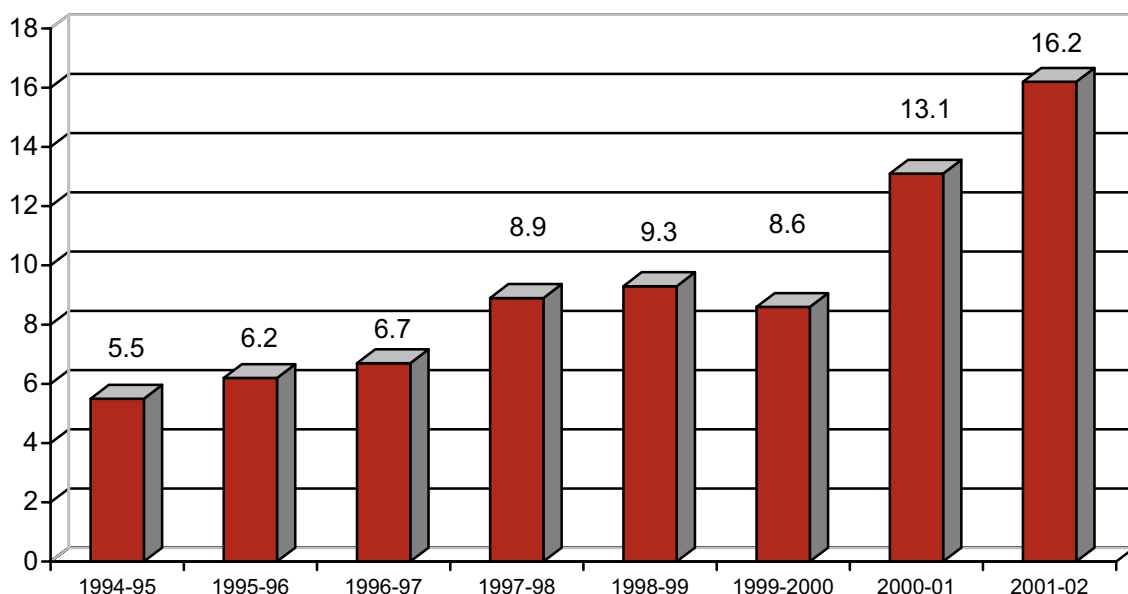
	2001-02	2000-01
Formula One Grand Prix	10.3	7.8
Motor Cycle Grand Prix	5.9	5.3
Total net operating costs incurred by the State (a) (b)	16.2	13.1

(a) Reflects the operating loss incurred by the Corporation during the 2001-02 financial year, including components relating to both the October 2001 and October 2002 Australian Motor Cycle Grand Prix.

(b) The Corporation paid a fee to the Department of Infrastructure (DOI) for the provision of public transport. However, DOI was unable to confirm if the fee fully reimbursed the State for the cost of running the services under the franchise agreements.

5.77 Under the established contractual arrangements, the Government has provided an undertaking to underwrite any deficits incurred by the Corporation for these events. **Chart 5G illustrates that the net operating costs to the State associated with the staging of the events since their inception is approximately \$74.5 million.**

CHART 5G
GRAND PRIX NET OPERATING COSTS TO THE STATE
(\$million)



5.78 As illustrated in Chart 5G, the net operating costs of hosting these events in 2001-02 have increased by \$3.1 million from the previous year. The Corporation advised that this increase was mainly as a result of:

- Formula One Grand Prix - increases in the cost of public liability insurance of \$500 000 combined with track safety works undertaken by the Corporation costing \$1.4 million; and

- Motor Cycle Grand Prix - decreases in revenues due to lower attendances attributable to poor weather leading up to the event and increased expenditure incurred with the introduction of superscreens to increase the event experience for patrons.

5.79 The marketing and gate receipt revenue for the Motor Cycle Grand Prix has been steadily declining in recent years in contrast to the Formula One Grand Prix which has steadily increased its revenue from these sources.

5.80 **The increasing costs incurred by the State from the staging of the Grand Prix events reinforce the need for the Corporation to continually assess its financial planning to ensure that the net costs to the State are minimised.**

Melbourne 2006 Commonwealth Games

5.81 As evidenced by the recent 2000 Sydney Olympic Games and 2002 Manchester Commonwealth Games, the staging of such events represents a significant logistical and financial commitment for a government over a number of years. Our previous reports to Parliament have provided commentary on the State's successful bid for hosting the 2006 Commonwealth Games, the subsequent establishment of an organising committee company known as the Melbourne 2006 Commonwealth Games Pty Ltd and the progress of organising the Games.

5.82 A government study in 1998 identified that the economic impact of hosting the Games in the short-term would be to increase Victoria's Gross Domestic Product (in 1998 dollars) by around \$373 million, and to increase State taxation revenues by around \$14.5 million. This compared with a total projected cost, excluding capital works, of \$195 million (in 1996 dollars) associated with the State Government hosting the Games. The study also identified longer lasting and intangible benefits to the State such as increased tourism, improved reputation for hosting "world class" events and an opportunity to foster long-term business relationships.

5.83 Under the terms of the endorsement contract, the State is required to underwrite any shortfall between the revenue and expenditure of the organising committee company until the winding-down of the company.

Administration arrangements and costs of the Games

5.84 Following the completion of a preliminary business plan and an operational plan by the organising committee company in the 2000-01 financial year, the Government, in recognition of the significant logistical and financial risk associated with the Games, established a working committee, implemented a number of administrative changes and enacted legislation.

5.85 A Commonwealth Games Budget Review Committee, comprising representatives of the Department of Treasury and Finance, the Department of Premier and Cabinet and the then Department of State and Regional Development, was formed in 2000-01 to develop a whole-of-government budget for the Games. As from July 2000, the former Department of State and Regional Development assumed responsibility for the co-ordination of the Government's involvement in the Games and the Minister for Sport and Recreation was appointed as the Minister responsible for the Games. In March 2002, following administrative arrangements, the Department of Tourism, Sport and the Commonwealth Games (DTSCG) was established and assumed the responsibilities of the former Department of State and Regional Development in relation to the Games.

5.86 In November 2001, Parliament passed the *Commonwealth Games Arrangements Act 2001*. This Act established a legislative framework to enable the preparation and staging of the Games. Among other things, the Act streamlines the planning and approvals processes for capital projects relating to the Games and facilitates the improved management of the financial risks associated with the timeliness of the provision of facilities and services for the Games. Further, the Act provides the Treasurer with the authority to execute a guarantee and/or indemnity in respect of the performance of any obligation relating to a Commonwealth Games project.

5.87 **At the date of preparation of this report, a revised whole-of-government budget for the Games had not been finalised, however, we were advised that it would be completed in time for consideration as part of the Government's 2003-04 Budget cycle, taking into account a review of the original budget and experience of the Sydney 2000 Olympic Games and the Manchester 2002 Commonwealth Games.** In addition, the economic impact assessment undertaken in 1998 prior to the successful bid announcement is planned to be updated in 2002-03 to take account of the recent economic outcomes of the Sydney 2000 Olympic Games and the Manchester 2002 Commonwealth Games, to assist the Government in its decision-making process.

5.88 **The net cost to the State of attaining (in 1998) the right to stage the 2006 Commonwealth Games in Melbourne was \$6.1 million. In addition, the State had provided further funding of \$49.6 million to 30 June 2002 to the organising committee company in relation to planning the Games. Further to this contribution, Victorian Government departments incurred related expenditures of \$2.5 million in 2001-02.**

Progress in organising the Games infrastructure

5.89 In the winning bid document, the former Government committed itself to a capital works program for the development of the sporting facilities required to meet the standards for the Commonwealth Games. Under the administrative arrangements entered into between the organising committee company and DTSCG, responsibility for delivering all the permanent infrastructure for hosting the Games rests with DTSCG. The organising committee company is responsible for all temporary infrastructure and the overall running of the Games.

5.90 Additional facilities identified by DTSCG as needing development or redevelopment include the Melbourne Cricket Ground, the Melbourne Sports and Aquatic Centre, the Games Village, the Training Velodrome and the State Lawn Bowls Centre. In March 2002, the Minister for Sport, Recreation and the Commonwealth Games announced that the State would construct a State Lawn Bowls Centre and Training Velodrome, of which the State is expected to contribute \$10.7 million. In October 2002, the Government announced that the Games Village would be built in the inner northern suburb of Melbourne on the former site of the Royal Park Psychiatric Hospital at Parkville.

5.91 The Melbourne Cricket Ground (MCG) has been nominated as the facility to host the Games' opening and closing ceremonies, and the athletics competition. The works to be undertaken at the MCG include the construction of a new Northern Stand to replace the Ponsford, Members and Olympic Stands, which will increase the seating capacity of the stadium to 100 000.

Melbourne Cricket Ground redevelopment

5.92 The MCG Trust is the body responsible for the management of the areas associated with the MCG ground under the authority of the *Melbourne Cricket Ground Act 1933*. The MCG Trust has delegated this responsibility to the Melbourne Cricket Club (MCC), subject to the MCG Trust's supervision. In August 2001, the Government announced that it supported, in-principle, the provision of guarantees and indemnities to the MCC and MCG Trust, similar to the arrangements entered into in previous years in relation to the construction of the Great Southern Stand, to facilitate the further redevelopment of the MCG.

5.93 Following a tender process in October 2001, Grocon Constructors Pty Ltd was selected as the preferred tender for the redevelopment by a Joint Steering Committee, consisting of MCC, MCG Trust and State Government representatives, and approved by the MCC and MCG Trust. The Government subsequently approved the design and construction contract, which was signed in June 2002 by Grocon, the MCC and MCG Trust. Demolition work commenced in late September 2002 following the Australian Football League (AFL) Grand Final, with the project scheduled to be completed by late 2005 at an estimated cost of \$434 million.

5.94 To date, the State's direct and indirect financial support for the project includes:

- a guarantee to the Treasury Corporation of Victoria (TCV) in relation to a loan of \$360 million provided by the TCV to the MCC;
- a grant of \$77 million to the MCC, to be paid in equal instalments in 2003-04 and 2004-05;
- a further contribution to meet the cost of the construction of the temporary athletics track, which is still subject to negotiation;

- various indemnities to the MCC and a financial guarantee to the MCG Trust under which the State may be required to meet certain costs under specified conditions;
- provision of compensation to the MCC, the AFL and the Victorian Cricket Association/Australian Cricket Board for lost events during the periods when the temporary athletics track works are undertaken and the 2006 Games are held; and
- provision of compensation to the AFL for the loss of seating capacity for AFL Grand Finals during construction for the years 2003 to 2005.

5.95 The debt finance provided by the TCV of \$360 million is to be repaid over 25 years from the date completion of construction. **When the existing debt associated with the Great Southern Stand is included, it is expected that total debt of the MCC will be \$384.9 million in 2006.**

5.96 Financial modelling undertaken by financial consultants engaged by the MCC and MCG Trust concluded that, after taking account of projected income and expenditure streams, the MCC and the MCG Trust would be able to service the new borrowings within the 25 year repayment period. A number of revenue-generating measures are to be introduced by the MCC to assist in financing the redevelopment, including a contribution by the AFL to the MCC of \$5 million per annum (indexed for movements in the consumer price index) over a 30 year period. The MCC also expects to generate an additional \$11 million per annum (indexed for movements in the consumer price index) in membership revenues by 2006 from an additional 2 200 seats in the MCC Members Reserve and improved amenities across the MCG.



MCG northern stands are to be redeveloped.

Withdrawal of Commonwealth funding

5.97 The 2001-02 Commonwealth Government's Budget announced that the Commonwealth Government would provide a grant of \$90 million towards the MCG redevelopment. In March 2002, the Commonwealth Government as part of the conditions of funding attached certain industrial clauses. In particular, it required that the National Code of Practice for the Construction Industry and associated Implementation Guidelines and Industry Guidelines apply to the project.

5.98 Following discussions with the MCC, the MCG Trust and the preferred tenderer, the Victorian Government formed the view that these requirements would place at risk the delivery of the project on time and within budget. Accordingly, it rejected the Commonwealth Government funding conditions. **Following the withdrawal of the offer of Commonwealth Government funding, the Victorian Government announced in June 2002 that it would inject \$77 million into the redevelopment by way of a grant (as outlined previously), with the balance of \$13 million to be provided by the MCC.**

Risks associated with the redevelopment

5.99 In structuring the indemnity arrangements associated with the MCC redevelopment, the Government considered that the existing 1990 Indemnity Deed, previously established for the construction of the Great Southern Stand, was too broad from a financial risk perspective to replicate. Further, the Government considered that while the MCG Trust had a series of supervisory powers, the delegated management of the ground lacked appropriate accountability and performance measures.

5.100 As a result, the requirements of the new indemnity arrangements provided for enhanced performance accountability requirements; compliance with the Government's Partnership Victoria risk sharing principles; government sign-off on the risk allocation of the design and construction contract for the project; government control of guarantee limits to MCC funding facilities; and a process to be followed if calls are made on any of the intended indemnities. In addition, the requirements establish a right for the Government to manage and control the redevelopment project if the capital cost for the project exceeds \$450 million.

5.101 As part of the redevelopment arrangements, the Treasurer agreed to the MCG Trust's extension of the MCC's tenure as lessee and ground manager until 2042, and an option for the MCC to occupy the Members Reserve for a further 25 years after 2042.

5.102 In addition, as part of the enhanced performance accountability requirements, the MCC has also agreed to prepare a rolling 5 year business plan and annual budget to be approved by the MCG Trust which will form the basis of annual business plans to be submitted by the MCG Trust for approval by the Minister for Sport and Recreation.

5.103 Under a Management and Indemnity Deed entered into in August 2002 between the MCC, the MCG Trust and the Treasurer, the MCC is to be indemnified by the Government for project costs in excess of \$450 million where there are insufficient operating surpluses to meet the scheduled debt servicing and repayments. However, all appropriate action (at the MCG Trust's direction) must be taken to raise funds and, where possible, avoid a call on the indemnity, including a reduction in the MCC's ground management fee.

5.104 The State's interests are sought to be protected through it having a majority interest on the Joint Steering Committee which is to supervise and direct the redevelopment, including the approval of all variations. The Joint Steering Committee consists of 8 members, 5 of whom are government-related representatives, including 3 from the MCG Trust and 2 State Government officials. The remaining 3 representatives are from the MCC. In addition, the design and construction contract includes provisions for capped liquidated damages in the event that the construction milestones and designated seating capacity levels are not met by the construction contractor.

5.105 **A summary of the guarantees and indemnities provided by the State to the MCC and the MCG Trust are disclosed in note 31 accompanying the Government's Annual Financial Report.**

Compensation for the impact of the redevelopment

5.106 A key aspect of the arrangements established for the redevelopment include a requirement for the State to reimburse the MCC for all costs associated with the temporary athletics track and associated works, and to pay appropriate compensation to the MCC, and third parties for lost events on account of these works and the period covered by the Games.

5.107 As part of the arrangement, the AFL has waived its rights for compensation from the MCC and the MCG Trust and has agreed to deal directly with the State for compensation claims resulting from the construction and the impact of the Games on AFL matches. In August 2002, the Minister for Commonwealth Games and Sport and Recreation and the AFL agreed to an initial compensation package of \$5.7 million for the loss of seating capacity for Grand Finals during years 2003 to 2005. The final compensation amount will be dependent on the overall seating capacity of the ground at the time of the Grand Finals. The compensation payable to the AFL as a result of the holding of the Games in 2006 is to be established following the completion of the draw for the 2006 AFL season.

Community Support Fund operations

5.108 The *Gaming Machine Control Act* 1991 provides for the establishment in the Public Account of a Trust Fund known as the Community Support Fund (CSF). The purpose of the CSF is to ensure that a proportion of government revenue from electronic gaming machines in hotels is made available for projects which benefit the Victorian community. The focus of the CSF is on addressing specific needs in the community, particularly those experiencing social and economic disadvantage.

5.109 The legislation requires 8.33 per cent of the total daily net cash balances (i.e. the total amount wagered, less the sum of all prizes paid) derived from electronic gaming machines in hotels to be paid into the Consolidated Fund. An equivalent amount is required to be transferred to the CSF from the Consolidated Fund by way of a standing appropriation. For each of the 5 financial years from 1 July 1998, the amount transferred into the CSF is to be \$25 million less than the amount payable to the Consolidated Fund under the above formula. In addition, interest derived from the investment of the balance of the CSF is required to be paid into the CSF.

5.110 Under section 138 of the *Gaming Machine Control Act* 1991, the responsible Minister may apply money in the CSF first, for the purpose of research undertaken by the Gambling Research Panel (established under the Act) relating to the social and economic impact of gambling and the causes of problem gambling, and second, for the following purposes:

- provision of programs including prevention of problem gambling, drug rehabilitation, community advancement, families in crisis and the benefits of youth, and programs for the benefit of sports, arts and tourism;
- any other programs or purposes relating to the support or advancement of the community as determined by the Minister; and
- costs incurred in administering and managing the Fund and for payment to the members of the Gambling Research Panel.



