

VICTORIA

Auditor-General
of Victoria

**AUDITOR-GENERAL'S
REPORT
on the
VICTORIAN
GOVERNMENT'S FINANCES
1997-98**

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PART 1

Executive Summary



Overview

This Report to the Parliament which is entitled the *Auditor-General's Report on the Victorian Government's Finances, 1997-98* outlines the results of the annual audit of the Government's Annual Financial Statement, including an analysis of the operating result achieved in the year and the State's assets and liabilities at year-end, together with the privatisation of government business enterprises and the sale of surplus and underutilised properties.

A confirming audit opinion has been provided on the Government's Annual Financial Statement, with the Statement disclosing that the State's financial condition has strengthened during the 1997-98 financial year, reflecting the positive impact of the financial management strategies implemented over recent years.

The upgrading of the State's credit rating to AAA by a major rating agency during the financial year is also reflective of the improved financial position of the State and represents a substantial achievement by the Government and the realisation of one of its key long-term targets. Notwithstanding these positive achievements, the Government estimates that the State's tax raising effort was still around \$220 million above the national average and remains a major challenge for the Government.

The Government's Annual Financial Statement discloses that as at 30 June 1998, the State held assets with an aggregate value of \$77.1 billion (30 June 1997, \$70.3 billion) and liabilities with an aggregate value of \$49.1 billion (30 June 1997, \$49.5 billion). While the level of State liabilities has decreased by around \$300 million, the level of State assets has increased substantially due to the recognition of certain assets for the first time, the revaluation of certain physical assets and an increase in the level of the State's cash and investment holdings.

In particular, cash and investment holdings have increased from \$13.3 billion to \$16.2 billion over the past 12 months, with a net amount of \$4.1 billion held by the Treasury Corporation of Victoria awaiting application by the Government.

Finally, given the increasing trend within the public sector for service delivery through contractor services and outsourcing arrangements, and the increasing impact of such services on agency financial operations, it is important that appropriate annual reporting requirements be introduced in relation such services.

Summary of major findings

OPERATING RESULT AND FINANCIAL POSITION

Page 17

- As at 30 June 1998, the State held net assets of \$28 billion (30 June 1997, \$20.8 billion), comprising assets with an aggregate value of \$77.1 billion, and liabilities with an aggregate value of \$49.1 billion.
Paras 3.6 to 3.7
- The State achieved an operating surplus prior to abnormal items of \$2 billion for the 1997-98 financial year, which was \$410 million higher than the result achieved in the previous year.
Paras 3.2 to 3.5
- The overall operating surplus for the year was favourably impacted by \$2.2 billion of abnormal transactions, mainly relating to the sale of entities in the electricity industry and the recognition of a future revenue stream receivable mainly from electricity distribution companies.
Para. 3.3
- The State's financial condition has strengthened during the 1997-98 financial year, in that:
 - the Government's capacity to maintain existing programs and operations has improved;
 - the Government's flexibility in responding to future opportunities requiring increased financial resources has also improved; and
 - the State's vulnerability to funding sources not directly within its control has decreased.
Paras 3.8 to 3.12
- The State's total cash and investment holdings have increased substantially from \$13.3 billion as at 30 June 1997 to \$16.2 billion as at 30 June 1998, with a net amount of \$4.1 billion held by the Treasury Corporation of Victoria awaiting application by the Government.
Para. 3.12
- Legislative reforms were implemented effective from 1 July 1998 involving the adoption of accrual-based appropriations and financial management focusing on the delivery of outputs.
Paras 3.21 to 3.23
- While it may have been expected that by shifting to accrual-based arrangements, the appropriations would be applied when expenditure was incurred, the Government's framework provides that the Treasurer will determine when Parliamentary appropriations will be applied, which will be when the Treasurer determines outputs have been delivered.
Paras 3.24 to 3.25

ASSET SALES**Page 29**

- The application of privatisation proceeds towards the reduction of State debt has been a major factor contributing to the strengthening of the State's financial position.
Paras 4.1 to 4.4
- It was estimated that the State derived annual net savings of approximately \$760 million during the 1997-98 financial year from electricity privatisations that have occurred to date.
Paras 4.35 to 4.38
- A formal independent valuation of Victorian Electricity Metering Pty Ltd was not obtained prior to its sale to enable an assessment of the adequacy of the result achieved by the State.
Paras 4.20 to 4.34
- Under a partnering agreement entered into between Melbourne Water Corporation and the purchaser of its business segment, Streamline Australia, the purchaser has been established as a "preferred service provider" to the Corporation, with the Corporation undertaking to provide business to the purchaser subject to competitive pricing and conditions over a 5 year period, up to a value of \$60.1 million in present value terms.
Paras 4.41 to 4.56
- The gross sale proceeds achieved for the former SECV building located at 452 Flinders Street, Melbourne were \$19.5 million higher than the reserve price set by the Valuer-General in July 1998.
Paras 4.57 to 4.65
- The gross sale proceeds achieved for the former SECV building were \$130.5 million less than the price of \$250 million paid by the SECV in 1994 to acquire ownership of the building, but the State has avoided the on-going exposure associated with the onerous lease contract.
Para. 4.65
- The successful tenderer for the provision of metropolitan bus services within the Footscray and Sandringham areas of Melbourne has entered into a 10 year contract with the Department of Infrastructure, in return for receiving annual fees which are estimated to total around \$135 million in nominal terms (around \$99 million in present value terms) over the period of the contract.
Paras 4.76 to 4.104
- While an inter-departmental evaluation committee initially selected a preferred tenderer for the provision of metropolitan bus services based on its assessment of tenders received against predetermined criteria, the second ranked tenderer was ultimately engaged by the Department of Infrastructure based on a re-assessment of tenders with an increased emphasis on service benefits.
Para. 4.102

ASSET SALES - *continued***Page 29**

- The savings to the State from proceeding with the service contract for the external provision of metropolitan bus services compared with the pre-existing inhouse arrangements were estimated by the Department of Infrastructure at \$2.5 million per annum.
Para. 4.104
- The net proceeds from the sale of the former Port Melbourne gasworks sites, after taking account of the estimated costs of \$8.5 million to be incurred mainly in relation to the required remediation works, will be around \$1 million.
Paras 4.105 to 4.124
- While the return of \$7.5 million obtained from the sale to the University of Melbourne of the former VicRoads property at Carlton by the Department of Treasury and Finance, was consistent with the valuation provided by the Valuer-General, the return to Victorian taxpayers may not have been maximised as the sale was not subject to a competitive process.
Paras 4.136 to 4.167
- Four months prior to the Governor-in-Council approving the sale of the former VicRoads property to the University of Melbourne, in December 1997 the University entered into a contract for the sale of the property to a private sector developer for a price of \$7.5 million.
Para. 4.165

REVENUE**Page 71**

- The operating revenues of the State totalled \$25.6 billion during the 1997-98 financial year, which was \$258 million higher than the revenues raised in the previous year.
Para. 5.1
- The Government estimated that, after taking account of the tax relief measures announced in its 1998-99 Budget, the State's tax raising effort was still around \$220 million above the national average.
Paras 5.5 to 5.7
- During 1997-98, the total revenues to the State from gambling activities totalled \$1.3 billion and represented 5 per cent of total State operating revenues.
Para. 5.25
- A fifth deed of variation to the Casino Management Agreement has been executed to defer the completion date of the construction of a second hotel tower and the Lyric Theatre from November 1999 to November 2003. The impact of the recent amendment which deferred the obligation by Crown is equivalent to the waiver by the State of up to \$73 million in liquidated damages which would have been payable from November 1999 to November 2003.
Paras 5.26 to 5.38

EXPENDITURE**Page 89**

- The operating expenses of the State totalled \$23.7 billion during the 1997-98 financial year, which was \$152 million lower than the expenditure incurred in the previous year.
Paras 6.1 to 6.3
- The net operating costs incurred by the State on the Formula One and Motorcycle Grand Prix projects, determined on an accrual basis, relating to the 1997-98 financial year were \$8.9 million.
Paras 6.24 to 6.40
- Since the inception of the Grand Prix events, the net aggregate operating costs incurred by the State were \$27.4 million.
Para. 6.31
- In May 1998, the Treasurer formally approved additional funding of \$10 million to the Department of Education to meet the associated costs of excess teachers. However, in October 1998 the Minister for Education announced that up to 2 600 teaching jobs will be available in Government primary and secondary schools in 1999. Around 1000 of the new jobs will be created as part of the Government's \$102 million a year early literacy initiative.
Paras 6.41 to 6.44
- The total cost to the State of the Government's Winter Power Bonus Scheme over the 3 year period will be around \$370 million.
Paras 6.45 to 6.47
- The electricity distribution businesses agreed to terminate the previously established sales tax reimbursement agreements with the State with effect from 1 July 1998. The total cost to the State associated with the termination of these agreements was around \$67 million.
Paras 6.48 to 6.51
- Given the increasing trend within the public sector for service delivery through contractor services and outsourcing arrangements, and the increasing impact of such services on agency financial operations, it is important that appropriate annual reporting requirements be introduced in relation to contractor and outsourcing services, to complement the existing reporting requirements relating to consultancy services.
Paras 6.52 to 6.57

ASSETS OF THE STATE**Page 107**

- Certain assets of the State are yet to be recognised by the relevant agencies, including certain parcels of crown land managed by Committees of Management which come under the ultimate responsibility of the Department of Natural Resources and Environment, the State's share of assets managed by the Murray-Darling Basin Commission, and land under roads.

Paras 7.5 to 7.9

- While supplementary information is provided in the notes to the Government's Annual Financial Statement on funds held in trust by State Trustees Limited, information is not disclosed on the extent of funds held in trust by the courts.

Para. 7.10

- Over the past 6 years, the TAC has achieved strong financial results and has maintained a strong financial position. The key factors impacting on these outcomes have been the achievement of high investment returns and the effective management of claims liabilities.

Paras 7.18 to 7.33

- The high level of financial performance achieved by the TAC over the past 6 years has enabled substantial contributions of around \$3 billion to be made by the TAC to other public sector agencies for application towards funding Government programs.

Paras 7.34 to 7.38

- In July 1997, the Rural Finance Corporation entered into a Loan Portfolio Sale and Management Agreement with a bank for the sale of the rights to a defined loan portfolio with an aggregate value of \$43.5 million. However, the arrangements were not subject to a contestable process, although the Corporation did consider various proposals from a number of financiers.

*Para. 7.49***LIABILITIES AND COMMITMENTS****Page 127**

- The liabilities of the State totalled \$49.1 billion at 30 June 1998, a reduction of \$317 million in the level of liabilities when compared with the previous year.

Paras 8.4 to 8.6

- The State also has quantifiable contingent liabilities of around \$1.4 billion. In addition, various other contingent liabilities existed at 30 June 1998 which could not be reliably quantified.

Para. 8.7

- The aggregate value of the State's operating lease and capital commitments as at 30 June 1998 were \$2.9 billion (30 June 1997, \$2.6 billion). However, these do not include all the State's commitments under outsourcing contracts entered into for the provision of services to the public sector, such as health services.

Par. 8.8s

LIABILITIES AND COMMITMENTS - continued**Page 127**

- While an assumption of debt of around \$1.1 billion by the Consolidated Fund from the Director of Housing has facilitated the consolidation of the Housing debt portfolio with the budget sector debt portfolio, it has resulted in reduced transparency associated with the net costs of providing housing rental and finance assistance.
Paras 8.36 to 8.41
- The State sold its 25 per cent interest in the Portland Smelter, without divesting that share of the exposure relating to the flexible electricity tariff arrangements.
Para. 8.96
- Based on current Government expectations of future aluminium prices and inflation levels, and after taking account of the impact of established hedge and levy arrangements, as at 30 June 1998, the estimated net present value of the State's future liabilities under the flexible electricity tariff arrangements was \$1.3 billion and the estimated amount receivable from the levy on distribution businesses established by the Government was \$894 million.
Paras 8.93 to 8.97
- Following receipt of an Auditor-General's certificate regarding the calculation of electricity tariffs payable under the electricity supply agreements relating to the aluminium smelters and discussions with the smelter operators, the SECV received an amount of \$10.7 million from the operators representing a cost adjustment to the period July 1993 to April 1998.
Paras 8.105 to 8.108
- Expenditure incurred by the Melbourne City Link Authority in relation to the total City Link project during the period ended 30 June 1995 to 30 June 1998 amounted to \$249 million, with the State's capital commitments in relation to the City Link project amounting to \$120 million as at 30 June 1998.
Paras 8.119 to 8.130
- Under a contract awarded by the Government to a company to develop an advanced computer network within the State, the company will build and own the network at a cost of between \$100 million and \$150 million over 5 years, with the respective Government agencies utilising the network on a fee-for-service basis and, in the event of the expiry or the early termination of the agreement, the State having the option to purchase the network equipment at its fair market value.
Paras 8.133 to 8.145

PART 2

Audit Opinion on Statement



FINANCIAL ACCOUNTABILITY FRAMEWORK

2.1 The *Financial Management Act 1994*, *Audit Act 1994* and *Constitution Act 1975* collectively establish the legislative framework which sets out the Government's accountability responsibilities to the Parliament over State finances, including the external financial reporting and audit arrangements which operate within the Victorian public sector.

2.2 A key element of the framework is the requirement, under the *Financial Management Act 1994*, for the Government to prepare an Annual Financial Statement which must be audited by the Auditor-General and presented to the Parliament each year, together with a Report of the Auditor-General on that Statement. Under the Act, **the Government's Annual Financial Statement must be prepared in a manner and form approved by the Minister for Finance and must include certain disclosures relating to the transactions and balances of the Public Account, comprising the Consolidated Fund and the Trust Fund, and the liabilities (including contingent liabilities) and prescribed assets of the State.**

2.3 To enhance the quality of the information available to the Parliament and the Government on the financial performance and position of the State, and in turn to facilitate more informed decision-making on financial strategy and resource allocation matters, in the 1996-97 financial year the Minister for Finance determined that, commencing from that year, the Annual Financial Statement would incorporate a consolidated financial report for the State. The consolidated financial report includes an operating statement, balance sheet, statement of cashflows statement and accompanying notes, which are prepared consistent with the requirements of Australian Accounting Standard AAS31 *Financial Reporting by Governments*.

2.4 Consistent with the Ministerial determination, the Annual Financial Statement for the 1997-98 financial year was presented on a similar basis.

AUDIT OPINION ON THE ANNUAL FINANCIAL STATEMENT

2.5 The Annual Financial Statement for the year ended 30 June 1998 has been audited in accordance with the requirements of the *Financial Management Act 1994*. The audit has been undertaken in accordance with Australian Auditing Standards, using methodologies consistent with those applied by the accounting profession. My opinion on the Government's 1997-98 Annual Financial Statement is as follows:

Audit Scope

The accompanying Annual Financial Statement for the year ended 30 June 1998 of the Government of Victoria (excluding local government bodies, universities and certain parcels of Crown land managed by Committees of Management), which comprises the consolidated operating statement, the consolidated statement of financial position, the consolidated statement of cash flows and the accompanying notes contained in Section 2 of the Statement, has been audited. The Secretary to the Department of Treasury and Finance is responsible for the preparation and presentation of the Statement and the information it contains. An independent audit of the Statement has been carried out in order to express an opinion on it as required by the *Financial Management Act 1994*.

The audit has been conducted in accordance with Australian Auditing Standards to provide reasonable assurance as to whether the financial statements are free of material misstatement. The audit procedures included an examination, on a test basis, of evidence supporting the amounts and other disclosures in the financial statements, and the evaluation of accounting policies and significant accounting estimates. These procedures have been undertaken to form an opinion as to whether, in all material respects, the financial statements are presented fairly in accordance with Australian Accounting Standards and other mandatory professional reporting requirements, and comply with the requirements of the *Financial Management Act 1994* so as to present a view which is consistent with my understanding of the financial position of the Government of Victoria and the results of its operations and its cash flows.

The audit opinion expressed on the Annual Financial Statement has been formed on the above basis.

Audit Opinion

In my opinion, the financial statements present fairly the financial position of the Government of Victoria as at 30 June 1998 and the results of its operations and its cash flows for the year ended on that date in accordance with Australian Accounting Standards and other mandatory professional reporting requirements and comply with the requirements of the *Financial Management Act 1994*.

Scope of the Annual Financial Statement

2.6 The Annual Financial Statement has been prepared in accordance with the requirements of the *Financial Management Act 1994*, relevant Australian Accounting Standards and, in particular, Australian Accounting Standard AAS31 *Financial Reporting by Governments* which requires the presentation by the Commonwealth and individual State and Territory Governments of general purpose whole-of-government financial reports for their relevant jurisdictions, prepared on the accrual basis of accounting.

2.7 In presenting the Government as a single economic entity, the Annual Financial Statement has been prepared by consolidating the financial statements of all public sector entities within the State, except for local government bodies, universities and certain parcels of Crown land managed by Committees of Management, which the Minister for Finance has determined not to include in these whole-of-government financial statements.

2.8 Substantially due to the implementation of the Government's asset identification and valuation program in recent years, most of the State's assets have been appropriately recognised within the financial statements. The major asset group yet to be recognised as at 30 June 1998 represents certain Crown land parcels managed by Committees of Management which ultimately come under the responsibility of the Department of Natural Resources and Environment. Other assets also yet to be recognised by the State include the State's share of assets managed by the Murray-Darling Basin Commission and land under roads. Further comments on the progress made during the 1997-98 financial year in relation to the valuation and recognition of State assets are included in Part 7 of this Report.

Auditor-General's Report on the Victorian Government's Finances

2.9 As mentioned earlier, the Government's Annual Financial Statement discloses the financial operations and financial position of the State, including the financial transactions of the Public Account. To assist in the analysis and assessment of the Statement, this Report to the Parliament is presented in a format consistent with that adopted for the Statement. The Report comments on:

- Operating result and financial position;
- Asset sales;
- Revenue;
- Expenditure;
- Assets of the State; and
- Liabilities and commitments.

PART 3

Operating Result and Financial Position



OPERATING RESULT AND FINANCIAL POSITION
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3.1 Table 3A presents a summary of the operating result achieved by the State for the year and its financial position as at 30 June 1998.

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

<i>Item</i>	<i>1997-98</i>	<i>1996-97</i>
Operating result		
Revenues	25.7	25.4
Expenses	23.7	23.8
Operating surplus for the year before abnormal items	2.0	1.6
Net abnormal items (a)	2.2	1.8
Operating surplus for year	4.2	3.4
Financial position		
Assets -		
Cash and Investments	16.2	13.3
Physical assets	56.1	53.1
Other	4.8	3.9
	77.1	70.3
Liabilities -		
Unfunded superannuation	14.9	15.2
Borrowings	19.0	19.8
Employee entitlements	2.5	2.4
Other	12.7	12.1
	49.1	49.5
Net assets	28.0	20.8

(a) Includes the impact of electricity industry privatisations of \$1.4 billion (1996-97, \$2.2 billion), the recognition in the 1997-98 financial year of the present value of amounts receivable of \$894 million mainly from electricity distribution companies to partly offset the State's exposure under certain onerous contracts, and the PRRT dispute settlement during the 1996-97 financial year of \$339 million.

Operating result for the year

3.2 The Consolidated Operating Statement provides information on the extent to which the costs of service delivery are covered by the revenues raised in the year, including movements in these items since the previous year. The difference between the revenues raised and expenses incurred in the year represents the operating result achieved by the State, which is a key measure of the Government's financial performance. In addition, when assessed over a number of years, the operating result is an important indicator of the financial impact and sustainability of the Government's financial strategies and policies.

3.3 The Government's Annual Financial Statement discloses that **the State achieved an operating surplus prior to abnormal items of \$2 billion for the 1997-98 financial year, which was \$410 million higher than the result achieved in the previous year. However, after taking account of the impact of abnormal transactions during the year, mainly relating to the impact of the electricity industry privatisation program and the recognition of a future revenue stream receivable mainly from electricity distribution companies, the overall operating surplus for the year was \$4.2 billion (1996-97, \$3.4 billion).** Detailed comment on the electricity industry privatisation program and the abovementioned receivable is provided in Part 4 and 8 of this Report, respectively.

3.4 The key factors positively contributing to the improved operating result achieved in the 1997-98 financial year, compared with the previous year, were increased taxation revenues and a reduction in interest costs mainly resulting from lower State debt levels attained from the application of electricity business privatisation proceeds towards debt retirement. However, the impact of these items was to some extent offset by reduced revenues from the sale of goods and services and increased expenditure on supplies and consumables associated with the delivery of government programs.

3.5 The major revenue sources contributing to the year's outcome were State taxation, grants from the Commonwealth Government and proceeds from the sale of goods and services provided by public sector entities. Collectively, these items represented \$23 billion or around 90 per cent of the revenues raised by the State during the 1997-98 financial year. The major components of the State's expenditure included costs incurred in relation to employee entitlements, the purchase of supplies and consumables, grants to third parties, and superannuation and financing costs. These items represented \$21.6 billion or around 91 per cent of State operating expenditures for the 1997-98 financial year. A more detailed analysis of the State's revenues and expenses is provided in later Parts of this Report.

Financial position

3.6 The Consolidated Statement of Financial Position discloses information on the level and composition of assets and liabilities held by the State as at 30 June 1998, including changes thereon since the previous year. Importantly, the statement serves as an indicator of the Government's financial strength and of changes in its overall financial position. In this regard, the Government's Annual Financial Statement shows that, **as at 30 June 1998, the State held net assets of \$28 billion (30 June 1997, \$20.8 billion), comprising assets with an aggregate value of \$77.1 billion, and liabilities with an aggregate value of \$49.1 billion.** The key factors contributing to the improvement in the State's net assets position during the 1997-98 financial year included:

- Increase in the State's asset holdings of \$6.8 billion, mainly comprising an increase in the reported value of physical assets, and increased investment balances. Further analysis of the State's asset holdings is presented in Part 7 of this Report; and
- Decrease in the State's liabilities of \$317 million, mainly comprising a decrease in the level of outstanding debt and unfunded superannuation liabilities, which was partly offset by an increase in the level of outstanding claims liabilities mainly relating to the State's transport accident and workers' compensation schemes. Further analysis of the State's liabilities is presented in Part 7 of this Report.