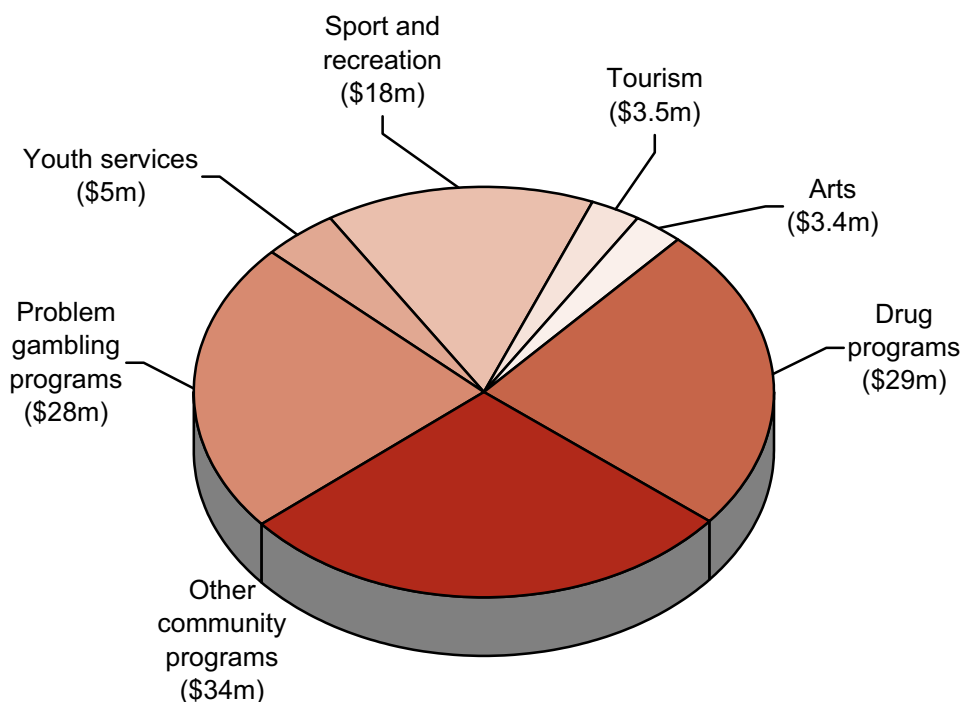
A portion of revenue generated from electronic gaming machines goes into the Community Support Fund.

Financial activities of the Fund

5.111 From the period since its establishment in 1992 to 30 June 2002, receipts into the Fund totalled \$792.6 million of which \$650.9 million has been expended. The balance held in the Fund at 30 June 2002 was \$141.7 million. Over this period, the major recipients of funding have included the Melbourne Sports and Aquatic Centre (\$55 million), the Royal Park Hockey and Netball Centre (\$27 million), the Immigration Museum (\$21 million) and the Federation Square Development (\$20 million). In addition, some \$231 million has been allocated to drug prevention programs and \$101 million for gambling-related programs. The CSF has also funded some \$17 million worth of community building projects across the State.

5.112 During the 2001-02 financial year, an amount of \$121 million was approved to fund various community programs and projects. Chart 5H details the amounts approved for allocation during the 2001-02 financial year, by category.

CHART 5H
COMMUNITY SUPPORT FUND GRANT APPROVALS (BY CATEGORY),
2001-02
 (\$million)



Source: Department of Premier and Cabinet, *Annual Report, 2001-02*.

5.113 In June 2001, the Government revised the guidelines which govern the operation of the CSF to provide a focus on community initiatives in line with the government priority of community building. This focus is reflected in funding approvals from the CSF in 2001-02.

5.114 As Chart 5H illustrates, 28 per cent of all approvals in 2001-02 related to the funding of community programs. The balance of approvals mainly related to programs that include initiatives to address problem gambling (23 per cent) and drug programs (24 per cent).

CSF funding for departmental programs

5.115 Under the Government's guidelines governing the operations of the CSF, projects can only receive funding on a time-limited basis (maximum period of 3 years). No project is able to receive ongoing or recurrent funding. However, in recent years the CSF has been used as a source of funding to support a number of departmental initiatives which, by their nature, may be regarded as ongoing programs critical to the achievement of government objectives.

5.116 For example, the Government's *Turning The Tide* drug initiative administered by the Department of Human Services has received substantial amounts from the CSF (around \$28 million per year since 1996). The drug program is now considered an ongoing program, and also receives recurrent funding from the State Budget.

5.117 A further example is the CSF expenditure of around \$8 million per year since 1999 (and is expected to grow to around \$13 million from 2002-03 onward) for problem gambling and financial counselling services. Funding from the CSF represents a significant proportion of the total funds available to deliver these services. The provision of information and services to people with a gambling problem is likely to require ongoing funding.

5.118 To comply with the Government's guidelines relating to the operation of the CSF which provides that the CSF should not be used to fund mainstream recurrent programs, the continuance of programs such as those illustrated above, will require reconsideration of either the source of funding for such programs or revisions of the guidelines.

Funding for the Maribyrnong Aquatic Centre

5.119 In 2001, the Government introduced the Better Pools Program for the development of aquatic leisure facilities across the State. In accordance with the guidelines established to administer the Program, only councils or groups of councils are eligible to apply for Program funding. Revenue for the Better Pools Program is sourced from the CSF which has committed around \$21 million to assist local councils with the development of aquatic centres in local communities.

5.120 Early in 2002, under the above Program, the Government approved a grant of \$2.5 million to the Maribyrnong City Council for the Maribyrnong Aquatic Centre to be developed adjacent to the Highpoint Shopping Centre at an estimated cost of \$17 million.

5.121 Subsequently, in June 2002, the Government approved an additional \$4.25 million CSF grant to the Council for the project.

5.122 However, the Better Pools Program guidelines, under which the initial \$2.5 million grant was provided to the Council, state that "*projects which are eligible under that program are automatically ineligible for further funding from the Community Support Fund*". Accordingly, the additional CSF funding of \$4.25 million was provided to the Council in contravention of the Better Pools Program guidelines.

5.123 According to CSF documentation, the grant was provided on the basis that the project was considered to be a significant regional initiative which has attracted a major private sector partner and will generate leisure opportunities for many community members.

RESPONSE provided by Minister for Finance**Expenditure**

Para. 5.10

The figures in Table 5D indicate a cumulative increase in wages, salaries and related costs of \$962 million to 2001-02. The actual reported year-on-year increase in employee entitlements shown in the Financial Report for the State of Victoria and verified in paragraph 5.5 is \$768 million. The figures quoted in the table therefore show a selected mixture of increased costs in the current year and cumulative costs based on decisions taken as from an arbitrary base year, indicated in note (a) of the table to be 2000-01. These amounts are included in the total employee entitlements cost of \$9.4 billion but are not necessarily new costs attributable to 2001-02. In addition, the table lists policy initiatives and cost estimates for the next budget year 2002-03 which have yet to be realised.

These award increases and policy initiatives include an element of catch-up in public sector wage rates and maintenance of relativities with comparable industries. The level of high quality staffing in Victorian schools, hospitals and public safety will be maintained, as shown in the table, partly by the redirection of existing funding away from non-priority areas. The effects of these awards and initiatives on the budget sector outcome and the budget and forward estimates are consistent with the Growing Victoria Together priorities included in 2002-03 Budget Statement (BP2) including:

- Sound financial management - maintaining a substantial general government operating surplus;
- Valuing and investing in lifelong education;
- Ensuring high quality accessible health and community services; and
- Creating safe streets, homes and workplaces.

Labour cost indicators

Para. 5.13

The data indicates that growth in Victoria public sector wage rates since June 1997 have been in line with the national public sector average. Whilst it is true that growth in the Victorian Wage Cost Index between June 2001 and June 2002 was the highest of all the jurisdictions "shown in the chart", it was not the highest of all jurisdictions (NT recorded growth of 3.8 per cent) and, at 3.7 per cent, was only marginally higher than South Australia and Tasmania (both 3.5 per cent).

A key conclusion which can be drawn from the data is that it confirms that, over the medium term, wage rates for different employers within an industry would be expected to grow at a similar rate. Indeed the chart clearly demonstrates that over the medium term (at least since 1996), growth in Victorian public sector wage rates has been consistent with national trends.

Grand Prix

Para. 5.80

The Government will continue to assess the annual costs to the State budget from the staging of the Grand Prix events and will ensure that these costs represent a substantial net benefit to the State. It should be acknowledged that the benefits of the Government's funding towards the Australian Grand Prix Corporation have been independently reviewed by the National Institute of Economic and Industry Research (NIEIR).

In July 2002, NIEIR reported on the economic impact of the 2000 Qantas Australian Grand Prix. The NIEIR report found that the 2000 Formula One Grand Prix contributed \$130.7 million to Victorian gross state product and generated 3 100 full year equivalent employment positions.

The NIEIR also reported on the 1997 Motorcycle Grand Prix at Phillip Island and found that the event contributed \$54 million to Victorian gross state product, incorporating a regional benefit of \$22.6 million to the Bass Coast Shire.

Part 6

Assets

SUMMARY OF STATE ASSETS

6.1 The State's assets mainly comprise physical assets, receivables, cash and investments with an aggregate value of \$97.1 billion as at 30 June 2002 - an increase of around \$1.7 billion on the previous year. The major factors contributing to this increase were:

- an increase in the value of physical assets of \$5.9 billion due to the upward revaluation of these assets by \$4.6 billion, and the construction and acquisition of new physical assets; and
- an offsetting reduction in receivables of \$4.4 billion due largely to the maturity of derivative transactions.

6.2 Table 6A presents a summary of the assets controlled by the Government as at 30 June 2002.

TABLE 6A
SUMMARY OF STATE ASSETS
((\$billion))

<i>Type of assets</i>	2001-02	2000-01
Financial and other non-physical assets -		
Investments	19.9	19.7
Receivables	7.2	11.6
Cash	1.6	1.6
Other assets	0.6	0.6
	29.3	33.5
Physical assets -		
Land and buildings	31.5	28.5
Plant, equipment and infrastructure systems	20.4	19.5
Roads and earthworks	12.8	12.1
Other	3.1	1.8
	67.8	61.9
Total State assets	97.1	95.4

Source: Annual Financial Report for the State of Victoria, 2001-02.

INVESTMENTS

6.3 Investments represent the largest component of the State's financial assets and comprise domestic and international equities, investment property and fixed interest securities. **At 30 June 2002, the State's investments totalled \$19.9 billion, an increase of \$233 million since the previous financial year.**

6.4 As detailed in Table 6B, the majority of the State's investments are held by 5 agencies:

- the Department of Treasury and Finance, to predominantly fund the State's infrastructure investment requirements under the Government's *Growing Victoria* initiative;
- the Treasury Corporation of Victoria, held for debt retirement, risk and program management, and investment purposes associated with deposits lodged by public sector agencies; and
- public sector insurance agencies, namely, the Transport Accident Commission, the Victorian WorkCover Authority and the Victorian Managed Insurance Authority, to fund their insurance liabilities.

6.5 The majority of State investments are managed on behalf of these agencies by the State's central fund manager, the Victorian Funds Management Corporation, which provides services to Victorian public sector agencies mainly for long-term investment requirements. The Treasury Corporation of Victoria manages short-term investment requirements as part of its role as the State's central financing authority.

6.6 The State's investments are managed within a risk management framework established through the *Borrowing and Investment Powers Act* 1987 and associated policy documents issued by the Department of Treasury and Finance. The framework is designed to ensure financial risks are contained, monitored and effectively managed by individual agencies, within an acceptable risk profile. It is the responsibility of each agency to establish relevant policies and procedures to comply with this risk management framework.

6.7 Table 6B details the key investment holdings of the State as at 30 June 2002 and movements in these holdings since the end of the previous financial year.

TABLE 6B
MAJOR INVESTMENT HOLDINGS (a)
(\$million)

<i>Agency</i>	<i>Investments 30 June 2002</i>	<i>Investments 30 June 2001</i>	<i>Movement between years</i>
Department of Treasury and Finance	2 438	1 922	516
Treasury Corporation of Victoria (b)	5 970	6 646	(676)
Transport Accident Commission	5 224	5 227	(3)
Victorian WorkCover Authority	4 935	4 748	187
Victorian Managed Insurance Authority	411	411	0

(a) Investments of the insurance agencies and the Treasury Corporation of Victoria are valued at net market values. Those held by the Department of Treasury and Finance are valued at the lower of cost and net realisable value.

(b) Includes cash investments but excludes cash at bank and on hand, and deposits with the Futures exchange. The Treasury Corporation of Victoria investments include \$2.3 billion of funds deposited by public sector agencies, public sector superannuation funds and the Budget Sector trust funds.

Source: Financial reports of the respective agencies.

6.8 The movements in investment balances in the year have resulted from the placement and redemption of funds throughout the year and unrealised gains or losses mainly arising from changes in the market value of equity investments. Specific reasons for major movements in investments, other than those associated with changing equity values, included:

- application of investment balances held by the Treasury Corporation of Victoria for payments made by State superannuation schemes under the Government's Beneficiary Choice Program, and for debt retirement purposes; and
- an increase in the Department of Treasury and Finance investments mainly attributable to the part allocation of Budget Sector cash surpluses to the "Growing Victoria" infrastructure initiative.

Impact of global downturn in equity markets

6.9 As detailed in Table 6C the State and its major investing agencies hold significant investments in domestic and international equities as part of their financial asset portfolios, in particular the major insurance agencies and the State Superannuation Fund.

TABLE 6C
INVESTMENTS HELD BY MAJOR AGENCIES
AT 30 JUNE 2002 (a)

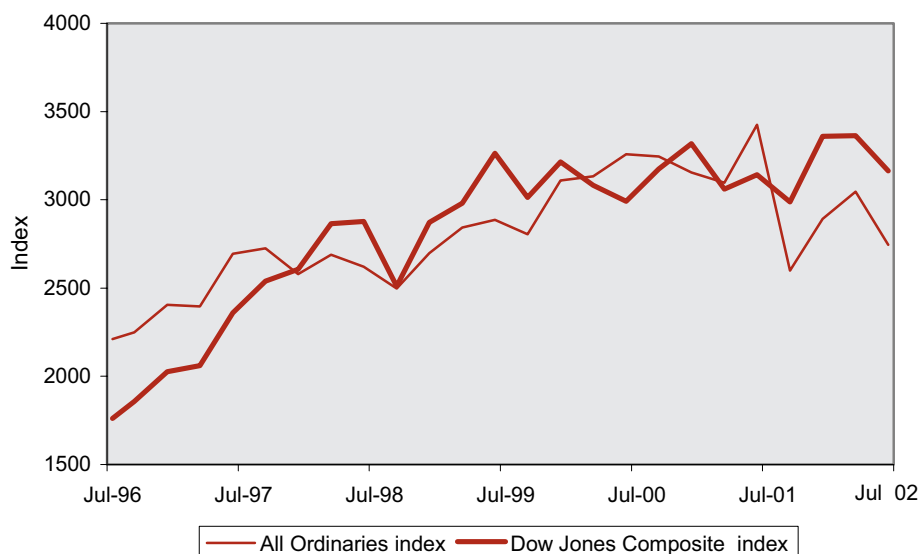
Type of investment	Transport Accident Commission		Victorian WorkCover Authority		Victorian Managed Insurance Authority		State Superannuation Fund	
	(\$m)	(%)	(\$m)	(%)	(\$m)	(%)	(\$m)	(%)
Domestic equities	1 401	27	1 607	33	138	33	2 161	36
International equities	1 256	24	1 187	24	103	25	1 142	19
Total equities	2 657	51	2 794	57	241	58	3 303	55
Other investments	2 567	49	2 141	43	170	42	2 704	45
Total investments	5 224	100	4 935	100	411	100	6 007	100

(a) All investments are shown at their market values.

Source: Financial investment reports of the respective agencies.

6.10 Equity investments are subject to the volatility of equity markets in the short to medium-term. However, over the longer-term, equity investments have provided significant returns to the above investing agencies through increasing share values. Chart 6D outlines the performance of the Australian (All Ordinaries index) and the United States (Dow Jones composite index) equity markets over a 6 year period.

CHART 6D
MOVEMENT IN THE ALL ORDINARIES AND DOW JONES COMPOSITE INDEX



Source: Victorian Funds Management Corporation.

6.11 Equity investments are held to fund longer-term liabilities, with the ultimate value of these investments crystallising upon their realisation. However, the short-term volatility in investment markets can significantly impact on the reported financial performance of investing agencies and consequently, the operating results of those agencies and the State in any one financial year.

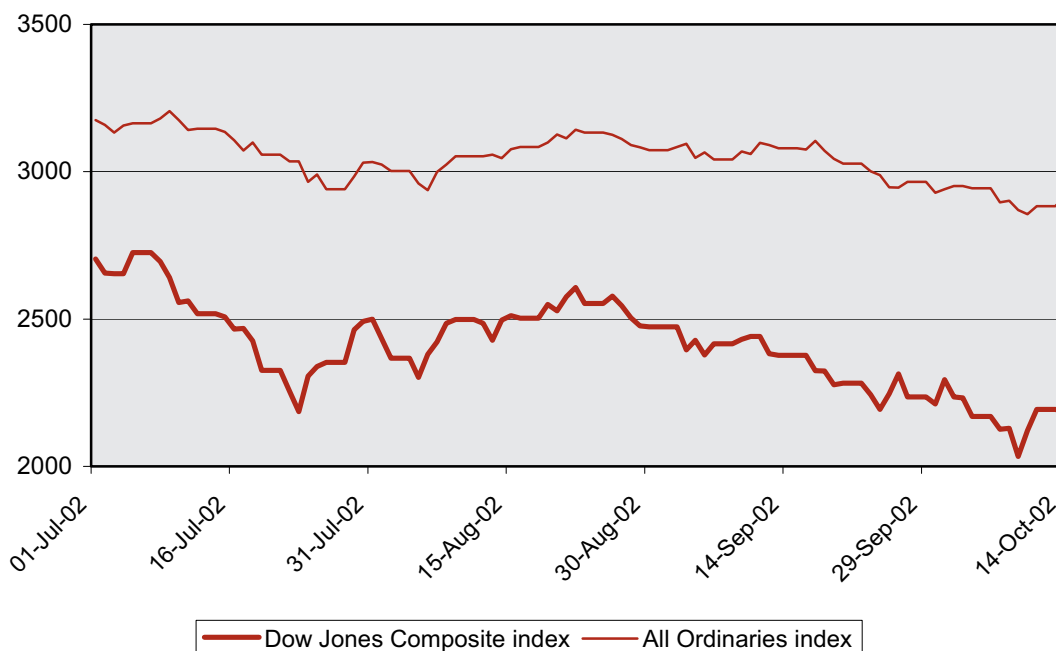
6.12 The impact of the downturn in the equity market has had a significant impact on the market value of investments held by public sector superannuation funds. While these investments are not recorded in the Annual Financial Report because they are not the assets of the State, the movement in the valuation of the portfolio has directly impacted on the State's liability for unfunded superannuation obligations. The impact on the State's unfunded superannuation liabilities is discussed in Part 7 of this report.