3.7 The State's financial position is favourably impacted by the level of physical assets held, which mainly comprise Crown and freehold land and buildings, plant and equipment and other infrastructure, which collectively account for \$56.1 billion or around 72 per cent of the State's aggregate assets. The major financial obligations of the State comprise unfunded superannuation liabilities and borrowings, which represent \$33.9 billion or around 69 per cent of total liabilities. A further analysis of the State's assets and financial obligations is provided in later Parts of this Report.

Analysis of the State's financial condition

3.8 While analyses of movements between years in the level of assets and liabilities, and the annual operating results achieved, are important measures of the State's financial performance and position, they do not necessarily provide a complete picture of its "financial condition". Informed assessments of the State's financial condition also need to take into account other indicators of financial health and strength, focusing on:

- **Sustainability** - indicating movements in the degree to which the 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 the 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 the Government is dependent on, and therefore vulnerable to, sources of funding outside its direct control or influence.

3.9 Below, I have provided some key indicators relating to the State's finances. The analysis of these indicators which follows, together with a consideration of trends in the overall net assets position of the State and the operating results achieved by the Government, which were presented earlier in this Report, is aimed at providing additional information relating to the condition of the State's finances.

3.10 It needs to be recognised that the audit analysis focuses on historical financial information and, accordingly, its scope does not extend to assessments of the effectiveness of government programs and the associated revenue and expenditure decisions. Also, given that audited whole-of-government accrual-based financial information for the State is only available for the past 2 years, the analysis presented in this Report is necessarily limited to this timeframe. However, as the base of information grows over future years, longer-term trend analyses of financial performance and condition will become possible.

3.11 Table 3B presents some of the key indicators relating to the State's finances for the 1996-97 and 1997-98 financial years.

TABLE 3B
STATE OF VICTORIA
INDICATORS OF FINANCIAL CONDITION,
1996-97 AND 1997-98

<i>Indicators (a)</i>		1996-97	1997-98	<i>Improvement/ (Deterioration)</i>
Sustainability of existing operations -				
Operating result - level of surplus/(deficit)	<i>(\$billion)</i>	1.6	2.0	0.4
Level of borrowings	<i>(\$billion)</i>	19.8	19.0	0.8
Operating result (before abnormal items) to Victoria's GSP	<i>(per cent)</i>	1.2	1.4	0.2
Operating result (before abnormal items) to total revenues	<i>(per cent)</i>	6.2	7.7	1.5
Borrowings to Victoria's GSP	<i>(per cent)</i>	14.9	13.5	1.4
Total liabilities to Victoria's GSP	<i>(per cent)</i>	37.4	35.2	2.2
Total assets to total liabilities	<i>(per cent)</i>	142	157	15
Finance charges to total expenditure	<i>(per cent)</i>	9	6	3
Flexibility in increasing financial resources -				
Own source revenue to Victoria's GSP	<i>(per cent)</i>	13.4	13.0	(0.4)
Own source revenue to total revenue	<i>(per cent)</i>	70.4	71.5	1.1
Finance charges to total revenue	<i>(per cent)</i>	8.4	5.6	2.8
Expenditure to Victoria's GSP	<i>(per cent)</i>	17.8	16.8	1
Level of fixed assets to net assets	<i>(per cent)</i>	255	200	55
Vulnerability to external sources of funding -				
Operating result (before abnormal items) to Victoria's GSP	<i>(per cent)</i>	1.2	1.4	0.2
Commonwealth revenues to total revenues	<i>(per cent)</i>	29	28	1
Finance charges to total revenue)	<i>(per cent)</i>	8.4	5.6	2.8
Current assets to current liabilities	<i>(per cent)</i>	105	70	(35)
Borrowings to Victoria's GSP	<i>(per cent)</i>	14.9	13.5	1.4
Foreign currency borrowings to total borrowings	<i>(per cent)</i>	28	19	9

(a) A number of the indicators provide reference to Victoria's GSP. This reference relates to the size of the State economy and is sourced from statistics published by the Australian Bureau of Statistics for the 1996-97 financial year and estimates provided by the Department of Treasury and Finance for the 1997-98 financial year.

3.12 The information contained in the above table highlights that **the State's financial condition has strengthened during the 1997-98 financial year, in that:**

- **The Government's capacity to maintain existing programs and operations has improved**, as indicated by the improved operating result achieved in the year, the reduced level of outstanding borrowings, the lower call on State revenues to meet financing charges, and the reducing proportion of State liabilities compared with the size of Victoria's economy;
- **The Government's flexibility in responding to future opportunities requiring increased financial resources has also improved**, as indicated by the reducing proportion of State expenditures compared with the size of the State's economy, the increasing proportion of own-source revenue collections and the reducing debt burden on State finances; and
- **The State's vulnerability to funding sources not directly within its control has decreased**, as reflected in the reducing debt burden on Victorian taxpayers and the reducing reliance on Commonwealth revenues. However, there is an excess of current liabilities over current assets as at 30 June 1998, mainly brought about by the State's borrowings profile and a reduction in the level of "current" investments. Nevertheless, **the State's total cash and investment holdings have increased substantially from \$13.3 billion as at 30 June 1997 to \$16.2 billion as at 30 June 1998, with a net amount of \$4.1 billion held by the Treasury Corporation of Victoria awaiting application by the Government.**

Consolidated Fund result for the year

3.13 As highlighted earlier in this Report, in addition to the presentation within the Government's Annual Financial Statement of the State's consolidated operating result, the *Financial Management Act* 1994 requires the presentation of certain additional information relating to the financial operations of the Public Account, which comprises the Consolidated Fund and the Trust Fund. In this regard, Note 29 to the Government's Annual Financial Statement provides these statutory disclosures.

3.14 My previous Reports to the Parliament have commented on the absence of a clear differentiation between operating and capital items within the Consolidated Fund, which inhibited the ability of users of the Government's Annual Financial Statement to ascertain and assess the Fund's operating result for the year. A positive development in the 1997-98 financial year was the implementation of action by the Government to address this deficiency, with the allocation of receipt and payment transactions changed from the previous recurrent and works and services classifications, to the current and capital classifications. Under the revised regime, the classification of Consolidated Fund transactions is more closely aligned with conventional accounting principles. However, as indicated in Table 3E, further refinement was required in relation to the classification of transactions.

3.15 The Government's Annual Financial Statement discloses that **the overall Consolidated Fund cash-based result for the 1997-98 financial year, not including receipts from borrowings, was a deficit of \$309 million, compared with a balanced budget expected outcome.** The key factor contributing to this outcome was the repayment of Consolidated Fund debt in excess of the surpluses generated by the Consolidated Fund in the year.

3.16 Table 3C presents the Consolidated Fund result for the year, segmented according to operating and capital transactions, and highlights transactions that are not of an ongoing nature, which are known in accounting terms as "abnormal items".

TABLE 3C
AUDIT RE-STATEMENT OF
CONSOLIDATED FUND RESULT FOR YEAR (a)
(\$million)

<i>Item</i>	1997-98	1996-97
<i>Operating transactions -</i>		
Receipts	16 461	15 955
Payments	13 782	13 503
Operating surplus prior to abnormal items	2 679	2 452
Add - Abnormal items (b)	2 089	4 154
Operating surplus for the year	4 768	6 606
<i>Capital transactions (excluding borrowing transactions) -</i>		
Receipts	684	833
Payments	1 931	2 017
Capital deficit prior to abnormal items	(1 247)	(1 184)
Add/(Less) - Abnormal items (c)	(567)	34
Capital deficit for year (excluding borrowing transactions)	(1 814)	(1 150)
Consolidated Fund surplus prior to borrowing transactions	2 954	5 456
Borrowing repayments	(3 263)	(5 999)
Overall Consolidated Fund surplus / (deficit) funded from borrowings for year	(309)	(543)

(a) Table 3E provides a summary of inappropriately classified receipts and payments, as identified by audit.

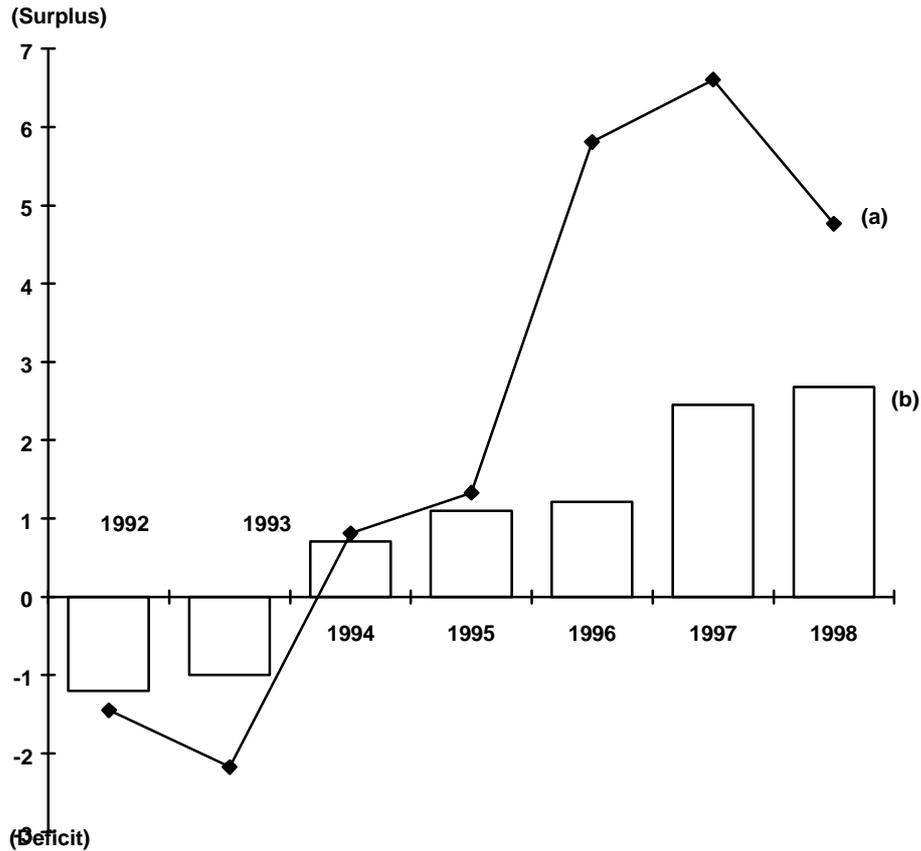
(b) Abnormal items of an operating nature include the receipt of \$2.1 billion from the sale of State-owned business enterprises (\$4.4 billion, 1996-97), employee departure program payments of \$20 million (1996-97, \$149 million), special dividends of \$173 million received from public bodies (\$135 million, 1996-97), a contribution of \$159 million (1996-97, \$154 million) to the Commonwealth Government in relation to its deficit reduction program, and costs of \$50 million (1996-97, \$94 million) associated with electricity industry privatisation.

(c) Abnormal items of a capital nature comprise capital grant payments of \$410 million to rural water authorities, additional payments of \$490 million made to the Emergency Services Superannuation Board and the Hospitals Superannuation Board to reduce the State's unfunded superannuation liabilities, the additional receipt of \$299 million from the Director of Housing representing a part repayment of outstanding advances from the Consolidated Fund, and the receipt from Crown Casino of \$34 million (1996-97, \$34 million) for the right to operate the new casino.