Australian Stock Exchange - equity trading screens.

6.13 Since 30 June 2002, equity markets have continued to experience significant volatility – as illustrated in Chart 6E.

CHART 6E
MOVEMENT IN THE ALL ORDINARIES AND DOW JONES COMPOSITE INDEX



Source: Victorian Funds Management Corporation.

6.14 As disclosed in the Annual Financial Report (based on the most recent valuation reports provided by investment fund managers) between 30 June 2002 and 30 September 2002 these adverse market conditions have resulted in a decrease in the value of the State's financial assets of around \$461 million and a further increase in the value of the State's unfunded superannuation liability of approximately \$384 million.

6.15 As required by Australian Accounting Standards, the impact of the downturn in equity markets subsequent to balance date (30 June 2002) is not recognised in the value of investments reported in the State's Consolidated Statement of Financial Position, but has been disclosed within note 35 (events subsequent to reporting date) in the Government's Annual Financial Report.

State's interest in the Snowy Mountains Hydro-Electric Scheme

6.16 In 1949, the Commonwealth Government established the Snowy Mountains Hydro-Electric Authority (SMHEA) under the *Snowy Mountains Hydro-electric Power Act 1949*, to investigate, design, construct, and subsequently operate the "Snowy Scheme". The Scheme, was completed in 1974, and consisted of an integrated system of dams, aqueducts and tunnels collecting, storing and diverting the headwaters of 3 catchments: the Murray, Murrumbidgee and Snowy Rivers.

6.17 In addition to the utilisation of the water for irrigation purposes, the water from the Snowy Scheme is used to generate electricity as it passes through a system of hydro-electric power stations. Today, the Snowy Scheme is the largest supplier of hydro-electricity in mainland Australia, providing approximately 5 per cent of south-eastern Australia's total energy requirements each year. The location of the Snowy Scheme between the Victorian, ACT and NSW markets, combined with its operating flexibility enables it to provide valuable backup services, which increase the reliability of electricity supply in these markets.

Management and ownership arrangements

6.18 Under the enabling Commonwealth Act and subsequent administrative arrangements, NSW was entitled to 58 per cent of the Scheme's electrical energy, Victoria 29 per cent and the Commonwealth Government 13 per cent. In 1997, a new company, Snowy Hydro Trading Pty Ltd (SHTPL), was established by the NSW Government and the State Electricity Commission of Victoria (SECV), as a joint venture, to trade electricity generated by the Snowy Scheme in the new national electricity market regime. The Commonwealth Government formally joined SHTPL in February 2000.

6.19 The SECV has been retained by the State as a "shell" to manage the remaining assets and obligations not allocated to the State's privatised electricity businesses. It is also responsible for managing the rights and obligations under electricity supply contracts relating to Victoria's power entitlement associated with the Snowy Scheme. **In 2001-02, the SECV received an annual distribution from SHTPL trading activities of \$38.8 million (2000-01, \$46 million).**

6.20 Following the establishment of SHTPL, legislation was passed by the NSW, Victorian and Commonwealth Parliaments to corporatise the Snowy Mountains Hydro-Electric Scheme to facilitate efficiencies across all core activities of SMHEA operations. The corporatised body, to be known as Snowy Hydro Limited (SHL), was to compete as an independent commercial business in the national electricity market. SHL would be licensed to collect and use water for electricity generation and release water to supply irrigators and environmental flow requirements.

6.21 **The ratio of ownership of SHL was based on the ratio of existing electricity entitlements** - specifically 58 per cent for New South Wales, 29 per cent for Victoria and 13 per cent for the Commonwealth Government. Under the provisions of the Shareholders Agreement, all the participating jurisdictions have equal voting rights. In addition, certain types of resolutions, including changes impacting on the nature and scale of SHL activities and wind-up provisions activities require unanimous agreement between the 3 jurisdictions.

Financial impact of corporatisation

6.22 In the past, SMHEA operated on a cost recovery basis which sought to meet its cost of operations and the repayment of loans associated with the construction of the Scheme. Since corporatisation, SHL is responsible for long-term planning and earning income through the sale of energy and related services. In April 2002, projection modelling covering a 5 year period from corporatisation concluded that SHL would:

- earn average annual profits over the next 5 years of around \$70 million, in nominal terms;
- provide average annual dividends to Victoria of around \$16 million over the next 5 years, in nominal terms; and
- result in Victoria having an interest in Shareholder's Funds of around \$236 million.

6.23 In May 2002, SMHEA had debts with a gross market value of around \$900 million. The debt comprised various loans and inscribed stock used to finance the building of the Snowy Scheme, which the Commonwealth Government, on corporatisation, consolidated into a single interim loan. The Commonwealth Government made the interim loan on the condition that SHL would refinance the loan within 12 months and that during that period NSW and Victoria would provide security for the debt. Under the arrangement, onerous financing margins apply if refinancing is delayed.

6.24 **Victoria has negotiated with the Commonwealth Government to provide a mortgage over its shares in SHL as a security for its portion of the debt.** Where refinancing is not achieved, SHL is required to pay all available cash to the Commonwealth Government to reduce the loan.

6.25 In order to provide a reasonable degree of certainty that the debt will be refinanced, the NSW and Victorian Governments have agreed to provide sufficient equity to ensure an appropriate credit rating to support the company's generation derivatives trading. Additional equity contributions are subject to negotiation for these purposes. Under the arrangement, Victoria's equity obligations do not cease if it ceases to be a shareholder.

6.26 Upon the proclamation of the Snowy Hydro Corporatisation Acts on 28 June 2002 the existing legislation was repealed, facilitating the transfer of SMHEA assets and the operations of SHTPL to SHL. The corporatisation arrangements also provide for Victoria to receive tax compensation from the Commonwealth Government for 75 years, based on the pre-corporatisation tax-free status amounting to \$6 million per annum.

6.27 SMHEA transmission assets were transferred to TransGrid, a NSW State-owned corporation at an agreed value of \$80 million with the proceeds used to retire SHL debt. In addition, the SECV's interest in hedging contracts entered into by SHTPL was transferred to SHL. Upon corporatisation, the assets held by SMHEA were valued by financial advisers and the 3 shareholders at \$1.59 billion based on projected cash flows of the assets, a reduction of around \$1 billion on the value of assets held at 30 June 2001. The net assets of SHL on 28 June 2002 were \$816 million.

6.28 As a result of the corporatisation, the State's interest in SHL, being 29 per cent of its net assets, was recognised in the Government's *Annual Financial Report* at a value of \$236.6 million. The key financial risks identified in our Report are not limited to Victoria, but shared between the 3 governments in proportion to their interest in SHL.

Environmental impacts

6.29 Under the corporatised arrangement, a joint NSW and Victorian Government Snowy Water Inquiry was required to be established to address environmental issues arising from the diversion of water from the Snowy River and other rivers in the region. Subsequently, a number of options were provided to the respective governments which defined the environmental operating conditions of the corporatised body.

6.30 A Heads of Agreement was entered into in December 2000 by the NSW, Victorian and Commonwealth Governments outlining arrangements to implement the findings from the Snowy Water Inquiry and to facilitate the corporatisation of SHL. In the Heads of Agreement, the Governments agreed, among other things, to achieve the following outcomes within a 10 year period:

- Total flows equivalent to 21 per cent of average annual natural flows in the Snowy River to be achieved. A further 7 per cent of water flows in the Snowy River may be achieved following implementation of a major capital works program, with contributions payable to SHL to compensate for all net revenue forgone resulting from the reduced availability of water flows; and
- Dedicated environmental flows allocated to the Murray River of 70 gigalitres per annum.

6.31 Under a subsequent Indemnity Deed, each Government has agreed to indemnify SHL in relation to any liabilities arising from increased flows made in accordance with a water licence established under the arrangements, provided SHL's claim on the respective Governments is made within 20 years of the date of corporatisation. The Governments have also agreed, for a period of 7 years from the date of corporatisation, to provide financial support to SHL to take steps to ensure that certain water pollution offences cease. The obligations of each Government under the indemnity are limited to its specified proportion of the amount claimable. In the event that Victoria ceases to be a shareholder in SHL, the liability under the Indemnity Deed does not cease.

6.32 The Heads of Agreement and subsequent agreements commit NSW and Victoria to each provide \$150 million and the Commonwealth Government \$75 million over a 10 year period to fund the activities and operations of a Joint Government Enterprise. The aim of the Enterprise is to acquire water at least cost, primarily through investing in water savings projects and, if necessary, through purchasing water entitlements and water rights.

Murray-Darling Basin Agreement

6.33 The legislation and Heads of Agreement for the Snowy Scheme are supported by around 38 legal documents covering numerous aspects of SHL operations. These include the Murray-Darling Basin Amending Agreement, implementing new arrangements for sharing water made available by the Snowy Scheme to the Murray River catchment above the Hume Dam. The Murray-Darling Basin Agreement was initially signed by the Commonwealth, NSW, Victorian and South Australian Governments in 1987, and revised in 1992, with Queensland becoming a signatory in 1996 and the ACT in 1998. Under the Agreement, the water is shared between NSW, Victoria and South Australia according to an agreement first developed in 1914. While certain details of the agreement have since changed, the principles upon which it is based remain the same.

6.34 To administer the Murray-Darling Basin Agreement, the State Governments and the Commonwealth Government established the Murray-Darling Basin Commission. The Murray-Darling Basin contains more than 20 major rivers as well as major water storage and diversion facilities. Infrastructure assets used for the storage and distribution of bulk water and for related activities have been constructed with funds provided by the Commission following contributions by the relevant Governments.

6.35 A valuation undertaken by the Commission during 1999-2000 valued these assets at \$1.6 billion, on a current replacement cost basis. However, the shares of the contributing States and Territories in these assets of the Murray-Darling Basin Commission have not been determined. Accordingly, as stated in note 1 to the Government's *Annual Financial Report* the State is not in a position to recognise its interest in these assets.

PHYSICAL ASSETS

6.36 The State's physical assets mainly comprise Crown and freehold land, buildings, roads, infrastructure systems, plant and equipment and cultural assets. Table 6F outlines the major movements during the 2001-02 financial year in the value of the State's physical assets.

TABLE 6F
STATE'S PHYSICAL ASSETS,
SUMMARY OF 2001-02 MOVEMENTS
((\$billion))

Opening balance – 1 July 2001	61.9
Revaluations	4.6
Disposals	(0.3)
Construction and purchases	2.6
Depreciation	(1.5)
Other	0.5
Closing balance – 30 June 2002	67.8

Source: Annual Financial Report for the State of Victoria, 2001-02.

6.37 The revaluation of non-current physical assets continues to be an important issue for effective accountability, decision-making, control and risk management of a significant public sector resource. Asset revaluations accounted for \$4.5 billion of the increase in the State's physical assets in the 2001-02 financial year. Included in this amount was the upward revaluation of the National Gallery of Victoria's works of art from \$614 million to \$1 790 million.

6.38 Commentary follows on certain transactions contributing to the movements in the State's physical asset base during the 2001-02 financial year.

Sale of the National Rail Corporation

6.39 The National Rail Corporation Limited (NRC) was incorporated in 1991 to operate interstate rail freight, with the objective of providing a catalyst for wider micro-economic reform of the rail industry. An agreement between the Commonwealth Government and all mainland Australian State Governments specified a 5 year establishment period, commencing in 1993, during which NRC would take over all of the interstate rail freight business conducted by the 5 separate State-based rail authorities. The shareholders of NRC were the Commonwealth Government and the Governments of New South Wales and Victoria.

6.40 During the establishment phase which concluded on 31 January 1998, the shareholders injected cash totalling \$406.5 million, with the Victorian Government contributing \$35.1 million, the Commonwealth Government \$295.8 million and the New South Wales Government \$75.6 million. NRC also obtained from Victoria rolling stock and terminal equipment valued at \$14.8 million, and a long-term lease of the South Dynon container terminal.

6.41 Over the course of the establishment period, the policy and competitive environment for NRC changed markedly as access to the rail network was opened up pursuant to National Competition Policy and various governments pursued privatisation of their transport business enterprises.

6.42 In November 1996, the Commonwealth Government announced its Rail Reform Package, which provided for the sale of its shareholding in NRC. However, the approval of the remaining shareholders for the Commonwealth Government to proceed with the sale was not obtained until mid-1997 and progress on the sale was further delayed due to negotiations regarding sale conditions.

6.43 In May 2000, the shareholders of NRC reached agreement to privatise the company by way of a trade sale of 100 per cent of their respective shares. A key condition of the sale required that other government-owned rail authorities be excluded from bidding for the shares of NRC. In September 2000, it was also announced that the New South Wales Freight Rail Corporation (trading as FreightCorp) would be sold as a separate business entity, but in parallel with the sale of NRC. (This latter decision reflected concern by the NSW Government that a privatised NRC could successfully bid for key FreightCorp contracts, leading to a decline in FreightCorp's viability prior to privatisation.)

6.44 In August 2001, the sale structure again changed with the Commonwealth Government and the Governments of New South Wales and Victoria announcing a combined sale of NRC and FreightCorp, whereby the 2 businesses would effectively be sold as one unit to a single purchaser. The key policy objectives outlined for this proposed sale were:

- to develop a commercially sustainable and competitive freight business, able to contribute to an efficient, competitive and viable domestic freight transport industry, recognising the inherent environmental benefits of rail transport; and
- to ensure quality freight services to customers in regional and rural Australia.

6.45 Expressions of interest for the joint sale of the entities were called for on 3 September 2001 and closed on 18 September 2001. Five parties were subsequently invited to participate at the request for tender stage, with final tender bids received on 14 January 2002.

Sale outcome

6.46 On 31 January 2002, the Commonwealth, New South Wales and Victorian Governments announced that NRC and FreightCorp would be sold to National Rail Consortium Pty Ltd, a company jointly owned by subsidiaries of Toll Holdings Limited and Lang Corporation Limited. The sale arrangements comprised:

- \$936 million cash proceeds for the purchase of the FreightCorp business (\$607.7 million) and NRC shares (\$328.3 million);
- the assumption by the purchaser of debt valued at \$118 million; and
- a commitment by the purchaser, valued at \$118 million, relating to the acquisition of rolling stock and the construction of grain handling facilities in New South Wales.

6.47 Victoria's share of the proceeds, totalling \$44.6 million, was received on the sale completion date of 21 February 2002. Table 6G outlines the composition of Victoria's proceeds.

TABLE 6G
COMPOSITION OF VICTORIA'S SHARE OF NRC PROCEEDS
((\$million))

Victoria's share of the cash proceeds (a)	43.3
<i>Plus adjustments</i>	
Compensation from the New South Wales Government for job guarantees (b)	0.4
Compensation for tax losses from the Commonwealth Government for tax losses (c)	0.9
Total proceeds	44.6

(a) Calculated as 13.2 per cent of proceeds of \$328.3 million for NRC shares based on Victoria's proportional shareholding.

(b) The New South Wales Government agreed to compensate the other shareholders for the potential reduction in sale proceeds arising from a 3 year restriction placed on the purchaser regarding forced redundancies. The restriction initially covered only FreightCorp employees, but was subsequently extended to NRC staff.

(c) The Commonwealth Government agreed to compensate other shareholders for the impact on proceeds of a restriction placed on the purchaser's right to utilise prior year tax losses.

6.48 The sale conditions also provided that the purchaser must continue the existing locomotive maintenance contract at the Spotswood maintenance facility located in Victoria until 2004 and, after that date, consult with the Victorian Government before seeking to terminate the maintenance contract.

State's infrastructure investment

6.49 The State's infrastructure is a complex network of public works, including roads, bridges, dams, education and health facilities, and utilities, which affects the everyday lives of all Victorians. Infrastructure projects can shape the future of a community, its economic growth and the quality of life.

6.50 Changing population patterns, a demand for quality and limited government funding have all placed pressure on the State's ageing infrastructure including water, roads, transport, health and education facilities. In recent years, the Government has attempted to address this issue through both direct allocation of public funds for infrastructure improvements and indirectly through the utilisation of the private sector for the financing and construction of infrastructure assets and the delivery of associated services traditionally provided by the public sector. The facilitation and the importance of private sector finance for public procurement is recognised in the Government's Partnership Victoria Policy.

"Growing Victoria" infrastructure reserve

6.51 As outlined in our previous *Reports on the Finances of the State of Victoria*, a major initiative of the Government, announced in the 2000-01 Budget, was the establishment of a \$1 billion "Growing Victoria" infrastructure reserve, funded from the 1999-2000 Budget surplus. These funds are to be applied towards infrastructure development over and above the capital expenditure funded through existing asset programs. The reserve was increased by an additional \$175 million during 2001-02, with a further budget of \$400 million approved for the 2002-03 financial year.

6.52 **Of the \$1 575 million allocated towards this reserve, \$1 363 million has been committed to various infrastructure projects. As at 30 June 2002, around \$209 million had been expended on approved projects.**

Regional Fast Rail Project

6.53 The Government's *Linking Victoria* initiative, launched in February 2000, provided the blueprint for over \$1.5 billion of transport infrastructure development to be undertaken across Victoria, including the Regional Fast Rail Project.

6.54 The Project aims to reduce passenger journey times between Melbourne and the regional centres of Ballarat, Bendigo, Geelong and the Latrobe Valley by undertaking infrastructure works that will allow trains to run at speeds of up to 160 kilometres per hour, or around 30 kilometres per hour above existing speed levels and obtaining trains capable of achieving such speeds. The infrastructure works will involve the upgrading of 500 kilometres of existing track, construction of new sections of track and installation of new signalling equipment. In addition, agreement was reached with the passenger public transport franchisee which services the 4 country rail corridors to introduce faster rolling stock than it was previously planning to introduce.

6.55 A feasibility study undertaken by external consultants, in September 2000, identified that nearly 6 million passengers are carried each year on the 4 rail corridors of Ballarat, Bendigo, Geelong and the Latrobe Valley. The study also identified that existing opportunities to improve travel times were limited by ageing rolling stock and rail infrastructure. **The feasibility study forecast that the Project would help overcome many of the obstacles to growth in regional Victoria and provide a major boost in terms of the State's economy, population, employment and quality of life. The Government estimated that the population for the 4 regions would increase by 21 000 over and above current growth projections as a result of the Project.**

Project feasibility study

6.56 As part of the feasibility study, the Government set maximum express journey travel time targets to be achieved for the 4 country rail lines based on a financial commitment by the Government for the Project of \$550 million. The Government also identified target express journey times for each of the rail corridors. Consultants were engaged to provide independent expert advice on the extent and cost of works necessary to achieve the various targeted travel times. Table 6H illustrates the estimated costs of the infrastructure upgrades in each of the corridors for the 2 options of achieving target express journey travel times or achieving maximum express journey times.

TABLE 6H
ESTIMATED JOURNEY TIMES (MINUTES) AND ESTIMATED COST

<i>Corridor</i>	<i>Target express journey times (a)</i>	<i>Maximum express journey times (a)</i>	<i>Current fastest express times</i>	<i>Expected time saving from maximum times</i>
Ballarat (minutes)	60	64	82	18
Bendigo (minutes)	80	84	101	17
Traralgon (minutes)	90	95	116	21
Geelong (minutes)	45	45	51	6
Total estimated cost (\$million)	\$810	\$550	n.a.	n.a.

(a) Ballarat and Bendigo journey times based on full express service; Traralgon journey times based on one stop at Dandenong; and Geelong journey times based on stops at North Melbourne and North Geelong.

Source: Department of Infrastructure.

6.57 The Department of Infrastructure advised that the journey times for trains that stop at all or some stations along the corridor will not be known until the final design for the entire track corridors is completed by March 2003. Given that the majority of current timetabled train services for these rails lines are not express, in particular peak hour services, the concentration of the feasibility analysis of the costs and benefits of the project predominantly on express journey times could be considered narrowly focused - not providing a meaningful analysis of the time savings potentially available to many of the passengers utilising the rail services in these corridors.

6.58 Following the feasibility study, the Government announced its intention to contribute \$550 million of the projected \$810 million cost that would be required to achieve the preferred target express journey time option. Accordingly, to deliver this option, the State would need to seek private sector investment to fund the additional \$260 million.

6.59 As part of preliminary steps to facilitate private sector investment, discussions were held with the lessee of the country rail track, Freight Victoria Limited, regarding the possibility of buying back the infrastructure lease agreement (entered into upon the sale of V/Line Freight Corporation in February 1999). However, the costs associated with both buying-back the infrastructure lease agreement and delivering the Project using this option were not pursued as it was not considered to offer value for money.

6.60 Subsequently, the Government elected to deliver the Project consistent with its existing funding allocation of \$550 million under a traditional public sector delivery model, confine the aim of the Project to meeting the less stringent maximum express journey times outlined in the above table, and not pursue private sector investment.

6.61 The State's commitment of \$550 million in nominal terms was intended to fund the full cost of the Project, including the infrastructure upgrade, the additional cost of bringing into service higher performance rolling stock and the incremental maintenance requirements.

Tender evaluation and selection process

6.62 Following the Government's approval for the Project, the Department of Infrastructure and the Department of Treasury and Finance jointly established the Rail Projects Group and allocated it responsibility for managing the evaluation of tenders received for the Project and recommending the successful bids to the Government.

6.63 In May 2001, the Rail Projects Group sought expressions of interest for the design, construction and delivery of the Metropolitan and Country Infrastructure Works Packages. Through the expression of interest process it was intended that 4 Country Infrastructure Works Packages would be let initially, followed by the Metropolitan Infrastructure Works Package at a later date. For each Country Infrastructure Works Package, the private sector participants were provided the flexibility to develop and bid for a scope of works that would provide the best journey time outcomes and optimal value for money within the specified standards. The Rail Projects Group received 9 registrations of interest by the closing date, July 2001.

6.64 The evaluation criteria used to assess the registrations of interest included general and project delivery capability, compliance and value capture opportunities. Of the 9 expressions of interest received, 2 of the respondents were assessed as not being in compliance with the project brief and consequently were considered unsuitable for short-listing. The remaining 7 respondents were assessed to have demonstrated their capability, expertise and experience in delivering the infrastructure upgrades. The Rail Projects Group shortlisted 3 of these parties for each of the Country Infrastructure Works Packages, which involved 5 separate respondents. In September 2001, the Secretary to the Department of Infrastructure approved the recommendations of the Rail Projects Group in relation to the short-listing selection process.

6.65 Subsequently, the short-listed respondents were issued with a Request for Tender for relevant Country Infrastructure Works Packages, with 3 tenders received in February 2002 for each of the Packages. The initial evaluation process revealed a number of strengths in the tender proposals but also highlighted shortcomings in all tenders. In order to rectify both the commercial and technical shortcomings, the best 2 tenderers for each corridor were invited to submit revised tenders by May 2002.

6.66 In June 2002, the Rail Projects Group ranked the Regional Rail Link consortium (consisting of John Holland Pty Ltd and Transfield Pty Ltd) on the Bendigo Infrastructure Works Package, and the Thiess/Alstom Joint Venture (consisting of Thiess Pty Ltd and ALSTOM Australia Ltd) on the Geelong Corridor as clearly ahead of the other tenders. Based on delivery capacity and risk, the Thiess/Alstom Joint Venture was also recommended for the Ballarat Works Infrastructure Package and Regional Rail Link was recommended for the Latrobe Valley Package.

6.67 In June 2002, the Government endorsed the Rail Projects Group recommendation of the preferred tenderer for each of the Country Works Infrastructure Packages. The current estimated project cost is \$556 million in nominal terms.

Design and construction

6.68 The successful contractors are to design and construct the upgraded rail infrastructure in accordance with the requirements of the contract and project brief. The design stage of the contract requires submissions by the contractors to the Department of Infrastructure for the preliminary corridor design, the final corridor design and the deferred design packages, to be completed within specified time frames from the date of signing the contract. The contractors are required to provide a security bond to the value of 5 per cent of the contract sum upon signing the contract and a further 5 per cent of the value of any payment certified by the Department of Infrastructure.

**CHART 6I
TRANSPORT CORRIDORS FOR THE REGIONAL FAST RAIL PROJECT,
AND SCHEDULED COMPLETION DATES**



Ballarat line scheduled to be completed 29 June 2005.

Bendigo line scheduled to be completed 28 October 2004.

Geelong line scheduled to be completed 19 February 2005.

Latrobe Valley line scheduled to be completed 22 March 2004.

Source: Department of Infrastructure.

6.69 The Department of Infrastructure and the current access provider for the regional train lines, Freight Victoria Limited trading as Freight Australia, have entered into an agreement in order to establish and agree a framework for ongoing co-operation in the delivery of the Project. In addition, Access and Occupation Agreements were entered into between the contractors and Freight Australia for each rail corridor, under which occupation of the tracks by the contractor is to be arranged directly between the contractor and Freight Australia, with payments for the track occupations to be made by the contractor to Freight Australia.

6.70 The contractors are also required to pay Freight Australia compensation suffered as a direct result of freight train delays or disruptions, and the associated costs of testing and commissioning the upgraded rail line. The contractors' liability to Freight Australia is limited to the payment of track occupation fees, testing and commissioning costs up to \$5 million and unlimited liability for freight train delay costs and the costs associated with ensuring the integrity of the rail infrastructure. For each track occupation overrun by the contractor, they are indebted to the Department of Infrastructure for specified liquidated damages.

6.71 In addition, under the Infrastructure Lease entered into at the time of the original franchising arrangement, Freight Australia is entitled to compensation from the State for certain losses suffered as a consequence of the Project, on a "no net gain/no net loss" basis. The State is, therefore, liable for the losses incurred by Freight Australia above those recoverable from the contractor.

6.72 If the contractor fails to meet provisional completion, 30 days after the milestone date, the contractor is liable for liquidated damages of \$20 000 per day, capped to a maximum of 5 per cent of the contract sum. The payment of liquidated damages is the State's sole damages remedy for any completion delays by the contractor prior to termination of the contract.

6.73 Under certain default events resulting from the contractor's actions, including failing to achieve provisional completion within a specified date, the Department of Infrastructure may terminate the contract. Where termination occurs, the contractor is entitled to be compensated for the value of works carried out, the cost of materials, plant and equipment ordered for the works, and reasonable demobilisation costs incurred.

6.74 Payments are to be made in accordance with approved milestones throughout the design and construction period.

6.75 Maintenance of the track in accordance with an Inspection and Maintenance Plan is to be undertaken by the current access provider, Freight Australia. Under the terms of the V/Line Passenger Access Agreement, Freight Australia is obliged to maintain the track in a condition which would allow V/Line Passenger to operate trains in line with pre-determined speeds for specified sections of the rail line. Any impact on costs of maintaining the track at a higher speed condition, up to 160 kilometres per hour, is to be negotiated between the Department and Freight Australia. However, the Department estimates savings in infrastructure maintenance costs over the life of the project.



Rail infrastructure is to be substantially upgraded as part of the Project.

6.76 It was originally expected by the Government that the Regional Fast Rail Project would be delivered through a combination of public and private sector financing, and would achieve certain targeted savings in journey times. Due to value for money considerations, the final arrangements do not involve private sector financing and are expected to deliver savings in journey times lower than those originally anticipated. The current estimated cost of this project is \$556 million in nominal terms.

RESPONSE provided by Minister for Finance

Fast Rail Link

Para. 6.57

Regional centres presently have a mix of express, semi-express and 'stopping-all-stations' services. A primary objective of the Fast Rail Project is to reduce the current express travel time, and for comparative purposes the greatest benefits flow when express travel times are reduced. That is, access to the Metropolitan areas from regional country areas, is greatly enhanced through the faster travel times. The Auditor-General has not acknowledged that the improved travel times flow to the semi-express and 'stopping-all-stations' services as well. Consequently, the project provides similar benefits to commuters along the fast rail corridors. It is incorrect to assert that the analysis was 'narrowly focused'.

RESPONSE provided by Minister for Finance - continued*Para. 6.76*

This Government acknowledges that the regional fast rail project, as originally planned, would be delivered through a combination of public and private sector financing and would achieve certain targeted savings in journey times.

Given the complex contractual arrangements set in place as a result of the previous Government's rail franchising and lease structure, the opportunities for private sector investment are extremely limited. Consequently, the Government has made a decision that expenditure be limited to the public sector component of \$556 million.

Part 7

Liabilities, commitments and contingencies

AGGREGATE LIABILITIES OF THE STATE

7.1 The Government's *Annual Financial Report* details liabilities of the State totalling \$47.7 billion at 30 June 2002, a decrease of \$3.5 billion compared with the previous year. This decrease was mainly due to reductions in payables of \$4.1 billion (mainly due to the maturity of derivatives in the year) and interest-bearing liabilities of \$1.8 billion, partially offset by an increase in unfunded superannuation liabilities of \$1.5 billion and outstanding insurance claims of \$491 million.

7.2 Table 7A illustrates the composition of the State's liabilities at 30 June 2002.

TABLE 7A
COMPOSITION OF STATE LIABILITIES
(billion)

<i>Type of liability</i>	<i>Total June 2002</i>	<i>Total June 2001</i>
Unfunded superannuation liabilities	13.4	11.9
Interest-bearing liabilities	13.1	14.9
Outstanding claim liabilities	10.7	10.2
Payables	5.0	9.1
Employee entitlements	2.7	2.5
Other liabilities	2.8	2.6
Total State liabilities	47.7	51.2

Source: Annual Financial Report for the State of Victoria, 2001-02.

7.3 In addition to the liabilities outlined in the above table, the State also has quantifiable and non-quantifiable contingent liabilities. These contingent liabilities represent potential commitments, the occurrence of which is dependent on future events or outcomes. **Quantifiable contingent liabilities were estimated at around \$1.8 billion at 30 June 2002** (\$1.7 billion, 30 June 2001).

7.4 The most significant quantifiable contingent liabilities relate to the value of correctional services to be provided by the private sector, beyond the initial 5 year contract period, and lease payments on new rail rolling stock if early termination of public transport rail franchise agreements eventuated. The major non-quantifiable contingent liabilities include those associated with contracts and agreements for the Melbourne 2006 Commonwealth Games, the provision of public transport services by private sector operators and the redevelopment of the Melbourne Cricket Ground.

7.5 The State has also entered into various arrangements giving rise to operating, capital and other commitments. These do not form part of the liabilities included in the Government's Consolidated Statement of Financial Position as the relevant goods or services had not been received or consumed at balance date.

7.6 The aggregate value of these commitments was estimated at \$13.2 billion at 30 June 2002 (\$13.3 billion, 30 June 2001) including:

- operating lease commitments (\$9.4 billion);
- capital commitments associated with works not performed under existing contracts (\$1.9 billion); and
- other commitments arising from commercial arrangements (\$1.9 billion).

UNFUNDED SUPERANNUATION LIABILITY

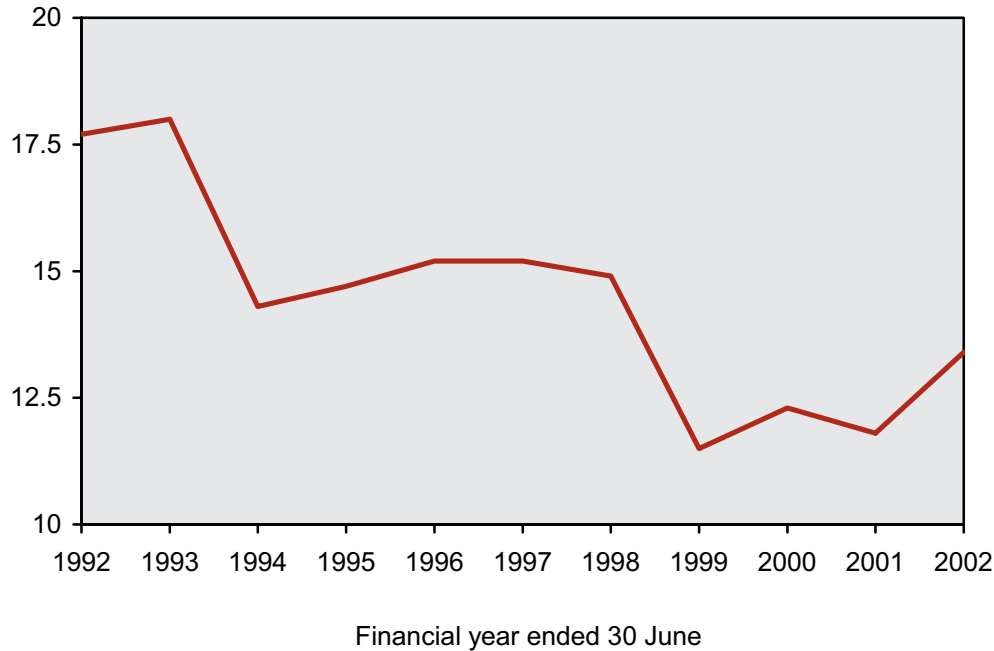
7.7 At 30 June 2002, the State's unfunded superannuation liability was the largest component of the State's liability portfolio. The liability represents employer superannuation contributions yet to be paid by the Government to superannuation schemes for services previously provided by government employees net of the market value of assets held by the respective superannuation funds. The value of the unfunded liability is based on actuarial assessments undertaken as at 30 June each year.

7.8 The liability has resulted from decisions of previous governments to progressively meet the employer share of superannuation benefits when, or after, employees retire (i.e. on a "pay-as-you-go" basis) rather than as benefit entitlements accrue over the working lives of employees. These "pay-as-you-go" schemes were progressively closed to new members by 1994. Approximately 99 per cent of the State's unfunded superannuation liability is attributable to the State Superannuation Fund.

7.9 The Government's *Annual Financial Report* disclosed an unfunded superannuation liability of \$13.4 billion as at 30 June 2002 (\$11.9 billion, 30 June 2001).

7.10 Chart 7B shows the movement in the level of the State's unfunded superannuation liability since 1992.

CHART 7B
MOVEMENT IN THE STATE'S UNFUNDED
SUPERANNUATION LIABILITY (a)
 (\$billion)



(a) All figures are presented in nominal values.

Source: Annual Financial Report for the State of Victoria, 2001-02.

7.11 During the 2001-02 financial year, the State's unfunded superannuation liability increased by \$1.5 billion. This substantial deterioration was largely attributable to:

- Negative investment returns of 5.03 per cent for the State Superannuation Fund (SSF) and 2.98 per cent for the Emergency Services Superannuation Scheme (ESSS) primarily attributable to the downturn in world equity markets. These negative returns were the major factor contributing to a reduction of approximately \$1.1 billion in the value of superannuation assets held by the Funds;
- Changes to actuarial assumptions, including an increase in the assumed proportion of Revised Scheme members opting to resign between ages 54 and 55; and
- Higher than projected member salary increases.

7.12 These negative factors were partially offset by the favourable impact on the unfunded superannuation position of the Beneficiary Choice Program of \$170 million in the 2001-02 financial year, and an additional contribution of \$250 million made to the State Superannuation Fund by the Government, representing the early payment of an amount that would normally have been paid in the 2002-03 financial year.

7.13 The most recent actuarial projections indicate that the State's unfunded superannuation liability will peak in nominal terms at \$13.9 billion in 2011 and then gradually reduce until the liability is eliminated by 2035. To meet this time frame, the State makes annual payments determined on the basis of actuarial advice. Should the State also continue to make additional contributions, the unfunded liability may be fully extinguished prior to the current projection of 2035.

Beneficiary Choice Program

7.14 In late 2000, the *Superannuation Acts (Beneficiary Choice) Act 2000* was passed by Parliament, providing the Boards of the Government Superannuation Office and the Emergency Services Superannuation Scheme with the authority to implement a commutation program referred to as the Beneficiary Choice Program (BCP).