3.17 An analysis of the Consolidated Fund result indicates that the operating surplus for the year prior to abnormal items was \$2.7 billion, compared with \$2.5 billion in the 1996-97 financial year. The improved outcome achieved in the 1997-98 financial year was mainly due to higher taxation receipts and increased operating grants from the Commonwealth Government. However, after taking account of abnormal items, mainly relating to proceeds of \$2.1 billion (1996-97, \$4.4 billion) received as a result of the Government's privatisation program, the operating result was \$4.8 billion (1996-97, \$6.6 billion).

3.18 Chart 3D illustrates the significant improvement that has occurred over recent years in the Consolidated Fund operating results achieved by the Government, reflecting the positive impact of major budget and financial management reforms, and the improved economic conditions within the State.

**CHART 3D
CONSOLIDATED FUND OPERATING RESULT,
1991-92 TO 1997-98
(\$billion)**



(a) Consolidated Fund result after taking into account abnormal items.
(b) Consolidated Fund operating result prior to abnormal items.

3.19 In relation to the capital sector of the Consolidated Fund, the result achieved prior to debt repayment transactions and abnormal items in the 1997-98 financial year was a deficit of \$1.2 billion, which was broadly consistent with the result achieved in the previous year.

Re-classified transactions

3.20 In Table 3E, audit has presented a re-statement of the Consolidated Fund result, which differentiates between operating and capital transactions. Table 3E below details those transactions which have been re-classified by audit.

TABLE 3E
RE-CLASSIFIED CONSOLIDATED FUND
TRANSACTIONS, 1997-98
(\$million)

<i>Item</i>	<i>Amount</i>
Receipts	
Operating receipts classified as capital - Privatisation proceeds	1 715
Capital receipts classified as current - Special dividends (a) Casino premium payment	173 34
Re-classified receipts	1 922
Payments	
Operating payments classified as capital -	52
Less - Capital payments classified as current - Additional superannuation payments to reduce State liabilities	(963)
Capital grants and other payments	(416)
Re-classified payments (net)	(1 327)

(a) Received from the Rural Finance Corporation, the Treasury Corporation of Victoria and the Urban Land Corporation.

FINANCIAL MANAGEMENT REFORM

3.21 The legislative accountability framework provides for specific disclosures in the Government's Annual Financial Statement in relation to the operations of the Consolidated Fund and Trust Fund, given that their financial operations are integral to the administration of budget sector finances.

3.22 The Consolidated Fund is established as the Government's main operating account and records the collection of all departmental revenues such as State taxes, Commonwealth grants and asset sale proceeds. Fundamental to the legislative framework is the principle that only the Parliament can authorise expenditure from the Consolidated Fund via the passing of Appropriation Acts, which provide the key means by which parliamentary control is exercised over public finances. The Trust Fund comprises various specific purpose trust accounts, mainly relating to the on-passing of certain Commonwealth grants to specified recipients, the operation of departmental suspense and working accounts, and the receipt and payment of moneys of a trust nature.

3.23 As part of the Government's *Management Reform Program*, **a package of initiatives including legislative reforms was implemented with effect from the 1998-99 financial year, involving a fundamental shift away from traditional "cash-based" appropriations and financial management to "accrual-based" appropriations and financial management, focusing on the delivery of outputs.** Under the new arrangements, which came into effect as from 1 July 1998, parliamentary appropriations provide for the allocation of Consolidated Fund revenues towards meeting the full "costs incurred" during a financial year relating to the purposes specified in the relevant Appropriation Acts. These costs will include both cash and non-cash components which may be paid in either the current or future years, including costs associated with depreciation and employee entitlements.

3.24 The new appropriation arrangements will assist in enhancing financial management within the budget sector by ensuring that the financial reporting arrangements for departments, which provide for the presentation of accrual-based financial statements to the Parliament, are aligned with the resource allocation and financial management processes within Government which will also be based on accrual principles.

3.25 Under the previous parliamentary appropriation system, appropriations were applied when payments were made. While it may have been expected that by shifting to accrual-based arrangements, the appropriations would be applied when expenditure was incurred, the Government's framework for the operation of appropriations as from 1 July 1998 provides that the Treasurer will determine when parliamentary appropriations will be applied, which will be when the Treasurer determines whether or not particular outputs have been delivered. Accordingly, under the new framework, the funding of Government operations will be initially dependent on the provision of advances to enable the incurring of expenditure to deliver outputs.

PART 4

Asset Sales



GOVERNMENT ASSET SALES PROGRAM

4.1 In recent years, the privatisation of government business enterprises and the sale of surplus and underutilised properties have been key elements of the Government's program associated with the implementation of its economic and budget strategies. In particular, the application of privatisation proceeds towards the reduction of State debt has been a major factor contributing to the strengthening of the State's financial position.

4.2 Among the key objectives of the privatisation program have been the maximisation of:

- efficiency and effectiveness in service delivery;
- competition within the economy; and
- the value of previously publicly-owned businesses to taxpayers.

4.3 The sale of surplus and underutilised assets has been focused at improving asset management and the financial performance of the public sector.

4.4 This Part of the Report outlines the major business and property sales undertaken or completed by the Government during the 1997-98 financial year, and up to the date of preparation of this Report. The sales covered in this Report include:

Business sales

- Electricity businesses; and
- Streamline Australia.

Property and equipment sales

- Former SECV building;
- South Melbourne Tram Depot site;
- Met Buses;
- Former Port Melbourne gasworks sites
- Newport railway site;
- VicRoads precinct in Carlton;
- Wellington Parade property;
- Spring Street property; and
- Former Melbourne Magistrates Court site.

Victorian electricity industry privatisation

4.5 My previous Reports to the Parliament have provided detailed comment on the Government's extensive electricity industry restructure program which commenced in 1994. The program initially involved the disaggregation of the State Electricity Commission of Victoria (SECV) to a new competitive structure, mainly comprising electricity distribution businesses and generation companies and, subsequently, the progressive privatisation of these businesses.

4.6 Under the restructure program, the State's 5 electricity distribution businesses were privatised during the 1995-96 financial year, followed by the privatisation of the State's major electricity generation companies also during the 1995-96 financial year and in the 1996-97 financial year. Comprehensive analyses of these sales, including the financial results achieved by the State and their impact on Victoria's finances, were provided to the Parliament in my past *Reports on Ministerial Portfolios* and my *Reports on the Government's Annual Financial Statement* (referred to prior to the 1996-97 financial year as my *Reports on the Statement of Financial Operations*).

4.7 During the 1997-98 financial year, a further 3 Victorian electricity industry entities were privatised, namely:

- *PowerNet Victoria* - which owned and maintained the high voltage electricity transmission grid which provides transmission services to electricity market participants by transmitting electricity from the generators to the distributors; and
- *Southern Hydro Ltd* - which owned and operated 3 hydro-electricity schemes at Kiewa, Dartmouth and Eildon, as well as some minor plants at other locations; and
- *Victorian Electricity Metering Pty Ltd* - which provided electricity metering services to the Victorian electricity industry.

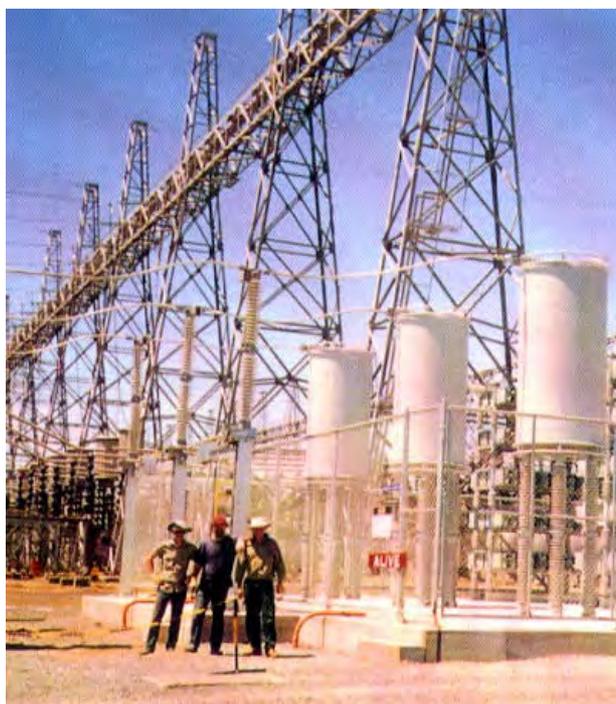
4.8 While my May 1998 *Report on Ministerial Portfolios* provided a comprehensive analysis of the above 2 larger privatisations, given that these transactions have had a significant impact on the financial result achieved by the State in the 1997-98 financial year, I have also outlined the key elements of the transactions below.

PowerNet Victoria

4.9 PowerNet Victoria (PowerNet) was established in October 1994 following the disaggregation of the SECV, with the primary function to own and maintain the existing high voltage electricity transmission system in Victoria.

4.10 As the sole supplier of high voltage transmission services in Victoria, PowerNet received the bulk of its revenue from Victorian Power Exchange (VPX) which operates the transmission system under the terms of a network agreement between the various parties. The next largest source of revenue for the business comprised network connection fees which are levied on the electricity distribution companies, the electricity generation companies and the large customers which are directly connected to the network.

4.11 Under the regulatory arrangements established for the Victorian electricity supply industry, PowerNet's revenues are substantially secured, with the company currently deriving in excess of 95 per cent of its total revenues from the above customers (relating to its regulated transmission business) under regulated tariff arrangements based on forecast maximum summer power demand.



PowerNet's terminal station located at Rowville.

4.12 Following a trade sale process involving the receipt and evaluation of competitive bids from prospective purchasers, in October 1997, the Government announced the sale of the net assets of PowerNet to the preferred bidder, Australian Transmission Corporation Pty Ltd, a wholly-owned subsidiary of GPU Inc., a United States-based utility company.

4.13 Under the sale arrangements for PowerNet Victoria, the State received gross proceeds of \$2.7 billion, comprising amounts relating to:

- sale of the State's interest in the net assets of the businesses (\$1.8 billion);
- repayment of outstanding business debt owed to the Treasury Corporation of Victoria (\$754 million);
- present value of transmission licence fees payable by the purchaser of PowerNet (\$161 million); and
- stamp duty payable on the sale transactions (\$10 million).

4.14 Table 4A outlines the key components of the proceeds received from the sale, which compared favourably with valuations of the business received by the Government during the sale process.

TABLE 4A
POWERNET VICTORIA
COMPOSITION OF SALE PROCEEDS
(\$million)

<i>Details</i>	<i>Amount</i>
Proceeds in excess of book value	1 249
Proceeds equal to the State's interest in the book value of the business (a)	542
	1 791
Repayment of outstanding debt of the business (b)	754
Future licence fees (present value) (c)	161
Stamp duty on sale transaction	10
Total proceeds	2 716

(a) Represents the value of net assets sold as disclosed in the audited financial statements of the business as at the date of sale completion.

(b) Under the sale arrangements, the State retained responsibility for the repayment of the entity's loans and accrued interest payable to the Treasury Corporation of Victoria.