7.15 The BCP provided pensioners and deferred beneficiaries of the State Superannuation Fund and the Emergency Services Superannuation Scheme with the opportunity to commute their pension benefits to lump sums. Under the BCP, current active members of the Funds will also, upon retirement or resignation, be able to have their entire benefit paid as a lump sum. Prior to the introduction of this legislation, upon retirement members of certain schemes within the Funds were only entitled to commute a maximum of 50 per cent of their pension to a lump sum benefit.

7.16 Under the BCP, eligible deferred beneficiaries could elect to fully commute their benefits by specified dates, ranging from mid-February 2001 to early November 2001. It is estimated that commutation offers were made to approximately 54 000 pensioners and 32 000 deferred beneficiaries. This option continues to apply to approximately 73 000 existing members.

7.17 At the close of the final election period, 35.4 per cent of pension fund members elected to commute half or their entire pension to a lump sum (25.7 per cent opting for full commutation and 9.7 per cent opting for 50 per cent commutation). Approximately 29 per cent of deferred beneficiaries elected to commute their deferred benefit to a lump sum which was then transferred to a superannuation fund of their choice.

7.18 As a result of the acceptance rate by members for this offer, the BCP has had a beneficial impact on both the unfunded superannuation liability and the Government's long-term contribution requirements.

7.19 **The overall reduction to the State Superannuation Fund's unfunded liability arising from the BCP over the past 2 years was \$538 million, with \$368 million in savings occurring in the 2000-01 financial year and a further \$170 million in the 2001-02 financial year. The BCP has also led to total savings to the Emergency Services Superannuation Scheme of around \$43 million in the 2000-01 and 2001-02 financial years.**

Funding position of the Emergency Services Superannuation Scheme and other State schemes

7.20 In recent years, we have commented on the funding position of the Emergency Services Superannuation Scheme (ESSS). **The Scheme moved from a net surplus position of \$275 million as at 1 July 2001 to a net deficit position of \$70 million as at 30 June 2002.**

7.21 Table 7C discloses the key employing agencies with an excess or shortfall of net assets relative to their portion of the superannuation liability within the Scheme.

TABLE 7C
SUPERANNUATION ASSETS IN EXCESS OF (DEFICIENCY OVER)
ASSOCIATED SUPERANNUATION LIABILITIES
30 JUNE 1999 TO 30 JUNE 2002
(\$million)

<i>Related agency</i>	<i>30 June 1999</i>	<i>30 June 2000</i>	<i>30 June 2001</i>	<i>30 June 2002</i>
State Electricity Commission of Victoria	66	58	53	35
Ambulance Service Victoria	49	64	60	30
Country Fire Authority	42	52	50	34
Metropolitan Fire and Emergency Services Board	56	69	63	14
Victoria Police	(398)	20	47	(184)
Other	-	3	2	1
Total	(185)	266	275	(70)

Source: ESSS financial reports.

7.22 As illustrated in the table, the surplus position of all key employer entities reduced significantly during the year. In particular, the **Victoria Police funding position deteriorated by \$231 million, moving from a surplus position of \$47 million at 30 June 2001 to a deficit position of \$184 million at 30 June 2002.** The actuary of the ESSS attributed the deterioration in the ESSS to negative investment returns earned over the past 12 months and the payment of contributions at recommended rates that were lower than the contribution rates required in the longer-term. In particular, around 17 per cent of the overall deterioration for Victoria Police was attributed to salary increases (including promotions) exceeding the assumed rate of salary growth per annum of 3.5 per cent used in actuarial assessments.

7.23 To reduce the deficit, the Board of the ESSS resolved to increase the employer contribution rate for Victoria Police from 1 July 2003. In addition, the Board is focusing on reducing the volatility of both investment returns and employer contribution rates by setting an investment objective more closely correlated to the actuary's current liability assumptions.

7.24 In addition, the Parliamentary Contributory Superannuation Fund also moved from a surplus position of \$13.1 million in 2000-01 to a deficit of \$5.2 million as at 30 June 2002 due mainly to a reduction in investment returns.

INTEREST-BEARING LIABILITIES

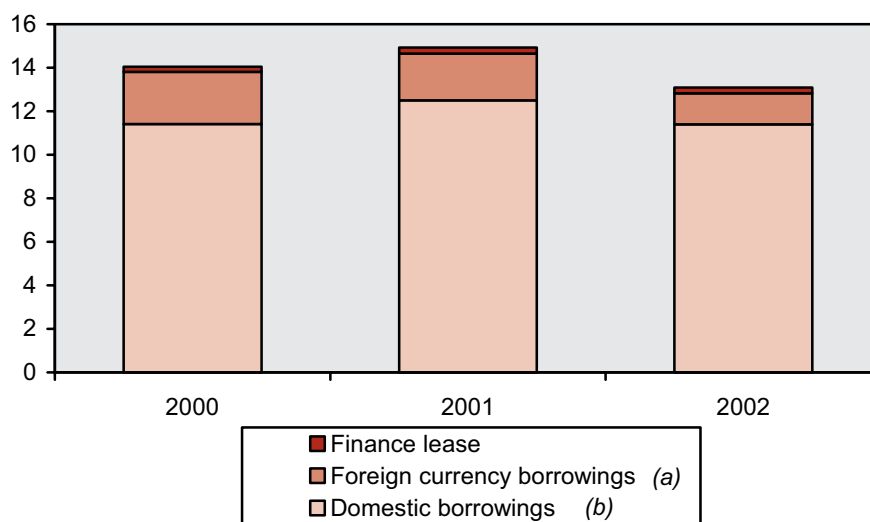
7.25 Interest-bearing liabilities of the State predominantly comprise public sector debt raised domestically and overseas, loans and advances from the Commonwealth Government and finance leases entered into by various public sector agencies.

7.26 At 30 June 2002, the State's interest-bearing liabilities, totalled \$13.1 billion, a reduction of \$1.8 billion compared with \$14.9 billion at 30 June 2001. The State's interest-bearing liabilities represented 7.2 per cent of Victoria's Gross State Product as at 30 June 2002, compared with 8.7 per cent as at 30 June 2001.

7.27 The decrease in interest bearing liabilities was largely due to the draw-down during the financial year of around \$1.2 billion of deposits by the State Superannuation Fund held by the Treasury Corporation of Victoria to meet lump sum payments associated with the Beneficiary Choice Program, and debt retirements.

7.28 Chart 7D illustrates the movement in interest-bearing liabilities for the financial years 2000 to 2002.

**CHART 7D
INTEREST-BEARING LIABILITIES,
30 JUNE 2000 TO 30 JUNE 2002
(\$billion)**



(a) Foreign currency borrowings represent borrowings issued in currencies other than Australian dollars.

(b) Domestic borrowings include Australian currency denominated borrowings issued in overseas markets.

Source: Annual Financial Reports for the State of Victoria.

Management of the State's debt

7.29 The Government's current objectives for debt management include:

- The application of budget surpluses to the acquisition of financial assets, thereby reducing the net debt of the State, rather than being directly applied to the retirement of existing debt;
- ensuring that the State maintains ready access to low-cost funding to finance government obligations;
- reducing the State's exposure to interest rate volatility; and
- maintain a well functioning market for the State's debt securities.

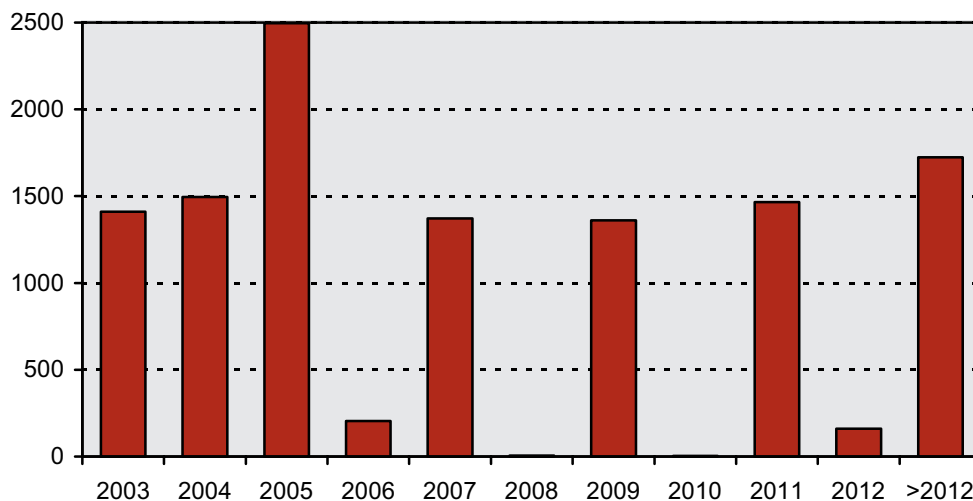
7.30 The State manages risks associated with its debt portfolio by borrowing from both domestic and overseas markets, issuing a mix of fixed rate, floating rate and inflation-indexed debt, and managing the maturity profile of its debt portfolio. The State's central borrowing authority, the Treasury Corporation of Victoria, manages virtually all of the State's debt portfolio and related risk management activities.

7.31 The State's exposure to market, liquidity and foreign exchange risks is managed by using both physical and derivative financial instruments. The majority of these derivatives were undertaken to manage currency and interest rate exposures. The State's foreign currency denominated borrowings are hedged into Australian dollars as protection from financial losses arising from movements in foreign exchange rates. The State does not maintain any material net foreign currency exposures. At 30 June 2002, the book value of payables relating to derivatives held totalled \$2.5 billion, while the book value of receivables under derivatives was \$2.6 billion.

State debt maturity profile

7.32 The State issues various debt instruments with terms to maturity ranging up to 30 years. Chart 7E illustrates the maturity profile of the State's debt (excluding debt associated with deposits lodged by public sector agencies with the Treasury Corporation of Victoria) as at 30 June 2002.

CHART 7E
STATE DEBT MATURITY PROFILE FOR THE NEXT 10 YEARS,
AS AT 30 JUNE 2002 (a)(b)
 (\$million)



(a) Face value of debt.

(b) Excludes debt associated with deposits lodged by public sector agencies with the Treasury Corporation of Victoria.

Source: Treasury Corporation of Victoria.

7.33 The State's exposure to risk arising from the repayment and/or refinancing of matured debt, is mitigated by maintaining a spread of debt along the maturity spectrum. As illustrated in the above chart, **\$1.4 billion of core debt will fall due for repayment in the 2002-03 financial year.**

OUTSTANDING CLAIMS LIABILITIES

7.34 The level of the State's outstanding claims liabilities increased by \$491 million (4.8 per cent) during the year to \$10.7 billion at 30 June 2002. The majority of these obligations are managed by the Victorian WorkCover Authority (personal workplace injury), Transport Accident Commission (motor vehicle and public transport personal injury), and the Victorian Managed Insurance Authority (participating public sector agencies insurance cover).

7.35 The liabilities for outstanding claims relating to each of these insurance entities at 30 June 2002 are detailed in Table 7F.

TABLE 7F
COMPOSITION OF OUTSTANDING CLAIMS LIABILITIES, AT 30 JUNE
((\$million))

Entity	Current	Non-current	Total	
			2002	2001
Victorian WorkCover Authority	984	4 890	5 874	5 622
Transport Accident Commission	629	3 661	4 290	4 082
Victorian Managed Insurance Authority	71	381	452	408
Other agencies	15	27	42	55
Total outstanding claims liabilities	1 699	8 959	10 658	10 167

Source: Financial reports of the respective agencies.

7.36 Over the past 6 years, the State's outstanding insurance claims liabilities have increased by 60 per cent, as reflected in Table 7G. The factors contributing to the overall increase in these liabilities include the impact of an increasing number of claims, reflecting the maturing nature of the schemes, rising claims costs for medical, legal, rehabilitation and settlement expenditure, and the higher number of motor vehicle and workplace accidents resulting in serious injury that have led to costly claims.

TABLE 7G
SUMMARY OF TOTAL OUTSTANDING CLAIMS LIABILITIES,
30 JUNE 1997 TO 30 JUNE 2002
((\$million))

Entity	1997	1998	1999	2000	2001	2002
Victorian WorkCover Authority	3 538	3 930	4 384	4 940	5 622	5 874
Transport Accident Commission	3 006	3 259	3 348	3 499	4 082	4 290
Victorian Managed Insurance Authority	83	96	229	300	408	452
Other agencies	11	18	32	32	55	42
Total outstanding claims liabilities	6 638	7 303	7 993	8 771	10 167	10 658

Source: Financial reports of the respective agencies.

7.37 The overall rate of increase in these liabilities during 2001-02 of 4.8 per cent was substantially less than in any other year over the previous 6 year period, mainly reflecting the positive effect of management initiatives in relation to common law claims at the Victorian WorkCover Authority and the long-term injury claims of the Transport Accident Commission.

7.38 Despite achieving a reduction in the rate of increase in claims liabilities, operating losses were incurred by all 3 State-owned insurance entities reflecting the significant downturn in investment returns.

7.39 The Victorian WorkCover Authority does not presently hold sufficient assets to cover its liabilities, with an excess of liabilities over assets of \$781 million as at 30 June 2002, following an operating loss of \$98 million for the 2001-02 financial year, and an operating loss of \$260 million for the 2000-01 financial year. While the Transport Accident Commission and the Victorian Managed Insurance Authority have positive net asset positions, deterioration in the financial position of these entities did occur during the 2001-02 financial year.

Understanding the uncertainty in actuarial assessments

7.40 The methodology used to determine the value of outstanding claims liabilities is essentially the same for the 3 insurance entities and accords with professional requirements including Australian Accounting Standards. External independent actuaries undertake full assessments at June and December each year, which support the preparation of financial statements at those dates.

7.41 The actuarial assessments cover claims reported but not paid and claims incurred but not reported. In assessing the outstanding liabilities, the actuaries take into account projected inflation rates to arrive at expected future payments, based on prior years' claims experience, which are then discounted to present values using a combination of risk-free and market-adjusted rates. Allowance is then made by the actuaries for the anticipated costs of settling the claims. The economic assumptions for 2001-02 were generally consistent with those of the previous year.

7.42 The extent of the "tail" for the State's insurance obligations is indicated by the "weighted average expected term to settlement" for claims, which varied at 30 June 2002 from 5.4 years in the case of the Victorian WorkCover Authority to 6.6 years for the Victorian Managed Insurance Authority and 9.7 years for the Transport Accident Commission. These average settlement terms differ from the previous year, reflecting the growth trends associated with seriously injured claimants and the maturing of the stock of claims.

7.43 The Australian Prudential Regulatory Authority has advocated the use of "prudential margins" where there is a significant level of uncertainty in actuarial estimates, as is experienced with "long tail" insurers such as the State's insurance authorities.

7.44 The decision on whether to incorporate a prudential margin and the quantum of such a margin is made by each insurance entity's governing board. For the Victorian WorkCover Authority, no prudential margin is included in the actuarial assessment and reliance is placed on the "central" or "best" estimate arrived at by the actuaries to adequately reflect the inherent uncertainty in the estimation process. The prudential margin for the Transport Accident Commission and the Victorian Managed Insurance Authority at 30 June 2002 totalled \$629 million, and effectively represented 13.3 per cent of their combined outstanding claims liability of \$4.7 billion.

7.45 The Department of Treasury and Finance has indicated that it is considering the adoption of prudential guidelines for the State public sector insurance entities along similar lines to that promoted by the general insurance regulator.

PAYABLES AND OTHER LIABILITIES

7.46 At 30 June 2002, payables and other liabilities, totalled \$7.8 billion, an overall decrease of \$3.9 billion compared with the previous year. This reduction was mainly attributable to a decrease in liabilities associated with derivatives which matured in the year. As there was also a reduction in the State's receivables associated with derivatives, these reductions had a minimal effect on the State's net asset position.

7.47 Comments on other major transactions impacting on payables and other liabilities during 2001-02 and future financial years are outlined in subsequent paragraphs.

Remaining financial obligations of the SECV

7.48 Our previous reports to Parliament have commented on the disaggregation and assumption of the remaining assets and obligations of State entities involved in the electricity, gas and port industries and the resultant effect on the financial operations and position of the State Electricity Commission of Victoria (SECV). An administrator is responsible for the management and, where appropriate, the disposal of the remaining assets and the resolution of the obligations retained by the SECV following the disaggregation.

7.49 Significant transactions in the financial year relating to the SECV have included:

- partial sale of Loy Yang 3-4 Bench site in August 2001 for \$490 000; and
- transfer of the SECV interest in hedging contracts entered into by Snowy Hydro Trading Pty Ltd to the newly corporatised Snowy Hydro Limited in which the State holds a 29 per cent interest.

7.50 At the date of preparation of this report, the remaining key obligations of the SECV included:

- administration of the flexible electricity tariff arrangements relating to the Portland and Point Henry aluminium smelters;
- management of the State's 29 per cent interest in Snowy Hydro Limited; and
- involvement in the defence as a cross-respondent in litigation arising from the class action concerning the Longford gas incident in October 1998.

Flexible electricity tariff arrangements

7.51 My previous *Reports on the Finances of the State of Victoria* have outlined the flexible electricity tariff arrangements established by the Government in 1984 in relation to the Portland and Point Henry aluminium smelters, which have imposed significant financial obligations on the State. Under the arrangements, the SECV is responsible for meeting the Government's obligation to subsidise electricity generators for the lower prices charged to the smelters when aluminium prices fall below a stipulated level.

7.52 To reduce the State's exposure associated with the smelter contracts, the SECV entered into a hedge arrangement and introduced, in July 1997, a levy payable by wholesale electricity market participants. The levy is collected and applied by the SECV towards the funding of future expected losses under the flexible electricity tariff arrangements.

7.53 Net payments made by the SECV under the smelter contracts during the 2001-02 financial year totalled \$101 million (2000-01, \$150 million). The SECV's obligations and rights arising from the smelter contracts and the energy levy are assessed at the end of each financial year using a valuation model. The valuation model takes into account developments in the electricity market and changes to underlying assumptions, in particular future aluminium and electricity prices, foreign exchange rates, discount rates and consumer price index forecasts.