(c) In accordance with the licence fee order, the purchaser of PowerNet agreed to pay future transmission licence fees totalling \$177.5 million in nominal dollar terms (\$161 million in present value terms) for the period July 1998 to December 2000, with no further fees expected to be payable beyond this date.

4.15 The table shows that the State received \$1.8 billion for the sale of the net assets of PowerNet Victoria, which at the effective date of sale had a book value of \$542 million. In effect, this resulted in **the State obtaining proceeds of \$1.2 billion in excess of the book value of the business. The State incurred costs totalling \$9.7 million in relation to this sale.**

Southern Hydro Ltd

4.16 Southern Hydro Ltd owned and operated 10 hydro-electricity power stations, comprising 21 generators situated mainly in the north-eastern region of Victoria. The power stations have a total installed generation capacity of 479 megawatts and are divided into 3 major generation schemes, located at Eildon, Dartmouth and Kiewa, and 2 minor generation schemes, located at Rubicon and Cairn Curran.



Cairn Curran power station generator room.

4.17 Following a trade sale process involving the receipt and evaluation of competitive bids from prospective purchasers, in November 1997, the Government announced the sale of the net assets of Southern Hydro Ltd to the preferred bidder, a consortium known as the Southern Hydro Ltd Partnership. **Under the sale arrangements for Southern Hydro Ltd, the State received gross proceeds of \$400 million**, comprising amounts relating to:

- sale of the State's interest in the net assets of the business (\$164 million);
- repayment of outstanding business debt owed to the Treasury Corporation of Victoria (\$42 million);
- present value of prepaid and future lease rentals (\$189 million); and
- stamp duty payable on the sale transactions (\$5 million).

4.18 Table 4B outlines the key components of the proceeds received from the sale of Southern Hydro Ltd, which **compared favourably with the valuations of the business, on the basis of a trade sale, provided by the Government's corporate advisers in August 1997.**

TABLE 4B
SOUTHERN HYDRO LTD
COMPOSITION OF SALE PROCEEDS
(\$million)

<i>Details</i>	<i>Amount</i>
Proceeds in excess of book value	112
Proceeds equal to the State's interest in the book value of the business (a)	52
	164
Repayment of outstanding debt of the business (b)	42
Prepaid and future lease rentals (present value (c))	189
Stamp duty on sale transaction	5
Total proceeds	400

(a) Represents the value of net assets sold as disclosed in the draft financial statements of the business as at the date of sale completion.

(b) Under the sale arrangements, the State retained responsibility for the repayment of the entity's loans and accrued interest payable to the Treasury Corporation of Victoria.

(c) In accordance with the lease arrangements, the purchaser of Southern Hydro Ltd agreed to pay lease rentals mainly for the lease of Crown land at Kiewa and Rubicon. The lease payments comprised an amount of \$180 million which was prepaid at the date of sale completion and \$9 million representing the estimated present value of lease rentals payable beyond the prepaid lease period.

4.19 The table shows that the State received \$164 million for the sale of the net assets of Southern Hydro Ltd, which at the effective date of sale had a book value of \$52 million. In effect, this resulted in **the State obtaining proceeds of \$112 million in excess of the book value of the business. The State incurred costs of \$3.8 million in relation to the sale.**

Victorian Electricity Metering Pty Ltd

4.20 The Victorian Power Exchange (VPX), which was recently re-named Victorian Power Exchange Pty Ltd, is a State-owned body which was established in 1994 following the disaggregation of the State Electricity Commission of Victoria (SECV). The entity is responsible for the provision of a wholesale electricity market to Victorian electricity participants and the operation of the electricity transmission network. Victorian Electricity Metering Pty Ltd, a wholly-owned subsidiary of the SECV, also plays an important role in the operation of the wholesale electricity market by ensuring that all electricity market connection points are metered, whether contestable or wholesale, and that the metered energy flow is measured in accordance with the Wholesale Metering Code. Historically, this metering business has operated as a monopoly within the Victorian electricity market.

Sale process

4.21 In August 1997, a proposal was considered by the VPX Board for the sale of the metering business, involving a targeted sale completion date of December 1997. The proposal identified that, on commencement of the national electricity market, metering policy development and enforcement would become the responsibility of the National Electricity Market Management Company Ltd (NEMCO) and the National Electricity Code Administrator Ltd. Consequently, it was considered that there would be considerable interest in the purchase of the metering business by companies wishing to participate in the delivery of such services as part of the national electricity market, and from potential gas market metering providers. However, the Board was aware that a number of conditions could reduce the value of the metering business over time, including:

- the current metering monopoly in Victoria would be eroded by the introduction of the national electricity market in 1998;
- in the event that the business did not enter the NSW market, its dominant market position would be lost within the next 6-12 months; and
- other metering service providers would quickly establish the relevant skills and experience to become credible providers and, with the transition to the national electricity market, current employment levels in the business may not be able to be maintained.

4.22 Following a recommendation provided by consultants engaged by the VPX, that the operations of the metering business should be commercialised and then sold, the VPX Board agreed in-principle to the sale of the business by December 1997. This decision was subject to the outcome of legal advice to be sought on potential stakeholder conflicts and the resolution of any stakeholder claims to ownership of the metering business and the associated intellectual assets.

4.23 While there were no formal business valuations undertaken for the business, an indicative business value of between \$6 million to \$11 million was determined by the VPX in mid-1997. A further indicative valuation was undertaken by the VPX in September 1997 which re-assessed the value of the business at \$8 million, reflecting the impact of the impending establishment of the national electricity market and the associated competitive business environment. Both of these indicative valuations represented projected assessments of the value of the business in the financial year 2000-2001.

4.24 In early October 1997, approval was sought from the Treasurer for the sale of the business. However, prior to such approval being granted, the Treasurer requested that additional analysis be undertaken to confirm that the sale of the business would not create a market dominant operator within Victoria.

4.25 In response to the Treasurer's request, the Department of Treasury and Finance advised that this matter had been closely examined by both the Department and its financial advisers and it had been concluded that it was unlikely that the sale of the business would result in a dominant player in the metering market in Victoria, due to the following key factors:

- competition would be established from a number of areas following the commencement of the national market, including interstate operators and the gas metering business which would be in competition against the electricity metering business;
- the expansion of the contestable market as from July 1998 would result in a significant increase in the metering market, sufficient to attract new market entrants; and
- there are no clear barriers to entry, and new technologies and an expanding market would diminish any competitive advantage the existing operator may have in the short term.

4.26 The Department and its financial advisers also concluded that it would be financially advantageous to sell the business within the shortest timeframe as the value of the business would likely erode over time.

4.27 In mid-October 1997, the Treasurer's approval was once again sought for the sale of the metering business and, in November 1997, an Information Memorandum for the sale of the Victorian electricity metering business was issued to a list of potential purchasers.

4.28 Eleven expressions of interest were received from interested parties, with the proposed purchase prices ranging from \$1 million and \$12 million. Following an assessment of the submissions by an evaluation panel comprising representatives from the Government's legal and financial advisers and a representative from the VPX, the panel recommended the short-listing of 5 parties, subject to one of the parties being able to demonstrate that it was able to meet the pre-determined evaluation criteria. These submissions were selected mainly on the basis of pricing factors and the capacity to add value to the business. Shortly afterwards, following the elimination of one of the short-listed bidders from further consideration due to a failure by that party to meet the pre-determined evaluation criteria, the panel accepted the nomination of an alternate bidder for short-listing, which subsequently proved to be the successful purchaser of the business.

4.29 In December 1997, formal tenders were submitted by only 2 of the 5 short-listed parties, with purchase prices ranging between \$7.2 million and \$7.6 million. Following an assessment of these bids, **the evaluation panel recommended that Texas Utilities Australia Ltd, the purchaser of the electricity distribution company Eastern Energy Ltd, be selected as the winning bidder for the metering business.**

4.30 At this time, the probity auditors appointed by the panel in November 1997, concluded that the sale process of the business was conducted in a manner which was fair and equitable to all bidders.

4.31 In December 1997, the Treasurer approved the allocation of 38 per cent of the net proceeds of the sale of the metering business to the 5 electricity distribution businesses, representing their share of the development costs and ownership rights of a central component of software used to support the metering business. However, the distribution businesses were not satisfied with this offer and requested a payment of 40 per cent of the total net sale proceeds of the business and a further amount representing 40 per cent of a Victorian Energy Network (VEN) one-off licence fee paid to the VPX, associated with the software which was integral to the operations of the metering business.

4.32 Following discussions between the parties, an agreement to facilitate the sale of the business was executed between the State and the distribution businesses in December 1997. The agreement provided that, in consideration of the electricity distribution businesses' consent to the sale, the State would pay the businesses, in agreed proportions, a total of 38 per cent of both the net proceeds of the sale of the metering business and the VEN licence fee.

Sale arrangements

4.33 Under the sale arrangements, in December 1997, the SECV received \$7.6 million for the sale of the net assets of the metering business to a wholly-owned subsidiary of Texas Utilities Australia Ltd. A number of other agreements were also entered into between the purchaser and other parties, relating to the use, access and ownership of the business assets, including the associated software and intellectual rights.

4.34 An analysis of the sale result indicated that:

- a formal independent valuation of the business was not obtained prior to its sale to facilitate an independent assessment of the adequacy of the result achieved by the State;
- the sale price of \$7.6 million was at the lower end of the range of indicative valuations for the business of between \$6 million to \$11 million, as determined by the VPX in mid-1997, and was consistent with the indicative valuation of \$8 million undertaken by the VPX in September 1997, both valuations of which represented projected assessments of the business value as at the financial year 2000-2001;
- the sale price was \$7.2 million higher than the book value of the business of \$378 000; and
- the net proceeds of the sale to the State, including those attributable to the VEN licence fee, were \$4.7 million after taking into account the amounts paid to the distribution businesses of \$2.9 million and the costs incurred by the State and the distribution businesses in relation to the sale of \$372 000.

What will be the ongoing impact of electricity business sales on State finances?

4.35 The cash proceeds of \$2.9 billion received by the State from the 3 business sales were mainly applied towards the:

- reduction of budget sector debt (\$2.1 billion);
- retirement of debt with the Treasury Corporation of Victoria relating to the businesses sold (\$796 million); and
- recoupment of the estimated privatisation and reform costs for the 1997-98 financial year through a contribution retained by the Consolidated Fund (\$60 million).

4.36 While substantial financial benefits accrued to the State from the sale of the 2 businesses, the State retained certain general obligations, with the key obligations outlined in my May 1998 *Report on Ministerial Portfolios*.

4.37 My previous Reports to the Parliament have provided an analysis of the future impact of the electricity privatisation program on State finances, in terms of the net interest savings to be achieved from the repayment of State debt from the sale proceeds, after taking into account revenue forgone in the form of dividends and State equivalent taxes.

4.38 The State has received in excess of \$21 billion from the sale of electricity businesses to date, the majority of which has been applied to the reduction of State debt which, in turn, has resulted in a significant reduction in interest costs. As was indicated in my October 1998 *Report of the Auditor-General on the Government's Annual Financial Statement*, on the basis of Department of Treasury and Finance projections, it was estimated that the State derived annual net savings of approximately \$760 million during the 1997-98 financial year from electricity privatisations that have occurred to date.

United Energy Limited - Franchise fee indemnity

4.39 My previous Reports to Parliament have commented on an indemnity provided by the State to the purchaser of United Energy Limited, an electricity distribution company, concerning the deductibility of franchise fees for taxation purposes. Under the indemnity, the State was required to make a payment of \$85 million to the purchaser in the event that an unfavourable tax ruling was received from the Australian Taxation Office, and the ruling was not overturned within 3 years of the date of sale of the United Energy business.

4.40 As the Australian Taxation Office's unfavourable private tax ruling to United Energy was upheld by the courts, in February 1998 the SECV paid an amount of \$85 million to the purchaser of United Energy Ltd. However, as outlined in my May 1998 *Report on Ministerial Portfolios*, \$20 million of this amount was repaid by the company to the State following the introduction by the Government of its winter power bonus scheme.

Streamline Australia

4.41 Streamline Australia was established in 1995 as a “stand alone” commercial business operation within the Melbourne Water Corporation to provide construction, project management and consultancy services to the water industry. The business is involved in all aspects of the design, construction, repair and commissioning of water supply, drainage and sewer assets, and operates from an complex located at Dandenong.

4.42 Given that the services of Streamline were not considered to be part of the Corporation’s core business, in December 1996 the Corporation decided to divest the business as a going concern. It was considered by the Corporation that this action would allow Streamline to expand into new interstate and overseas markets, which would provide the business with an opportunity for future growth.

4.43 Following the above decision, a Steering Committee, comprising representatives of the Melbourne Water Corporation, Streamline Australia, the Department of Treasury and Finance, and legal and financial consultants, was formed to manage the sale process. Furthermore, in January 1997, a consultant was engaged to assess a number of divestment options and to recommend to the Steering Committee the best method of delivering the services provided by Streamline Australia from the point of view of both the Corporation, as the purchaser of these services, and the prospective purchaser of the business.

4.44 Subsequently, following an evaluation of the available options, the consultant confirmed that the recommended option would be the development of a “preferred supplier partnering agreement” between the Corporation and the prospective purchaser, whereby the Corporation would direct specified business levels to the purchaser over a 5 year period, if the price and conditions are competitive, under a service contract with Streamline Australia. This option would ensure a continuity of the services provided by Streamline to the Corporation and maximise the saleability potential of the business. Such an arrangement would also ensure the smooth transition of the business to the private sector.

Selection of the preferred tenderer

4.45 In February 1997, expressions of interest for the purchase of Streamline Australia were sought from 42 potential bidders selected by the Corporation with the assistance of a chartered accounting firm in its capacity as transaction adviser to the Corporation. Subsequently, the Corporation received 22 responses from interested parties and issued an Information Memorandum to these parties to assist in the further development of their bids.

4.46 **The Information Memorandum proposed that the purchaser of the business would enter into a contract with the Corporation for the provision of construction and project management services on a preferred supplier basis over a period of 5 years, with the business required to competitively tender for contracts not covered by the preferred supplier arrangement.**

4.47 The potential purchasers were also advised that the sale would be effected by way of the disposal of specified assets and liabilities of the business, including fixed assets (excluding land and buildings), contracts for works in progress, goodwill and employee related liabilities. It was envisaged that cash, trade debtor and trade creditor balances of the business would be retained by the Corporation. The Dandenong property from which the business operated was available for purchase or, alternatively, could be leased by the purchaser. However, the preference of the Corporation was for a sale of this property.

4.48 In March 1997, the Corporation received 11 indicative offers from interested parties. Following an evaluation of these submissions by the Steering Committee, 4 of the offers were rejected as interest only lay in the purchase of a segment of the Streamline business. Following a short-listing process, the Steering Committee identified 4 parties which could proceed with the due diligence process and submit final offers.

4.49 Subsequently, 3 final submissions were received by the Corporation in May 1997 and, following an assessment of these submissions by the Committee and a recommendation by the Corporation's transaction adviser, **the Corporation approved the sale of Streamline Australia to the preferred bidder, Enetech Pty Ltd, which is a subsidiary of Eastern Energy.** The selection of the preferred bidder was based mainly on the willingness of the purchaser to offer employment to existing employees, its ability to provide the required level of service to the Corporation and pricing factors.

Key terms of sale arrangements

4.50 In May 1997, the Corporation and the purchaser entered into a number of agreements to effect the sale of both the Dandenong property and the specified net assets of the Streamline Australia business.

4.51 Under the arrangements, the Corporation received \$1.9 million for the sale of the Dandenong site, with a deposit of \$188 500 paid on execution of the contract and the residual of \$1.7 million paid on settlement, which occurred in June 1997. The purchaser provided an indemnity to the Corporation against any liabilities resulting from any clean-up or remediation costs caused by any pollutant or contaminant emanating from the land acquired.

4.52 Furthermore, under the arrangements, the net assets of the Streamline Australia business were sold to Enetech Pty Ltd for an amount of \$9.8 million, comprising \$2.5 million for plant and equipment, \$5.6 million for goodwill and \$2 million for works in progress, less \$320 000 for outstanding employee entitlements. However, an adjustment of \$1.6 million to the purchase price, resulting from a re-assessment of the net assets of the business as at the date of sale, reduced the purchase price for the business assets to \$8.2 million. A deposit of \$980 000 was received by the Corporation in May 1997, with the balance of \$7.2 million paid to the Corporation in June 1997.

4.53 Other key terms of the sale arrangements included:

- the Corporation assigned all hiring agreements and business contracts to the purchaser as from the sale completion date, with the company agreeing to indemnify the Corporation for any liabilities arising in relation to the failure to fulfil any contractual obligations;
- the company agreed to offer employment to specified employees on terms and conditions no less favourable than those provided by the Corporation;
- all debts of the business as at the date of sale were to remain with the Corporation; and
- the company would utilise certain premises owned by the Corporation in Altona North, under a lease agreement.

4.54 To ensure a continuous provision of services previously supplied by Streamline Australia to the Corporation, a 5 year Partnering Agreement was entered into with the purchaser, with a commencement date of May 1998. Under the terms of this agreement, the Corporation agreed to provide works to the company up to an indicative aggregate contract value of \$60.1 million in present value terms over the 5 year period of the agreement. Other key terms of the agreement included:

- The services to be provided by the company are to include project management, construction and consultancy services, with a service agreement between the parties to govern the terms and conditions of the provision of these services. Furthermore, the Corporation is required to prepare a project list which identifies the works to be conducted in any one financial year and the indicative level of expenditure for services to be incurred by the Corporation;
- The Corporation is to endeavour to ensure that expenditure on services in any one financial year is not less than the annual indicative expenditure level provided for within the agreement. In the event that such expenditure levels are not being met, the Corporation is to attempt to make up the shortfall in subsequent financial years. However, the Corporation will not provide a guarantee and will not bear responsibility or be liable to the company if these pre-determined levels are not achieved;
- A partnering committee comprising representatives of Melbourne Water, Eastern Energy and an independent member, will monitor the actual level of expenditure incurred under the agreement to ensure compliance with the indicative level of work and to resolve any disputes between the parties. The committee may determine that expenditure levels for any financial period may be reduced;
- The Corporation may seek to source services from a third party in relation to any project where the purchaser does not intend to make an offer, where the company has failed to make a conforming offer in accordance with selected operational and financial criteria, or where either the partnering committee or a direction from Government require these services to be subject to competitive tendering;

- The Corporation may terminate this agreement immediately if the purchaser ceases to carry on its business, disposes of the business without the prior consent of the Corporation, the company becomes insolvent, is wound up or dissolved. In addition, either party may terminate the agreement if the other party is in default of the agreement and there is a failure to remedy the default; and
- The company may not novate, assign or transfer any rights or obligations under this agreement without the prior consent of the Corporation.

Assessment of sale result

4.55 Under the arrangements entered into by the Melbourne Water Corporation associated with the sale of the Streamline Australia business:

- the specified net assets of the business and the property utilised by the business at Dandenong were sold for a net price of \$9.3 million, comprising \$8.2 million for the sale of the business' net assets, \$1.9 million for the sale of the property, less \$795 000 of costs incurred by the Corporation associated with the sale;
- in relation to the business net assets, the sale result was \$1.2 million greater than a comparable business valuation of \$7 million provided by an external consultant in November 1996, and \$5.4 million greater than the book value of the assets of \$2.8 million; and
- in relation to the sale of the Dandenong property, the sale result was \$500 000 greater than the April 1997 Valuer-General's valuation of \$1.4 million, and was \$900 000 less than the book value of the property at the date of sale.

4.56 Furthermore, under a partnering agreement entered into between the parties, the purchaser has been established as a "preferred service provider" to the Corporation, and the Corporation has undertaken to provide business to the purchaser subject to competitive pricing and conditions over a 5 year period, up to a value of \$60.1 million in present value terms.

Sale of former SECV building

4.57 My May 1995 *Report on Ministerial Portfolios* outlined the circumstances leading to the purchase by the State Electricity Commission of Victoria (SECV) in July 1994 of a building located at 452 Flinders Street, for a price of \$250 million. In particular, the acquisition of the building enabled the SECV to avoid lease payments over a 20 year period with an estimated net present value of \$324 million, representing the difference between the assessed rental value of the building at the time of \$134 per square metre and the actual rental of \$808 per square metre payable by the SECV under the initial lease agreement. However, based on the future probable rental income to be derived from the building, the SECV recognised a loss of \$149 million in its financial statements during the 1993-94 financial year, representing the difference between the purchase price and the net recoverable amount of the building which was estimated at \$101 million.

4.58 The building was constructed in 1994 and comprises approximately 40 000 square metres of net lettable space, with 18 levels of office space and 3 levels of car park. The building features landscaped balconies, a gymnasium, a 200 seat auditorium and an on-site bistro and dining restaurant. The property is situated within the central business district's western precinct.



Former SECV building.

4.59 Due to the disaggregation of the SECV and the subsequent privatisation of the electricity distribution and generation businesses, the property was identified as surplus to the Government's requirements. Consequently, in March 1998, the Administrator of the SECV appointed agents to market and sell the property. The appointed selling agents advised that the indicative value of the property was \$93 million, which was above a formal valuation undertaken by the selling agents in June 1995, at which time the property's value was estimated at \$81 million.

Sale process

4.60 In April 1998, the Administrator of the SECV advised the Treasurer of his intention to sell the property through a public sale process. Around this time, consultants from varying disciplines were engaged to provide advice on various aspects of the sale process.

4.61 The Treasurer subsequently formally approved in June 1998 that the building could be sold and an independent valuer was engaged by the SECV to assess the value of the property to assist in establishing a reserve price for the sale. The valuer determined that, **based on the existing lease agreements which covered most of the building's lettable area, with the major lease agreements covering a period of 2 to 12 years, the property's estimated value was around \$100 million**, which was consistent with an estimate provided on behalf of the Valuer-General in July 1998. Consequently, a reserve price of \$100 million was set for the sale of the building.

4.62 In July 1998, registrations of interest were received from 9 parties interested in purchasing the property, with proposed prices ranging from \$95 million to \$119.5 million. A subsequent short-listing process identified 3 submissions from prospective purchasers which warranted further consideration.