7.54 The estimated value of the energy levy and the smelter contracts as at 30 June 2002 is outlined in Table 7H. The energy levy represents the sum of the cash inflows of levies to be received in the future and the smelter contracts are the sum of future cash outflows for the remaining term of the smelter contracts.

TABLE 7H
ENERGY LEVY RECEIVABLE AND SMELTER CONTRACTS
LIABILITY, AS AT 30 JUNE 2002 (a)
(\$million)

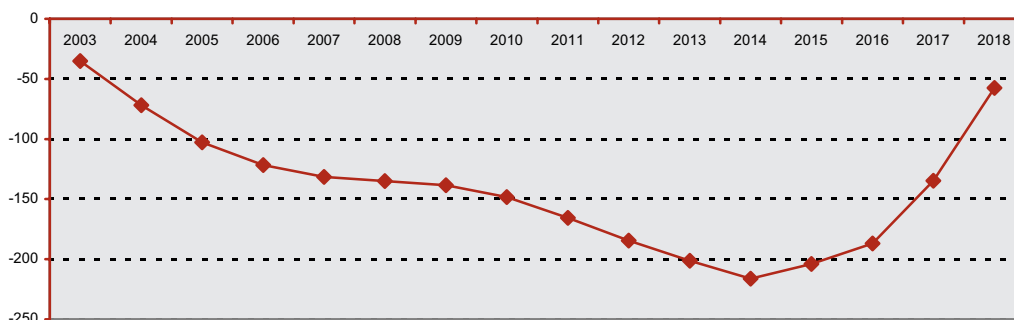
	2002
Energy levy receivable	1 193.6
Smelter contracts liability	1 251.0
Deficit	57.4

(a) Net present values.

Source: State Electricity Commission of Victoria.

7.55 As indicated in the above table, it is expected that, **the State will incur a loss of \$57.4 million for the remaining duration of the smelter contracts.** The cumulative net cash outflow position for the remaining 16 years of the smelter contract is illustrated in Chart 7I. Under current projections, the State will have net cash outflows in each year until 2014, but is expected to have net cash inflows thereafter.

CHART 7I
CUMULATIVE NET CASH FLOW POSITION (NET PRESENT VALUE)
 (\$million)



Source: State Electricity Commission of Victoria.

Longford gas incident

7.56 In May 1999, a class action against Esso Australia Pty Ltd and Esso Australia Resources Pty Ltd (together Esso) was initiated on behalf of gas users and stood-down workers who suffered losses during the fire and explosion at the Longford plant in September 1998. The SECV, together with VENCORP, Gascor Pty Ltd and certain other public sector entities have been named as third parties in this class action.

7.57 In August 2001, Esso initiated proceedings against the SECV and various other cross-respondents, for contributions and indemnity. The SECV along with certain other public sector agencies named as third parties in the class action have issued fourth party claims against their insurers for indemnity, and against BHP Petroleum (Bass Strait) Pty Ltd for contributions and indemnity.

7.58 The defence of this matter is being centrally managed through the Department of Treasury and Finance on behalf of State entities named as third parties. The first trial commenced in the Victorian Supreme Court in September 2002 in which certain threshold issues were heard. At the date of preparation of this report, no other significant developments have emerged from the legal proceedings.

7.59 This claim is recognised in the Government's *Annual Financial Report* as a non-quantifiable contingent liability.

Restructuring of housing home loan scheme

7.60 In June 2002, the Government announced a Home Loan Support Package offering financial support to people who took out various types of government home loans between 1984 to 1996. Over that period, the Government provided several types of loan products to people on low to moderate incomes who were not able to obtain access to private sector home finance. Due to the impact of changes in interest rates, loss of income and other economic factors, many recipients have experienced difficulties in meeting repayment terms for these loan liabilities. **Of around 25 000 loans that were provided in the period since 1984, just under 4 689 remained in the portfolio as at 30 June 2002, with an estimated value of \$203 million.**

7.61 The financial support contained in the Government's Package includes:

- Enhanced hardship support measures, such as not charging interest where an outstanding loan balance may exceed the value of the property;
- Improved sharing of home ownership costs between co-owners and the Director of Housing under shared home ownership arrangements. Many co-owners will also receive improved rent subsidies; and
- Support for borrowers wishing to exit loans by offering alternative housing options and a write-off of any loan amount in excess of the net sale proceeds from a property.

7.62 The cost of the Package is estimated at \$85 million over a 20 year period. This includes direct cash outlays, income forgone and the write-off of loan balances.

Car fleet financing arrangements

7.63 Our 1996-97 *Report on the Government's Annual Financial Statement* outlined an arrangement under which the Minister for Finance in July 1997 entered into a 7 year Master Lease Agreement (MLA) with the Commonwealth Bank of Australia (CBA), involving the sale and leaseback of the Budget Sector vehicle fleet. At that time, the State sold and leased back approximately 7 200 vehicles, with the sale proceeds of \$168 million paid into the Consolidated Fund.

7.64 Under the terms of the MLA, the State is required to fund any shortfall, between the value of motor vehicles sold at the end of a lease term and the previously agreed residual value of the motor vehicles via increased rentals on new leases. Alternatively, if there is a profit associated with these transactions, the State is to obtain the benefit at the expiry of the lease facility. These transactions are recorded in a "Profit and Loss Adjustment Account" (PLAA) maintained by the Department of Treasury and Finance.

7.65 As commented in our November 2001 *Report on the Finances of the State of Victoria*, there has been a gradual accumulation of a deficit in the PLAA. The Department attributes the significant growth of the deficit in the PLAA to the downward movement in used car prices as a result of the introduction of the Goods and Services Tax. **At 30 June 2002, the Department estimated the aggregate loss associated with vehicle disposals under the leasing arrangement to be \$63.6 million, which will be progressively realised over the remaining term of the lease arrangement.**

7.66 In September 2001, the Department engaged consultants to conduct a high level review of the current vehicle fleet management and financing arrangements. The review, completed in October 2001, found that under the current fleet management arrangements the Government appears to pay more and receive less service when compared with best practice fleet management services.

7.67 At the time of preparation of this report, the Government was in the process of finalising proposed action in relation to the findings of the review.

St Vincent's Hospital redevelopment

7.68 Our previous *Reports on the Finances of the State of Victoria* have commented on the financial arrangements entered into by the Victorian Government in 1991 to finance the redevelopment of St Vincent's Hospital, which is owned by the Sisters of Charity religious order. The redevelopment commenced in January 1993 and was completed in October 1995 at a cost of \$144.3 million.

7.69 The redevelopment was initially funded from a combination of borrowings raised by St Vincent's Hospital (Melbourne) Ltd and equity finance provided by 2 major Australian private banks. Ownership and use of the redevelopment is governed by a series of leasing arrangements.

7.70 Under the complex financing arrangements established for the redevelopment, the Hospital had ongoing obligations in relation to repayment of the borrowings and payment of lease rentals. In particular, arrangements provided for:

- **Borrowings** - The Hospital to raise an amount of \$80 million through the issue of annuity indexed bonds, which was on-lent to the Trustees of the Sisters of Charity of Australia. The Trustees, in turn, on-lent \$62.9 million to certain banks from the proceeds of the bond issue, to be used for financing the redevelopment. The arrangements in regard to the servicing of the obligations to the bondholders provided for:
 - funding from the Department of Human Services to the Hospital under a 25 year Health Services Agreement to include an annual grant of \$7 million, indexed annually, to be used by the Hospital to make the principal and interest payments to the bondholders; and
 - any excess of grant moneys, following payments to bondholders, to be held by the Hospital in a reserve account to meet certain additional costs associated with the arrangements, with any unspent amount reverting to the Treasurer of Victoria at the expiry of the leasing arrangements; and
- **Lease obligations** - Ownership of the redevelopment to initially reside with the banks. Under a finance lease arrangement the Trustees leased the redevelopment from the banks and, in turn, sub-leased the redevelopment to the Hospital.

7.71 The Treasurer of Victoria, under the provisions of the *Health Services Act 1988*, guaranteed all repayments to bondholders and indemnified the Hospital against default by the Department in making payments for public hospital services under the 25 year Health Services Agreement. The indemnity was assigned to the benefit of the banks, therefore, ensuring that sufficient funds were available to the Hospital to meet the financial obligations to the banks.

7.72 The original arrangements governing the ownership and use of the redevelopment involved leasing agreements which provided for:

- ownership of the redevelopment to rest with the banks for the first 15 years of the arrangement and then to pass to the Trustees following the payment of a compensation amount sufficient to discharge the outstanding bank obligations;
- the Trustees to apply \$6.7 million of the proceeds from the issue of bonds to purchase a zero coupon bond with a face value of \$28 million maturing in December 2007, and to use the proceeds from the bond to partially fund the abovementioned compensation amount;
- the Trustees to lease the hospital redevelopment from the banks, with the leasing arrangements due to expire in December 2007; and
- the Trustees to sub-lease the redevelopment to the Hospital, with the rental paid by the Hospital matching the Trustees' lease payment obligations to the banks.

7.73 However, in the period since the leasing arrangement was established, the decline in prevailing interest rates has reduced the cost-effectiveness of the finance lease facility. Accordingly, in 1999 the Hospital commenced negotiations with the Department of Human Services to vary the financial arrangements as they pertained to the participation of the banks in order to structure a more cost-effective and straightforward debt facility. The Hospital had estimated that the replacement of the leasing arrangements with fixed interests loan financing would result in savings to the Hospital of \$5.7 million over 10 years.

Termination of the leasing arrangements

7.74 The Hospital received approval from the Department of Treasury and Finance in May 2001 for the termination of the leasing arrangement. Consent to vary the financial arrangements was provided by the bondholders in September 2001.

7.75 In late December 2001 a net amount of \$73.6 million representing the remaining liability associated with the finance leasing arrangement was paid to the banks in order to terminate the leasing arrangements, calculated as a compensation amount of \$153.7 million to extinguish the Hospital's financial obligations to the banks, less an amount of \$80 million representing the repayment by the banks of the money on-lent from the Trustees. The payment was sourced from:

- a new 10 year loan from the Treasury Corporation of Victoria (TCV) of \$46.1 million;
- proceeds of \$19.5 million from the early redemption of the Trustees' zero coupon bond; and
- payment from the Hospital's reserve account of \$8 million.

7.76 The loan from the TCV is secured by a guarantee from the Treasurer of Victoria under the *Health Services Act 1988*.

7.77 Overall, the refinancing has resulted in a reduction of \$5 million in the State's liabilities, including the impact on bondholder repayments, lease repayments and loan repayments over the period.

7.78 Following the application of \$8 million from the Hospital's reserve account towards termination of the leasing arrangements, a further \$6.2 million remained in the Hospital's reserve account.

7.79 In accordance with the provisions of the financial arrangements the amount of \$6.2 million was available to be paid to the Treasurer of Victoria at the end of the leasing arrangements. However, in April 2002 the Hospital paid the balance into an escrow account under the management of the Department of Treasury and Finance. These funds will be held in escrow pending the outcome of negotiations with the Department of Human Services regarding restructuring of elements of the Health Services Agreement and the application of the balance of the reserve account.

Spencer Street Station redevelopment

7.80 The Spencer Street Station precinct covers an area of around 21 hectares, stretching from Dudley Street, along Adderley and Spencer Street down to Flinders Street. The Station is the gateway to interstate rail, coach services and metropolitan trains, and was constructed in 1859, followed by a number of refurbishments and a major redevelopment in the 1960s.



Existing Spencer Street Station site.

7.81 In June 2001, following the substantial progress with the Docklands precinct development, the Government released a master plan for the Station comprising a major refurbishment of the rail terminal, the provision of significant new transport infrastructure and the integration of the precinct with the west end of the Melbourne central business district and the Docklands precinct. The Government's plans included a multi-modal interchange for passengers on country and metropolitan rail services, tram and regional buses and the commercial development of the Station.

7.82 The redevelopment of the Spencer Street Station formed part of the Government's *Linking Victoria* initiative, launched in February 2000, which provided a blueprint for transport infrastructure works to be undertaken in the State. Under this initiative, the Minister for Transport announced that the redevelopment of the Spencer Street Station site (the project) was likely to proceed with private sector involvement under the Government's Partnership Victoria framework.

7.83 The key objectives of Government for the project are to:

- obtain a world class transport interchange facility providing high quality services for passengers and transport operators;
- significantly enhance the public amenity and aesthetic quality of the Station;
- minimise the long-term costs to the taxpayer for provision of the new facility;
- transfer risk to the private sector where it is appropriate to do so; and
- make cost-effective allowances for future patronage growth and for new transport services and infrastructure at the Station over time.

7.84 To facilitate the proposed redevelopment, in December 1999, the *Rail Corporations and Transport (Amendment) Act 1999* was enacted, establishing the Spencer Street Station Authority. The functions of the Authority are to manage the precinct and its development for transport and related purposes, and to monitor current and future requirements for transport facilities at the precinct.

7.85 The Department of Infrastructure (DOI) and the Department of Treasury and Finance (DTF) jointly established the Rail Projects Group, consisting of senior staff from both departments and external advisers, to manage this and other rail infrastructure projects.

7.86 During the construction period, the Authority will be responsible for the operations of the Station, while the Rail Projects Group will manage the delivery of the project on behalf of the Authority. On completion of the project, the Authority will assume responsibility for managing ongoing service agreements with the private sector.

Use of the Partnership Victoria framework for the project

7.87 One of the key requirements of the *Partnership Victoria* framework is to compare the costs of private sector procurement with conventional government procurement by using the Public Sector Comparator (PSC).

7.88 The PSC is essentially the cost to the public sector of undertaking the design, construction, financing, maintenance and operation of a project, compared with a competing private sector bid. The PSC is expressed in net present value terms (NPV) and is based on the cost of providing the defined outputs within the public sector, and identifying and quantifying risks which would be encountered under the public sector method of procurement. The exercise involves identifying and quantifying risks, assessing the probability of risks eventuating and determining who should manage those risks.

7.89 External financial advisers appointed by the Rail Projects Group conducted a business case analysis using the PSC, taking into account the design, construction and operation of a transport interchange facility over a 30 year period, and the commercial development of the surrounding site. The analysis identified a NPV cost of \$294.4 million if the project was delivered via the traditional public sector works program, compared with a cost of \$234.4 million (NPV) if the project was delivered by the private sector.

7.90 The forecast cash flows were discounted to present day values based on inflation and discount rates determined by DTF. The consultants estimated that the NPV cost of private sector delivery could typically be expected to generate savings of between 15 per cent to 25 per cent on construction capital costs and a further saving of 5 per cent to 10 per cent on operating costs over the life of the project, by comparison with government delivery.

7.91 The consultants anticipated that the private sector savings would be achieved through:

- efficiencies resulting from better resource and time management;
- designing and operating the project under a long-term approach;
- greater ability to diversify risk;
- increased scope for financial and tax structuring;
- use of patented equipment and systems; and
- the more diverse experience of the private sector in delivering similar works and services.

7.92 Under the Partnership Victoria framework, risk allocation aims to minimise the chances of project risks materialising and the consequences if they do, by allocating risks to the party best able to manage them at the least cost. Effective risk identification and allocation is critical in ensuring that the Government achieves value for money from the delivery of a project.

7.93 In the project brief for the Spencer Street Station development issued to the market in July 2001 the Government proposed the allocation of the following identified risks to the developer:

- the majority of the design, construction, finance and operational risks associated with the transport interchange;
- all of the key design, construction, finance and operational risks associated with the commercial development; and
- the risks associated with the construction of the rail and signalling infrastructure.

7.94 It was intended that risks which neither the Government nor the private sector could fully control, and the private sector is unable to insure, would either be shared or retained by the Government where it was identified that the cost of passing such risks to the private sector would not deliver value for money.

Tender evaluation and selection process

7.95 In July 2001, the Rail Projects Group sought expressions of interest for the design, construction, finance, lease, maintenance and redevelopment of the existing Spencer Street Station site. The project brief invited proponents to submit proposals for the development of a transport interchange facility and associated rail modifications within the framework of the Partnership Victoria policy, on the basis of a payment stream over a 25 year to 30 year period. Respondents were also encouraged to include in their submissions proposals for commercial developments beyond the requirements of the transport interchange area on a lease arrangement of up to 99 years. The option to include an upgrade of the signalling system was also made available.

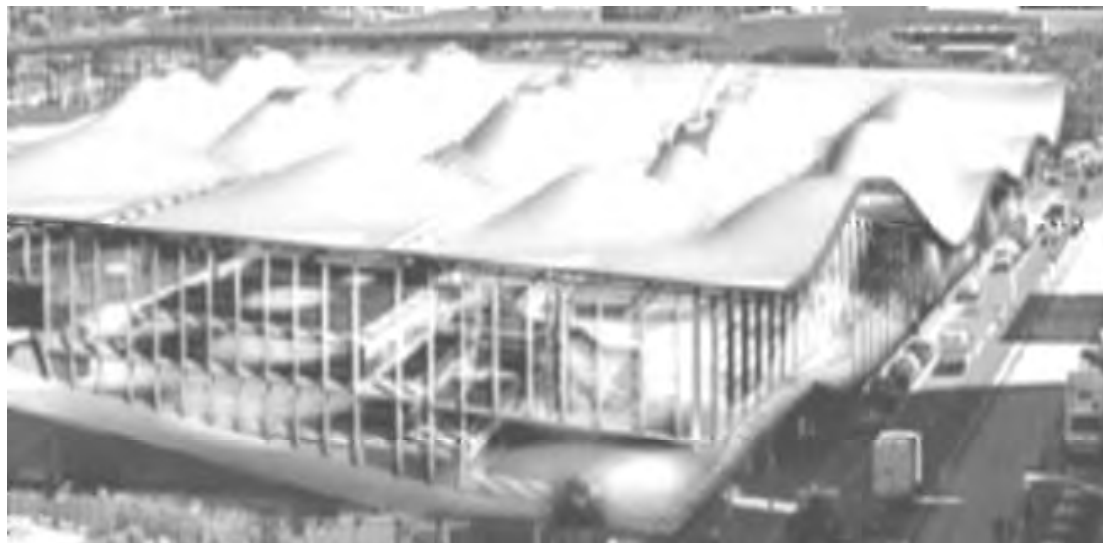
7.96 Of the 7 registrations of interest received, 3 bidders were short-listed and were provided with a Request for Proposal in November 2001. The 3 short-listed bidders were requested to provide a base bid comprising a proposal for the following 4 stages of the project:

- **Facility** - The requirement for the developer to design, construct, finance, lease, maintain and operate the transport interchange facility to a specified standard. The design life expectancy for the permanent structure was to be 100 years. Final commissioning was to occur on or before 30 June 2005, at which time the developer will become fully responsible for operating the transport interchange facility for a period of up to 30 years. At the end of the 30 year operating phase, the facility is to be returned to the State;
- **Rail modifications** - Construction of 2 additional station platforms and the possible relocation of an existing platform;
- **Signalling upgrade** - Upgrade of the existing signalling system located at the Station which is used on the regional train services network; and
- **Commercial development** – Potential developers were required to bid an upfront, non-refundable cash payment to the State in return for the property rights acquired for a lease term ending on 31 December 2100.

7.97 In February 2002, the Rail Projects Group eliminated one bidder due to major departures from the risk allocation matrix outlined in the request for proposal and the bid being significantly higher than the PSC. The remaining 2 bidders were invited to submit revised bids by May 2002.

7.98 The PSC benchmark was subsequently adjusted from \$294.4 million to \$301 million, reflecting more clearly the defined insurance risks associated with the redevelopment.

7.99 Following assessment of the revised bids, the Rail Projects Group recommended that Civic Nexus Pty Ltd be accepted as the preferred tenderer for the construction and operation of the new transport interchange facility, the signalling works and the associated commercial development in the Spencer Street Station precinct. The net present value of the price tendered by Civic Nexus was \$15 million below the adjusted PSC benchmark. Civic Nexus Pty Ltd is a consortium established specifically for this project, consisting of ABN AMRO Australia Pty Ltd, Leighton Contractors Pty Ltd and a number of other sub-contractors.



*Proposed redevelopment of Spencer Street Station.
(Photograph courtesy of the Department of Infrastructure.)*

7.100 The independent probity auditor appointed by the Rail Projects Group concluded that the tender evaluation process was conducted fairly and impartially, and all bidders were evaluated in accordance with agreed selection criteria. The recommended bid was subsequently endorsed by the Government on 1 July 2002.

7.101 In August 2002, certain requirements of the arrangement with Civic Nexus were fulfilled, including the receipt by the Authority of fully executed documents and copies of specified insurance policies. In addition, the Authority received a \$66 million payment under the Commercial Development Agreement referred to later in this report, and a \$15.2 million construction bond. The construction bond was arranged to secure the performance of the developer with respect to design, construction and commissioning of the facility.

7.102 Comments follow on the key obligations of each party, including the allocation of responsibility for managing and mitigating identified risks under the terms of the contractual arrangements.

Commercial development

7.103 In August 2002, the developer paid \$66 million (exclusive of GST) to the Authority for:

- the right to receive income from the retail businesses, advertising and any other permitted commercial operations located within the transport interchange Facility over a 30 year lease period; and
- a non-exclusive licence over each commercial development site to enable construction of the commercial elements of the project. Upon completion of each development, the developer is to be granted a lease until 2100.

7.104 The commercial developments to be undertaken comprise an office complex, retail precinct and a residential tower. While construction is scheduled to commence within periods specified by the Authority, the developer has the ability to exercise an option to defer construction of each of the developments by providing an additional payment to the Authority.

7.105 The developer assumes virtually all risks relating to the commercial development. However, **the State retains specific defined risks including 50 per cent of the remediation costs associated with non-identified pre-existing contamination and any adverse financial impact resulting from changes to the interpretation or application of the *Land Tax Act 1958*.**

7.106 In the event of a defined termination event, such as a failure to cure a default notice or to start or complete construction by predetermined deadlines, the Authority must pay the developer a termination payment. This payment is calculated as the lesser of either the market value of the commercial development at the date of termination and the associated costs incurred by the Authority, or the payment made by the developer to the Authority (\$46 million) less the associated costs incurred by the Authority.

7.107 Following completion of the construction of the commercial development, a commercial lease will be issued. In respect of each development, the lessee is required to pay the Authority a nominal rental of \$10 per annum and all charges for utility services, including rates and taxes, in respect of the land. In addition, the developer is to maintain specified insurance policies and coverage.

7.108 Overall, the developer assumes the key risks and costs associated with the commercial development, including the risk of cost overruns, construction delays or design construction flaws, and the risks associated with occupancy utilisation of the commercial facilities. In 2100, the land and the associated commercial development works on the land, revert back to the Authority for nominal consideration.

Design and construction of the interchange facility

7.109 The developer is to design, construct and commission the transport interchange facility, including rail modifications and a signalling upgrade. Under the approved works program, the developer is required to meet design and construction milestones, including a final construction completion date. The final draft design documentation prepared by the developer is to be consistent with the final contractual documents and comply with the project brief and provide a construction cost estimate. The final design documentation cannot be changed without the approval of the Authority.

7.110 The Authority may at any time prior to final construction completion request a modification, with any resultant costs borne by the Authority. The developer may also claim any costs associated with a delay or disruption arising from a defined government extension event and any costs associated with the acceleration of progress of the works.

7.111 **Where a construction milestone is not achieved, the developer will be liable for liquidated damages of \$10 000 per day and, if final completion does not occur by the scheduled completion date, the developer will be liable for liquidated damages of \$25 000 per day until the final completion date.**

7.112 Throughout the construction period, the developer must keep rail network franchisees fully informed of progress and endeavour to minimise any disruption to the franchisees' use of the area in order to minimise any costs incurred and any revenue forgone by the franchisees. Under the agreements, construction is to be undertaken in a manner that will not disrupt the daily operations of the Station.

7.113 Under the contractual arrangements, the developer is required to compensate the franchisees for agreed occupation costs. In the event of unplanned delays or late hand back, the developer is liable for specified liquidated damages that are to be paid to the Authority. **The affected franchisees can make a claim against the State for the financial impact of unplanned delays or late hand-back under the terms of the Franchise Agreements. The State, therefore, will meet any additional costs claimed by the affected franchisees where the specified liquidated damages paid by the developer to the State are insufficient.**

7.114 The Authority and the developer have agreed to appoint an independent reviewer to monitor progress against the terms of the agreement, and resolve any disputes between the parties. In the event that a default event takes place between the developer and the construction contractor, the Authority has the option to step-in, in place of the developer, to complete the project

Occupancy and operational phase

7.115 Upon final construction completion certified by an independent reviewer, the developer will be granted a 30 year lease in return for a nominal rental of \$10 per annum from the operations commencement date. During the operating phase, the developer is to provide all associated services at a level detailed in the agreement.

7.116 The developer is to prepare quarterly performance reports and the Authority may monitor, review and audit the developer's performance against the provisions of the service agreement and the developer's performance management systems. The Authority has the power to enter and inspect any part of the facility. Key performance measures to be reported and monitored include availability, repairs and maintenance, security and emergency services, cleaning, passenger information and signage, baggage handling and traveller assistance, telecommunications, food and beverage, car parking, energy management, waste management, pest control and bus bays.

7.117 In exchange for providing the service, each quarter after the receipt of the developer's quarterly performance report, the Authority is to make specified payments to the developer which are adjusted for movements in the consumer price index which cover capital, operating and insurance costs totalling \$341 million in net present values (using a discount rate of 8.65 per cent) over the life of the arrangement. In addition, the Authority agreed to accept the risk for any changes in insurance cost premiums for public/product and industrial special risk insurance until the start of the operations commencement date. Thereafter, the developer assumes the risk of insurance premium increases except in the event of increases in excess of 30 per cent on the previous insurance period, where upon the Authority will compensate the developer for the difference (provided that any increase is due to market movement and not the performance of the developer). The above payments will be adjusted for penalties incurred for failing to achieve the relevant key performance indicators to specified levels assessed by the Authority.

7.118 Any costs associated with remedying damage, defects or matters requiring repair are to be borne by the developer. To meet maintenance costs over the life of the development, the Authority is to pay from the commencement of operations a specified portion of the quarterly payments into an escrow account, upon receipt of appropriate documentation from the developer. Payments to be made to the escrow account total \$11.8 million in net present value terms over the life of the lease term.

7.119 The developer assumes the risk of complying with any change in law, with the exception of a change in law of the State which directly affects the facility works or the facility. In addition, in the event that the interpretation or application of the *Land Tax Act* 1958 is changed, the Authority is required to compensate the developer for the costs incurred, as a result of the imposition of that component of amount of land tax.

7.120 The developer bears the risk of loss, damage or destruction of the facility works, the facility or the site. In the event of destruction of the entire facility or a substantial portion of the facility, the developer is required to reinstate the facility within a reasonable time, unless the Authority issues a notice to the developer not to carry out its reinstatement and directs the developer to pay the insurance proceeds to the Authority. However, the Authority has accepted the risks of destruction if caused by an uninsurable event. If the uninsured damage is less than \$338.2 million (indexed), the Authority is required to meet the cost to reinstate the facility. If the uninsured damage is estimated in excess of \$338.2 million (indexed), the agreement is to be terminated.

7.121 If a default event occurs including a breach of an obligation under the agreement, the developer is required to submit a plan to correct the default within a reasonable period. In the event that a major default is not remedied, the Authority is able to exercise its step-in rights to cure the default or terminate the agreement.

7.122 **In the event of defined termination events, the Authority has the option to terminate the agreement activating various termination payment principles.** In certain defined termination events, the Authority is able to exercise its step-in rights. Upon termination of the agreement, the developer is not entitled to make any claim in respect of any indirect or consequential loss incurred including loss of business opportunity and payment of liquidated sums, penalties and damages under other agreements.

7.123 Other key restrictions imposed on the developer include change in ownership interest, amendments to the trust deed, constitution and membership. In addition, the developer is not to create or allow to exist, any security interest over or assign, transfer, or dispose of any rights or obligations of the facility and lease without the Authority's approval.

Accounting treatment for the arrangement

7.124 Australian Accounting Standards provide indicative criteria for determining the accounting treatment for lease arrangements. These include an indicative benchmark which provides that the present value of the discounted lease payments under a lease are not to exceed 90 per cent of the fair market value of an asset for it to be considered an operating lease for accounting purposes.

7.125 An initial assessment of the Spencer Street Station redevelopment, in line with this criteria, indicates that the arrangements associated with the transport interchange facility will need to be classified as a finance lease, given that the present value of the capital component of lease payments under the arrangement, is well above this benchmark. The Department of Treasury and Finance advised that its preliminary assessments of the arrangement have also indicated that the arrangement should be classified as a finance lease. Accordingly, the lease arrangements associated with the transport interchange facility will need to be reported in future statements of financial position as a liability of the State, with the corresponding asset also reported.

CONTINGENT LIABILITIES OF THE STATE

7.126 Contingent liabilities of the State represent potential commitments, the occurrence of which are dependent upon future events or outcomes. Such potential commitments may arise from the provision of guarantees, indemnities, sureties, letters of comfort, litigation actions and other forms of financial support.

7.127 Guarantees oblige the State to meet commitments to third parties in the event that organisations in receipt of guarantees are unable to meet their commitments in the first instance. Indemnities, on the other hand, generally impose a primary obligation to the Government to protect entities in receipt of indemnities against certain financial losses.

7.128 The Government's *Annual Financial Report* discloses that the estimated quantifiable contingent liabilities of the State at 30 June 2002 were around \$1.8 billion, an overall increase of \$120 million or 7 per cent over the previous year. This increase was mainly attributable to \$127 million in contingent liabilities for lease payments relating to new rolling stock delivered during 2001-02 and \$134 million in contract variation claims relating to the Geelong Road Project. This increase has been offset by decreases associated with guarantees and indemnities provided to the Melbourne Cricket Club and Melbourne Cricket Ground Trust relating to the construction of the Great Southern Stand and the imminent expiry of the initial 5 year period for the private prisons contracts.

7.129 In addition to the quantifiable contingent liabilities, the Government's *Annual Financial Report* details a number of non-quantifiable contingencies, including contingencies relating to the Melbourne 2006 Commonwealth Games, the Seal Rocks Centre (disclosed as a post-balance date event in the *Annual Financial Report*), the Longford gas incident, public transport franchise agreements, exposures relating to the collapse of the HIH Insurance Group and the potential for payments of refunds of duty on general insurance premiums.

7.130 Comments follow on some of the more significant developments during 2001-02 which impact on contingent liabilities.

Impact of High Court ruling on responsibility for road accident liabilities

7.131 Public sector authorities, like any private sector corporation or institution, can be sued for acts of negligence in failing to carry out a duty, or to carry it out properly, when it is required or reasonable to do so. However, relevant Australian public authorities with responsibility for maintenance of roads and associated infrastructure have, until recently, been able to rely on common law immunity from damages for injuries to persons or property resulting from accidents caused through a failure to repair the normal wear and tear of the road or infrastructure asset.

7.132 This immunity is referred to as the “highway rule” and arose from decisions by the High Court prior to World War 2. However, the immunity does not extend to injuries to persons or property arising from negligent maintenance undertaken on road infrastructure. Failure to repair is termed “nonfeasance” by the High Court, while negligent repair is termed “misfeasance”.

7.133 Recent appeals to the High Court tested the well-established immunity of road authorities for nonfeasance. In May 2001, the High Court handed down decisions on 2 cases. In both instances, the litigants suffered injury to person or property as a consequence of the condition of a road or pedestrian infrastructure, and sought damages against a local government council.

7.134 In each case, the High Court was asked to reconsider the “highway rule” and overrule what was previously thought to be established law. In one case, the High Court found that the appellant had failed to establish that the council was negligent and the appeal was dismissed. In the second case, the High Court found that the distinctions between “nonfeasance” and “misfeasance” were artificial, were not based on sound law and led to perverse outcomes in that it appeared less risky for authorities to neglect roads rather than repair them. This decision, in effect, resulted in the abolition of the common law immunity that had been the basis of the “highway rule”.

7.135 State and local government authorities can no longer assume that they are immune from being sued for damages in respect of accidents caused by failure to maintain roads and infrastructure to an appropriate standard.

7.136 In response, the Government in mid-2002 prepared a discussion paper outlining the major issues and proposing a set of principles that underly any future legislation, and provided options for legislative amendments.



The High Court ruling raised significant road maintenance issues for State and local governments.

7.137 In October 2002, the Government introduced a Transport (Highway Rule) Bill into Parliament which proposes to establish a legislative immunity from civil action for VicRoads and local government councils that mimics, as closely as possible, the former “highway rule” abolished by the High Court. The immunity provisions include a sunset clause of 1 July 2004, which is intended to allow sufficient time for road authorities to adjust their activities in accordance with their extended responsibilities for inspection, maintenance and repair of roads and related infrastructure.

Transmission Interconnect

7.138 In January 2002, VENCORP (a State public sector agency) and private sector participants, SPI PowerNet and ABB Australia entered into an arrangement to build, own and operate a \$44 million project – a 400MW upgrade of the power link between Victoria and New South Wales. The upgrade aims to provide a 5 per cent boost to Victoria’s electricity reserves and ensure that Victoria has increased access to interstate electricity at times when the State’s electricity demand is high.

7.139 Under the contract, VENCORP will pay SPI PowerNet and ABB Australia a monthly charge for periods up to 30 years for provision of the ongoing services required for the project. VENCORP will recover these costs through regulated transmission use of system charges which require approval by the Australian Competition and Consumer Commission (ACCC) and levied on transmission customers (i.e. distribution businesses and major electricity users).

7.140 The project received approval under the National Electricity Code as a regulated project. The Code sets out the rules and objectives of the electricity market, and the rights and responsibilities of market participants. VENCORP views its financial exposure as minimal given that the Code has been authorised by the ACCC as an access code in the National Electricity Market under the *Trade Practices Act 1974*.

7.141 Overall, the State’s financial exposure is limited to the possibility that the ACCC does not approve VENCORP’s transmissions charges, resulting in VENCORP being unable to recover its costs associated with the project.

Finalisation of Melbourne City Link Authority

7.142 In previous reports to Parliament we have provided detailed analysis of the arrangements established between the State and Transurban for the financing, construction and operation of the Melbourne City Link. The key arrangements for the City Link project are set out in the Concession Deed (contract) established between the State and Transurban in October 1995.

7.143 We have previously reported that, **while certain project responsibilities and risks were assumed by the State, substantial risks and exposures were also transferred to Transurban and users of the City Link.** In particular, the State has accepted certain obligations, mainly relating to the maintenance of the overall operating environment for the City Link, including certain traffic management measures to enable the most efficient use of the overall road network and provide benefits to local communities.

7.144 Under the arrangements, Transurban has designed, financed, constructed, and is maintaining and operating the City Link.

7.145 The Melbourne City Link Authority (MCLA) was formed in December 1994 under the auspices of the *Melbourne City Link Authority Act 1994* and was allocated primary responsibility for overseeing the State's involvement in the development and delivery of the \$2.2 billion City Link.

7.146 Following the completion of the construction phase of the City Link project in December 2000, the Government reviewed the arrangements for ongoing management of the City Link contract. Subsequently, in December 2001, Parliament passed the *Melbourne City Link (Further Amendment) Act 2001* that established the position of Director, Melbourne City Link and imposed a number of statutory responsibilities on that position which is located within the Department of Infrastructure and came into effect on 1 January 2002.

7.147 In order to accommodate the completion of minor financial and administrative arrangements, the legal entity of the MCLA was retained for a brief period. Following proclamation of relevant sections of the *Melbourne City Link (Miscellaneous Amendments) Act 2000*, the MCLA was abolished on 28 February 2002, with its rights, obligations and net assets transferred to the Department of Infrastructure.