4.63 **Following a further assessment and due diligence process, in August 1998 the Administrator of the SECV advised the Treasurer that Permanent Trustee Australia Ltd, as trustee of the Advance Property Fund, was selected as the successful purchaser of the property, for a price of \$119.5 million.**

Key terms of the sale

4.64 Under the terms of the sale agreement, a deposit of around \$12 million was paid to the SECV in early August 1998, with the residual balance of \$107.5 million paid in late August 1998. The key conditions of sale included:

- the SECV agreed to pay the purchaser, on the date of settlement, a sum of \$4 million as a contribution to the building's rental income;
- the purchaser acknowledged that the property was sold subject to existing leases and agreed to observe the obligations of the SECV under each of the leases; and
- the SECV assigned the benefit of building warranties to the purchaser, including the benefit of guarantees, bonds, agreements and any licences relating to the conduct of businesses on the site.

Assessment of sale result

4.65 An analysis of the sale result indicated that:

- the gross sale proceeds were \$19.5 million higher than the reserve price set by the Valuer-General in July 1998;
- the net proceeds of sale were \$114.6 million, after taking into account an income support payment of \$4 million made by the SECV to the purchaser and costs incurred in relation to the sale of \$930 000; and
- the gross sale proceeds were \$130.5 million less than the price of \$250 million paid by the SECV in 1994 to acquire ownership of the building, but the State has avoided the ongoing exposure associated with the onerous lease contract.

South Melbourne tram depot site

4.66 The former South Melbourne tram depot, which was located on a site bounded by Kings Way, Dorcas Street, Wells Street and Bank Street in South Melbourne, was vacated by the Public Transport Corporation as a result of the construction of a new depot situated nearby, between Montague Street and Normanby Road, South Melbourne. The former South Melbourne tram depot situated on a 2.8 hectare site, which was declared surplus in November 1992, comprises numerous brick office and warehouse-style buildings and a large steel frame workshop.

4.67 In September 1996, the Department of Treasury and Finance appointed a firm of property consultants to act as project managers for the sale of the site, with the first major task involving the appointment, following a tender process, of a real estate agency to market the property.



Former South Melbourne tram depot site.

4.68 The property was offered for sale by public tender in August 1997, with a target sale price of \$16.75 million approved by the Minister for Finance at that time.

4.69 Subsequently, in September 1997, the Department received 4 bids for the purchase of the site, ranging in value from \$12.5 million to \$18.8 million. As the 2 highest bids were based on varying settlement terms, the Valuer-General assessed each bid received by the Department and determined their comparable values. Subsequently, the Minister approved the sale of the site to Renak Holdings Ltd, now called Phileo Australia Ltd, which provided the highest bid price of \$18.8 million for the site, or \$18.3 million in net present value terms.

Property valuations

4.70 In April 1984, the Valuer-General provided an informal estimate of the property's value of \$5.1 million in response to a request at that time for a rental assessment for the property by the former Melbourne and Metropolitan Tramways Board.

4.71 Subsequently, in April 1992, the Department was advised by a private valuer that the market value of the site was in the range of \$4.7 million to \$5.2 million. The property was again re-assessed in June 1996 by a private valuer, who estimated its value at \$11 million, based on the limited number of comparable development sites within the South Melbourne area.

4.72 Prior to the sale of the site, in August 1997 the Department received a valuation from a private valuer of \$16.1 million and a valuation of \$16.75 million from the Valuer-General. Both valuers recognised that the increase in the value of the site reflected the higher interest in sites suitable for residential development located within or near Melbourne's central business district.

Contract of sale

4.73 Consistent with the terms of the sale agreement, the sale proceeds of \$18.8 million were paid to the Consolidated Fund as follows:

- a deposit of \$940 000 paid in September 1997 and in November 1997; and
- payment of the remaining balance in March 1998.

4.74 Under the sale agreement, the purchaser became responsible for all costs associated with the presence of any contamination on the site and acknowledged that the site is zoned for "Mixed Use (South Melbourne) Zone" under the Port Phillip Planning Scheme, with a height control and a potentially contaminated land overlay.

Assessment of sale

4.75 An analysis of the sale indicated that the net proceeds from the sale of the site, after taking account of the estimated costs of sale of \$216 000, were \$18.6 million and the purchase price compared favourably with the available property valuations.

Sale of Met Buses and outsourcing of the associated services

4.76 My previous *Reports on Ministerial Portfolios* have outlined the key elements of the major reform program for the Public Transport Corporation, which was introduced by the Government in 1993.

4.77 One of the key elements of the reform program was the contracting-out of all metropolitan bus services which were previously provided in-house by the Corporation. The initial implementation of this initiative involved the awarding, in 1994, of 80 per cent of the Corporation's in-house bus services to the National Bus Company, with the remaining 20 per cent of services retained and managed by the Corporation.

4.78 In March 1997, the Department of Infrastructure called for registrations of interest from prospective operators to deliver the remaining 20 per cent of public passenger bus services, namely, the Sandringham and Footscray bus routes, which were then provided by the Corporation. An Evaluation Committee, chaired by a consultant from a private sector accounting firm and comprising representatives of the Departments of Infrastructure and Treasury and Finance, was subsequently established to examine the registrations of interest, prepare and issue the tender documentation, and evaluate the tenders with a view to recommending a preferred tenderer to the Department of Infrastructure.

4.79 The tender documentation provided that the bids would be evaluated against a number of criteria, including price, the ability of tenderers to operate the services, proposed service levels and standards, the financial capacity of tenderers and the employment opportunities available for the existing employees of the Corporation. The Department appointed a firm of consultants as probity auditors to ensure the integrity and fairness of the evaluation process.

Tender process

4.80 In response to the Department's invitation for parties to register an interest in the provision of public passenger bus services within the Footscray and Sandringham franchise areas, 34 parties expressed interest in April 1997. A subsequent assessment of these submissions by the Evaluation Committee led to an invitation to 30 of these parties to lodge tenders.

4.81 Given that the fees payable by the Department in relation to the contracted services would be determined with reference to the number of passengers carried and the distance of passenger trips, the tender documentation provided bidders with the flexibility to submit alternate tenders which included options to improve service provision, and an option to purchase the bus depots and vehicles owned and utilised by the Corporation. Prior to the closing date of the tenders, bidders were also advised by the Department of the following matters of interest:

- the Footscray bus depot site was valued at \$2.8 million;
- the Sandringham bus depot site was valued at \$920 000, however, a rental of \$44 000 per annum would be payable by the selected service provider in the event of a need to take immediate possession of the site prior to settlement; and
- the basis upon which payments would be made by the Department to the successful service provider for the delivery of services.

4.82 In late August 1997, the Department received 13 bids from the parties invited to lodge tenders. An initial assessment of the bids by the Evaluation Committee in September 1997 resulted in the short-listing of 5 interested parties.

4.83 Following further deliberations by the Evaluation Committee, **in November 1997, the Committee concluded that the 10 year service contract to operate both the Footscray and Sandringham services should be awarded to a selected preferred tenderer, at an annual cost to the Department of \$12.8 million.** The Committee also confirmed that the preferred tenderer was prepared to acquire the fleet of 86 buses at a price of \$6.1 million, and the Footscray and Sandringham bus depots at a total purchase price of \$3.7 million.

4.84 In particular, the Committee recommended that the contract should be awarded to the preferred bidder on the basis that the contracted services would cost the State \$95 million in net present value terms over the period of the 10 year contract, which was 5 per cent lower than the second ranked bidder. While the Committee concluded that the submission by the second ranked bidder was superior on the basis of certain factors other than price, it considered that these perceived benefits were insufficient to enable the bid to be ranked higher.

4.85 At that time, the probity auditor issued a report on the tender and evaluation process, confirming that the processes and procedures adopted by the Committee were comprehensive, thorough and undertaken in a fair and equitable manner.

4.86 However, following consideration by the Department of Infrastructure of the Committee's recommendation of the preferred tenderer, in December 1997, the Department requested the Chairman of the Committee to re-assess the recommendation, taking into account the following factors identified by the Department as requiring attention:

- The second ranked bidder was considered to be better able to integrate existing bus services with the Sandringham and Footscray bus routes, which would provide opportunities to develop cross-city links as opposed to the preferred bidder whose operations were expected to be isolated to the Footscray and Sandringham routes;
- Combined with existing bus services already managed by the second ranked bidder, the awarding of the additional transport services to this party would enable it to operate almost 200 buses, becoming the second largest route service operation in Melbourne. Such an operation would provide significant economies of scale and service benefits as the company would be able to synergise its operations, leading to a restructuring of its total franchise service area. However, these savings were not factored into the bid evaluation; and
- There was potential for industrial disputes to be faced by the preferred tenderer due to the existence of an agreement between the company and the Public Transport Union, which was not factored into the overall assessment of rankings of the bid.

4.87 Subsequently, the Chairman of the Evaluation Committee advised the Department that the preferred bidder had an advantage over the bid submitted by the second ranked bidder as the Committee placed a high weighting on the pricing component of the evaluation criteria for the bids. However, the Chairman indicated that if the non-price factors were given a higher relative significance than the pricing factors, this could have resulted in the second ranked bidder receiving preferred tenderer status. The Chairman further conceded that all the non-price factors were not fully appreciated during the tender evaluation process.

4.88 The documentation maintained by the Department indicated that, subsequently, the probity auditor advised that there was no objection to the selection of the initially second ranked bidder as the preferred tenderer, given the above considerations.

4.89 In December 1997, the Victorian Government Purchasing Board of the Department of Treasury and Finance approved the engagement of the initially second ranked bidder, Melbourne Bus Link (MBL), for the provision of specified bus services for a period of 10 years.

4.90 The successful bidder is a consortium consisting of the current operators of the East West, Dynons and Reservoir bus companies, which collectively operate 110 metropolitan route buses under existing service contracts with the Department of Infrastructure.

Contractual arrangements

4.91 In April 1998, the Public Transport Corporation, MBL and the Department of Infrastructure entered into a number of contractual arrangements for the provision of public passenger bus services by MBL, and the sale of the bus depots, the bus fleet and associated equipment to MBL.

Service Agreement

4.92 Under the *Transport Services Agreement for Metropolitan Buses* between the company and the Department, the company has agreed to provide high quality and reliable passenger bus services, in return for the receipt of service fees from the Department over a period of 10 years, from April 1998 to December 2007.

4.93 In particular, the Department is obligated to make annual contract payments to the company, commencing with an initially estimated amount of \$13.3 million and progressively increasing to around \$17.2 million by the year 2007 as a result of the application of a 2 per cent per annum price escalation factor and agreed contributions for a proposed bus replacement program over the contract period. These payments are also required to be adjusted annually for movements in patronage levels. However, the Department is able to reduce the payments to the company in the event that specified services are not delivered, or where patronage levels fall below targets.

4.94 The company is required to deliver passenger services in accordance with agreed timetables, with each vehicle used in providing these services to be in a safe operating condition at all times and not exceeding the established loading standards. The company is required to regularly review the levels of service provided to ensure that demand for services is adequately met. Under the terms of the agreement, the Department and the company may agree to a reduction in the level of service if there is a loss in patronage or financial hardship is experienced due to reasons beyond the control of the company.