Material adverse effects claim

7.148 As part of the contractual arrangements with Transurban, the State agreed to compensate Transurban if certain events had a material adverse effect on Transurban. In particular, the State is subject to certain compensation claims in the event that it can be shown that Transurban's revenue has been adversely affected by State actions.

7.149 Our *Report on the Finances of the State of Victoria, 2000-01* detailed a claim submitted by Transurban in February 2001, alleging that the construction of Wurundjeri Way (within the Docklands precinct), Network Roads (the Latrobe Street and Bourke Street extensions and alterations to Footscray Road and Flinders Street Extension) and the widening of the West Gate Freeway, would reduce traffic volumes on the City Link. It was claimed that this would result in lost revenue with a net present value of around \$36 million over the concession period. While the State accepted the validity of the notice in respect of the material adverse effects claim received from Transurban, it did not accept that a specified claimable event had occurred.

7.150 Under the dispute resolution mechanism provided for in the contract, agreement was reached in March 2001 to appoint an independent expert to determine the matter. In July 2002, the independent expert determined that Transurban had suffered no detriment as a result of the road network changes and, therefore, a specified claimable event had not occurred. Transurban has appealed the determination of the independent expert. Under the processes provided for in the contract, the matter will now progress to arbitration. The Department of Infrastructure is managing the claim on behalf of the State.

Imposition of stamp duty in respect of the GST element of insurance contracts

7.151 The *Duties Act* 2000 (and previously the *Stamps Act* 1958) imposes duty on the premium paid for general insurance policies at the rate of 10 per cent. As defined in the *Duties Act* 2000, the premium represents the total consideration given to an insurer to affect the insurance. Following the introduction of the GST on 1 July 2000, the State Revenue Office adopted the practice of levying stamp duty on total insurance premiums inclusive of GST.

7.152 In August 2002, following litigation brought by Royal & Sun Alliance Insurance Australia Limited against the Commissioner of State Revenue, the Supreme Court held that the GST component of the amount payable by the insured was not part of the insurer's gross premiums and, therefore, was not dutiable.

7.153 As a consequence of the Supreme Court's ruling, the Government has included in its *Annual Financial Report* an unquantifiable contingent liability for the payment of refunds of stamp duty on general insurance, pending the outcome of an appeal to the Court of Appeal by the State Revenue Office. In the meantime, the Government has announced that it proposes to draft legislation to confirm and clarify existing arrangements to ensure that the entire premium remains subject to duty.

Seal Rocks Life Centre

7.154 In March 1997, the State entered into a series of agreements with Seal Rocks Victoria Australia Pty Ltd (SRVA) for the development of the Seal Rocks Life Centre, located on Crown land at Point Grant on Phillip Island, some 130 kilometres east of Melbourne. Stage One of the development, the onshore facilities, was commissioned in March 1998 to serve as an interpretative centre on sharks, seals and the surrounding environment. The capital cost of the completed onshore facilities was around \$13 million. Stage Two of the development related to the proposed development of offshore facilities, including an undersea tunnel and observation tower, at an estimated capital cost of \$50 million.

7.155 Under the project arrangements, SRVA agreed to construct and operate the Centre and transfer it, together with amenities, to the State at the completion of the 25 year term of the arrangements. The financial and operating arrangements were set out in a series of agreements between the State, SRVA and the project's financier. A project monitor was appointed by the State to ensure compliance with the agreements and produce monthly reports against benchmark measures set out in the agreements.

7.156 The Centre opened in April 1998 and subsequently SRVA has been involved in disputes with the Government over various aspects of the contractual arrangements. This situation led to the appointment of an independent arbitrator in July 2000, after SRVA lodged a compensation claim against the Government for breach of contract.

7.157 An interim award was handed down by the independent arbitrator on 9 August 2002. The Government has since made application to appeal against the independent arbitrator's interim award. The application is scheduled for hearing in the Supreme Court.

7.158 As a consequence of the Government's action to appeal the interim decision, SRVA lodged an application in the Supreme Court on 6 September 2002 for leave to appeal against the interim award, and seeking compensation for loss of future earnings of up to \$400 million.

7.159 The Government's *Annual Financial Report* for 2001-02 discloses this matter as an unquantifiable event occurring after balance date.

7.160 A detailed review by my Office of the Seal Rocks arrangement was suspended in July 2000 due to the commencement of the arbitration process. Due to the prolonged period of arbitration and the recent litigation initiated by both the Government and SRVA, it has not been possible to recommence and report to Parliament on this issue. Our review will proceed once the current legal proceedings are completed.

Geelong Road project

7.161 VicRoads is the statutory authority responsible for the construction and maintenance of all major roads in Victoria, including the redevelopment of the Geelong Road (Princes Freeway) which commenced in January 2000.

7.162 The Geelong Road project involves the widening and reconstruction of the Princes Freeway for nearly 50 kilometres between Laverton North and Corio. When fully completed, 4 lanes will be available in each direction beyond the Western Ring Road at Laverton North through to the start of the Maltby Bypass and 3 lanes each way from Werribee to Corio, on Geelong's northern outskirts. In addition, a 24 kilometre off-road recreational path to be known as the Federation Trail is being constructed from Brooklyn to the Werribee River.

7.163 The project is estimated to cost \$270 million and is being jointly funded by the Victorian and the Commonwealth Governments as a Road of National Importance. The Commonwealth Government is providing \$120 million with a further \$150 million to be provided in State funding from the Better Roads Victoria Program. Completion of the project is expected by late November 2002.

7.164 The Government's *Annual Financial Report* includes quantifiable contingent liabilities to the value of \$134.4 million relating to claims by contractors for contract variations on the 4 major road construction contracts associated with the Geelong Road project.

7.165 At the date of preparation of this report, the majority of claims were still being assessed by VicRoads. In addition, VicRoads advised that the majority of the claims will be settled by the end of the 2002-03 financial year.

RESPONSE provided by Minister for Finance

Geelong Road project

Para. 7.164

In accordance with standard VicRoads conditions of contract, contractors on road projects can lodge claims with the contract superintendent in relation to any variations associated with the project.

As at 30 June 2002, some 50 per cent of these claims have been reviewed and have subsequently resulted in accepted variations of \$650 000.

Part 8

Review of the Government's Estimated Financial Statements

REVIEW OF THE GOVERNMENT'S ESTIMATED FINANCIAL STATEMENTS

8.1 Government budgets are among the most widely recognised financial planning, management and accountability documents in government, and when approved by Parliament, can be regarded as a kind of social contract between the Government and the public. The Budget Statement and Estimates are used, or referred to, by many people and organisations from both inside and outside government.

8.2 A key element of the Government's financial responsibility reform has been the widening of my mandate to include a review and report on the Government's Estimated Financial Statements to ensure that they are consistent with accounting conventions and that the methodologies and assumptions used are reasonable.

Legislative requirements

8.3 Under the *Financial Management (Financial Responsibility) Act 2000*, the Estimated Financial Statements are required to be prepared on the basis of generally accepted accounting principles, covering a 4 year period incorporating the budget year plus 3 forward years, and must take into account government decisions and other circumstances that may have a material effect on the statements. My Office's first review of the Government's Estimated Financial Statements was undertaken for the 2000-01 Estimated Financial Statements.

8.4 In accordance with the requirements of the Act I am required to conduct a review of the Estimated Financial Statements and provide a report to Parliament on whether it appears that:

- the Statements have been prepared on a basis consistent with the accounting policies on which they are stated to be based;
- the Statements are consistent with the targets specified in the Government's current financial policy objectives and strategies statement for each key financial measure specified in that statement;
- the Statements have been properly prepared on the basis of the stated assumptions; and
- the methodologies used to determine those assumptions are reasonable.

Objectives of the review

8.5 Based on the above legislative requirements and the requirements of Australian Auditing Standards, it is not the objective of the review to express an opinion on whether the projected results outlined in the Estimated Financial Statements will be achieved, given the prospective nature of the financial information contained within the Statements. Rather, appropriate review procedures are performed to provide a form of “negative assurance” to Parliament on the technical construction of the Statements. That is to confirm that on the basis of review procedures performed and information provided, the Statements have been prepared and presented consistent with the requirements of the Act. Accordingly, the scope of the review does not extend to assessments of the merit of budget policy and resource allocation decisions made by the Government.

8.6 My short-form report identifies that while evidence may be available to support the assumptions and underlying data upon which prospective financial information is based, such evidence is generally future oriented and, therefore, less certain in nature. As a result, I am not in a position to obtain the level of assurance necessary to express a positive opinion on those assumptions and the accompanying forecast information included in the Statements. Accordingly, an opinion is not expressed on whether the forecast will be achieved, with the short-form report highlighting that the actual results achieved are likely to be different than those forecast.

8.7 **Notwithstanding the above professional, legislative and inherent limitations associated with prospective financial information, the review process does provide assurance that the Statements present the Government’s fiscal plans in accordance with appropriate policies and assumptions. Accordingly, the accountability to Parliament is enhanced and the overall Estimates process is improved.**

8.8 Increasingly, other jurisdictions are recognising the benefits of independent reviews in improving the Estimates process. Overseas precedents for similar reviews include the UK National Audit Office, which provides assurance on certain economic assumptions and conventions used to underpin the Budget Estimates, which is undertaken at the request of the Chancellor of the Exchequer. The Auditor-General of Nova Scotia (Canada) is also required by legislation to review the Estimates of Revenue used in the preparation of the annual budget and provide Parliament with an opinion on the reasonableness of the revenue estimates.

8.9 Given the increasing parliamentary and public interest in issues arising from the Government *Budget Papers*, it is my intention to report to Parliament on a progressive basis on key components of the Statements, including the methodologies and assumptions used to derive the Budget Estimates for particular areas. This report outlines the results of our review into the methodology used for forecasting a key element of State taxation revenue, namely conveyancing duty.

Forecasting of taxation revenue

8.10 Taxation revenue mainly comprises payroll tax, taxes and duties on financial and capital transactions, gambling, motor vehicles, immovable property and other miscellaneous items. Each of these revenue streams has its own unique complexity and reacts differently to changes in the economy, thus making forecasting of taxation revenue a challenging exercise. The sensitivity associated with taxation revenue on the operating result is illustrated in the *Budget Papers*, which shows that, in broad terms a one per cent change in the growth rate of any one of the gross state product, employment, consumer price index, average weekly earnings or property prices (volumes) indices can be expected to have a \$25 million to \$27 million impact on the operating result in the first year.

8.11 Economic forecasting is carried out by the Department of Treasury and Finance (DTF), which is responsible for monitoring and forecasting economic conditions, analysing the impact of economic policies and events, and maintaining systems for economic, fiscal and financial analysis. However, the financial forecasting process is not merely a mechanical exercise of applying a set formula to economic assumptions. In calculating the estimates for each taxation stream, DTF staff must use their technical and professional knowledge of policies, legislation, and economic and demographic assumptions and data to arrive at the Estimates.

8.12 When a government presents its annual budget, there is a presumption that it has been prepared according to sound and prudent fiscal management principles. An approach to forecasting is generally considered “reasonable” when it is comprehensive and addresses the different risks in a prudent manner.

8.13 A degree of caution is an essential principle of sound fiscal management and financial reporting under conditions of uncertainty. However, the principle of prudence should not be advanced as a reason to support deliberate and excessive caution that brings undesirable bias in the budget process, just as the presence of inherent uncertainties in forecasting should not be a reason to support deliberate and excessive optimism.

Taxation Forecasting Performance

8.14 Table 8A outlines the Government's forecasting performance for the major taxation categories, when compared to the original budget estimates over a 3 year period.

TABLE 8A
TAXATION BUDGET TO ACTUAL PERFORMANCE
((\$million))

Taxation category	Budget 1999-00	\$ Variance 1999-2000 (a)	Budget 2000-01	\$ Variance 2000-01 (a)	Budget 2001-02	\$ Variance 2001-02 (a)
Taxes on other immovable property: conveyancing duties	911.0	383.0	1 040.0	244.0	1 150.0	735.2
Taxes on other immovable property, including land tax, metro improvement levy, market securities, mortgages, FID, debit taxes, rental businesses, non-residential leases, miscellaneous duty and financial accommodation levy	1 412.7	142.9	1 587.2	128.5	1 127.8	39.7
Payroll tax	2 231.5	136.0	2 469.3	83.6	2 607.2	(48.6)
Taxes on insurance, including insurance duty, CTP insurance, non-life insurance and life insurance	365.6	24.4	429.1	14.7	695.8	42.7
Motor vehicle taxes, including motor vehicle registration fees, motor vehicle stamp duty and other motor vehicle taxes	883.9	32.2	931.6	36.5	989.9	49.8
Gambling taxes, including private lotteries, electronic gaming machines, casino, racing and other gaming	1 428.2	91.9	1 235.1	41.2	1 374.1	(4.1)
Other licenses and levies, including probate duty	1 458.1	62.5	153.0	(6.7)	31.7	63.1
Total taxation	8 691.0	872.9	7 845.3	541.8	7 976.5	877.8
% of net operating result	..	73	..	87	..	172

(a) Source: Annual Financial Reports for the State of Victoria and State Budget Papers.

8.15 The table shows that there have been substantial variations between the actual outcomes and the Budget Estimates associated with State taxation revenue over the past 3 years.

8.16 In 2001-02, the revenue collected from conveyancing duty was \$735.2 million (64 per cent) higher than forecast. In each of the past 3 years, the impact of property price increases and the sustained strength of the property market have been underestimated.

8.17 It should, however, be acknowledged that the difficulty of forecasting property market movements and accordingly conveyancing duty is not confined to Victoria with other Australian jurisdictions also experiencing significant variances from forecast in recent years. In this regard, DTF is liaising with other States in identifying opportunities to improve conveyancing duty forecasting.

Estimating conveyancing duty

8.18 Up to and including the 2001-02 forecast, DTF used a basic 2 stage model for forecasting conveyancing duty, taking into account the relationship between the value of Victorian housing finance commitments and the variable standard housing loan interest rate and, secondly, the relationship between stamp duty revenue and the value of Victorian housing finance commitments.

8.19 Following the inaugural review by my Office of the Government's Estimated Financial Statements for 2000-01, the Government commissioned external consultants to undertake a review of the Victorian budget forecast performance for the period 1994-95 to 1999-00. **The review identified conveyancing (stamp) duty as the most important single contributor to the taxation forecasting variances over the review period. It also acknowledged that the economic drivers of this tax are inherently difficult to forecast. However, the use of a simplistic forecasting methodology by DTF was also regarded as a contributing factor to the forecasting variances.**

8.20 The external consultants concluded, consistent with views held by DTF, that the model used focused on interest rates as the key driver and did not take into account other underlying drivers of housing demand, including household formation rates, demographic and interstate population movements. The external consultants recommended development of a new forecasting model including enhancing the data currently collected by the State Revenue Office as well as collecting data in relation to the wider Victorian property market. DTF is currently considering these issues.

8.21 Based on the significant variations experienced in forecasting results in the preceding 2 financial years, the model for forecasting conveyancing duty up to and including 2001-02 was not applied for the 2002-03 estimates process. Instead, DTF produced forecasts of conveyancing duty based on the long-run relationship between conveyancy duty collections and the Gross State Product. Other factors considered in developing the forecasts included year-to-date revenue receipts, market intelligence, interest rates, Commonwealth Government housing-related initiatives, and the impact of vacancy rates and price growth on residential property investors.

8.22 **A key budget risk confronting the Government is in not predicting a downturn in the property market or the strength of such a downturn which will adversely impact on conveyancing revenue and may adversely affect the Government's capacity to achieve its stated financial objectives and other priorities. The inherent difficulties in forecasting conveyancing duty, as well as the absence of timely, cost-effective data and a comprehensive model, will continue to impede the Government's ability to produce accurate forecasts for this revenue item. Accordingly, to mitigate this risk, the forecasting methodology and data availability issues should be addressed as a matter of priority.**

RESPONSE provided by Minister for Finance

Forecasting performance

Para. 8.16

It should be noted that there have been continuing improvements in taxation forecasting for taxes other than conveyancing duty. If conveyancing duty is excluded from the analysis, the taxation forecasting error has fallen from 6.3 per cent in 1999-00 to 4.4 percent in 2000-01 and finally to 2.1 per cent in 2001-02.

Para. 8.20

For 2002-03, the Department of Treasury and Finance revised its forecasting methodology to a model based on the relationship between conveyancing duty and gross state product (as disclosed in Budget Paper No.2, 2002-03, p33-34). In particular, the forecasts are based on a movement in the ratio of conveyancing duty to its long-term average of 0.7 percentage points of gross state product by the end of the forward estimates period. In addition, the Department of Treasury and Finance has obtained the available property transaction data from the Valuer General for the period from 1998-99 to 2000-01 and is using the data to further improve and test its conveyancing duty forecasting model. The Department of Treasury and Finance continues to seek opportunities to improve its modelling of conveyancing duty by working with the State Revenue Office to improve data collection and analysis, together with liaisons with other State Treasuries and private organisations including banks.

Para. 8.21

To improve the estimate for 2002-03, the Department of Treasury and Finance produced forecasts of conveyancing duty based on the long-run relationship between conveyancing duty collections and gross state product as noted in the response to paragraph 8.20.

Para. 8.22

The Department of Treasury and Finance always produces 'best estimate' forecasts of revenue and is currently and continuously seeking to improve its forecasting techniques - through statistical methods and liaison with other organisations. It is recognised that the inherent difficulties in forecasting conveyancing duty, as well as the absence of timely, cost effective data may impact on the Government's ability to produce accurate forecasts for this revenue item. Accordingly, to mitigate this risk, the forecasting methodology and data availability issues will continue to be addressed as a matter of priority.

The Minister notes that the Auditor-General signed off the estimated financial statements for 2001-02 giving the assurance that the forecast methodologies and processes were reasonable while also making the general point that actual results often vary from those forecast. The presence of a forecast error does not mean that the forecasting technique is unreasonable.

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