4.95 Other key provisions of the agreement are as follows:

- Contract payments to be subject to indexation and based on the number of passengers carried by the company and the distance travelled by passengers;
- The company to collect on behalf of the Corporation all fares in respect of the services provided and issue tickets in respect to those fares. In particular, the company will be required to sell and honour multi-modal tickets and will observe the Corporation's requirements relating to the installation, operation, management and maintenance of the automated ticketing system with respect to the collection of revenue and keeping of records necessary to enable the company to account for all revenue collected;
- Any proposed changes to the fares must be communicated to the Department, however, the price of the fares must not exceed the pricing of the relevant multi-modal tickets;
- The company must maintain specified public risk insurance to cover any accident resulting in death or injury of any person or damage or loss to any person in connection with the provision of a service by the company;
- The company to indemnify the Department against all actions, demands or claims arising from the death or injury of a person or damage or loss to any person or property in connection with the services provided by the company, except where the loss or injury is a result of an act or omission on the part of the Department;
- The Department may terminate the service agreement in the event that the company sub-contracts all or part of the specified services without the prior consent of the Department, the company becomes insolvent or fails to provide the specified services for a period exceeding 2 consecutive days, unless such failure is due to factors beyond the reasonable control of the company. In addition, either party may terminate the agreement if there is a breach of the agreement and there is a failure to remedy the breach within 30 days; and
- If the agreement is terminated by the Department within 3 years from the commencement date, the company is responsible for meeting all costs and expenses incurred by the Department arising from the contracting of all or part of the services previously agreed to be provided by the company.

4.96 The Department has paid the company an amount of \$3.1 million, mainly representing the value of accrued employee entitlements assumed by the operator for employees who have transferred to the company. For the transferred employees who elected to remain within the State Superannuation Fund, an additional payment of around \$169 000 (subject to further actuarial assessment) will be paid to the operator to compensate for the higher employer contribution levels required for this scheme when compared with the employer's scheme.

4.97 As part of the arrangements, incentive payments with a total value of \$1.4 million were paid to 129 former employees of the Corporation who commenced employment with the company. The Corporation also paid \$390 000 in retrenchment benefits and employee entitlements to staff who were not employed by the company and could not be redeployed within government.

Sale of depots and bus fleet

4.98 Contracts of sale were entered into between the Public Transport Corporation and MBL for the sale of the 2 bus depot sites. **In relation to the Footscray depot site, the property was sold for a price of \$2.8 million, which was consistent with valuations obtained by the Corporation in July 1997 from a private valuer and the Valuer-General.** Under the contract, the purchaser accepted the present condition of the property, including the presence of any contamination.

4.99 The Sandringham depot site was sold for a price of \$920 000, which was also consistent with valuations obtained by the Corporation in July 1997 from a private valuer and the Valuer-General. The tenderers were previously advised that, as the Sandringham site was comprised of a number of titles, a single title would need to be issued in respect of the land prior to settlement. The contract of sale requires the Corporation to take all necessary steps to ensure that one title to the land is obtained. Once the title is issued, the successful tenderer is required to settle the purchase price in full within 60 days.

4.100 In order for the purchaser to take possession of the depot sites as at the date of sale, lease agreements were executed between the bus operator and the Corporation. The lease over the Footscray site, with an annual rental of \$280 000, will cease either within 60 days of the sale contract being executed or at the date of settlement, whichever is the earlier. The settlement of this sale occurred in June 1998. However, in relation to the Sandringham site, the lease agreement will expire either within 10 years of the date of sale or on the date of settlement, whichever is the earlier, with settlement not to occur until a new title to the land is issued. At the date of preparation of this Report, a new title had not been issued. In the event that the title is not obtained within 2 years from the date of sale, either party to the sale agreement may rescind the contract. The annual rental payable on this site is \$44 000.

4.101 An Asset Sale Agreement was also executed by the Corporation and MBL for the sale of the Corporation's bus fleet (except for certain specific purpose buses), plant and office equipment, furniture and fittings and other assets held at the Footscray and Sandringham depots, for the price of \$7.4 million. An initial sum of \$3.7 million was paid to the Corporation on execution of the agreement, with the residual amount paid progressively as ownership of the buses passed to the operator as roadworthy certificates are obtained. The key elements of the agreement include:

- The purchaser to gain title to the assets on sale completion date;
- The purchaser may use the automated vehicle monitoring system, which is owned by the Corporation, until May 1998. If the purchaser wishes to continue the use of this equipment beyond that time, a fee of \$15 000 per month must be paid to the Corporation; and
- Until such time that roadworthy certificates for certain buses are obtained by the Corporation, the company will lease these vehicles. However, the transfer of ownership of these buses is required to pass to the purchaser prior to 30 June 1998. Pursuant to these requirements, ownership of these buses passed to the operator in June 1998.

Concluding comments

4.102 While an inter-departmental evaluation committee initially selected a preferred tenderer for the provision of metropolitan bus services based on its assessment of tenders received against predetermined criteria, the second ranked tenderer was ultimately engaged by the Department of Infrastructure based on a re-assessment of tenders with an increased emphasis on service benefits.

4.103 The successful tenderer has entered into a 10 year contract with the Department to provide bus services within the Footscray and Sandringham areas of Melbourne, in return for receiving annual fees which are estimated to total around \$135 million in nominal terms (around \$99 million in present value terms) over the period of the contract. Furthermore, the successful tenderer agreed to purchase most of the bus fleet previously maintained by the Public Transport Corporation, and the associated depots and equipment for a price of around \$11.1 million, which was approximately \$900 000 higher than that proposed by the initially selected tenderer.

4.104 The savings to the State from proceeding with this service contract compared with the pre-existing inhouse arrangements were estimated by the Department at \$2.5 million per annum.

Former Port Melbourne gasworks sites

4.105 The former Port Melbourne gasworks sites comprised 4 property lots mainly located at Pickles Street, Port Melbourne, which had not been utilised since 1955, when the gasworks ceased operation. The sites were previously owned by the former Gas and Fuel Corporation of Victoria (GFCV) and had not been utilised since the cessation of the gasworks, with significant soil contamination and certain other complications associated with the sites' redevelopment.

4.106 As mentioned in my October 1997 *Report on the Government's Annual Financial Statement 1996-97*, the Government embarked upon the restructuring of the gas industry in September 1994, through the transfer of the former Corporation's property, rights and liabilities, to separate gas distribution and transmission businesses. This process was followed by the wind-up of the former Corporation and the transfer of its residual property, rights and liabilities to the State Electricity Commission of Victoria (SECV). Consequently, the Administrator of the SECV assumed responsibility for these sites.

Initial sale attempt

4.107 In early 1995, the GFCV called for expressions of interest for the sale of the sites. A taskforce comprising representatives from the GFCV, legal consultants and a private sector accounting firm was established for the principal purpose of determining a short-listing of interested parties.

4.108 The GFCV received expressions of interest from 6 developers, including the former Urban Land Authority. These submissions were assessed against certain criteria which included the financial capacity of the interested parties to finance the proposed development, the nature of the development, the ability of the parties to manage large projects, the sale price and associated conditions, the previous experience of the parties and their ability to conduct site remediation works.

4.109 Following an evaluation of the submissions, in August 1995 the GFCV was advised by the accounting firm which formed part of the taskforce that there was doubt regarding the ability of the interested developers, except for the Urban Land Authority, to undertake such a large project and their level of experience to effectively handle the risks and complexities associated with the nature and extent of the sites' contamination. In addition, it was identified that the more experienced developers within the industry had failed to express an interest in the purchase of the sites. Nevertheless, based on the established selection criteria, 5 developers, including the former Urban Land Authority, were short-listed to submit a formal tender.

4.110 In September 1995, the Urban Land Authority received a private valuation of the sites, based on the properties being used for medium-density residential housing but not taking account of the costs of remediation works. The valuations obtained were as follows:

- *Meter shop site* - \$1.9 million;
- *Laboratory site* - \$1.15 million;
- *Number 2 Holder site* - \$700 000; and
- *Number 1 Holder site* - "nil" value.

4.111 In July 1995, 2 formal bids were received for the purchase of the sites. The first bid, which was submitted by the Urban Land Authority, proposed a nominal purchase price of \$1, on the basis that the SECV would meet any costs of remediation in excess of \$3.9 million. As the SECV had estimated that remediation works would cost around \$5.6 million, the terms of the Authority's bid were deemed to be unacceptable. The second bid was lodged by a private developer and proposed a purchase price with a present value of \$1.9 million. However, this price was substantially below a site valuation of \$3.8 million provided at that time by the Valuer-General and a valuation of \$2.5 million provided by a private valuer.

4.112 Consequently, in November 1995, the Administrator of the SECV advised both parties that their bids were unsuccessful. The Administrator also informed the then Minister for Energy and Minerals that, as the offers were rejected, the SECV would consider funding the required remediation works for the sites and then re-offer the properties to the market on a "clean site" basis.

Final sale process

4.113 While the SECV was considering the available options for the sites, in December 1995, the Urban Land Authority offered to enter into an agreement with the Administrator, for the de-contamination, sub-division and development of the sites at the SECV's expense, on a fee-for-service basis. Subsequently, in March 1996, the Urban Land Authority advised the former Department of Planning and Development of its intention to undertake remediation work at the sites once an approved development agreement had been finalised. Furthermore, the Authority proposed to initially approach the private developer that had submitted a formal bid under the previous sale process and, if negotiations failed to reach a satisfactory result, to then approach another previously short-listed bidder who had not submitted a formal bid but had demonstrated an interest in a joint venture with the Authority.

4.114 In July 1996, preliminary submissions were received by the Authority from 2 developers, namely, MAB Corporation Pty Ltd and Intrapac Consolidated Pty Ltd in association with the Becton Corporation Pty Ltd, for the development of the sites. Subsequently, in August 1996, the Treasurer approved the delegation by the SECV Administrator to the Authority of certain powers in relation to the sites, to enable the management of the decontamination, sub-division and redevelopment of the site. Shortly thereafter, the Authority invited the above mentioned companies to submit a formal tender for the purchase and development of each of the sites.

4.115 In October 1996, a deed was executed between the Urban Land Authority and the SECV, under which the Authority was appointed to manage the required remediation works, prepare and implement development site plans, install services and enter into agreements with third parties for the sale of the sub-divided land.

4.116 Subsequently, in December 1996, the previously mentioned developers submitted indicative bids for the purchase of all of the sites. Based on an assessment of the bids and the available options, it was considered by the Authority that the best financial outcome would be derived from splitting the total parcel, and accepting one of the bids for the Laboratory and the properties known as Number 1 and 2 Holder sites, and the second bid for the Meter shop site.

4.117 Following concerns raised by one of the bidders, in February 1997, the SECV Administrator proposed to both parties that reasonable pre-development and planning costs would be reimbursed if the SECV was unable to present the land in an appropriate remediated condition for their purposes. Furthermore, in March 1997, the Urban Land Authority adopted a budget of \$7.5 million for the cost of remediation works based on advice received from a firm specialising in the preparation of remediation strategies.

4.118 In May 1997, the SECV entered into a sale agreement with Port Melbourne Gas Works Developments Pty Ltd, an entity associated with Intrapac Consolidated Pty Ltd, for the purchase of the Laboratory, and Number 1 and 2 Holder sites, for a purchase price of \$6.6 million. In the following month, the sale arrangements between the SECV and Danbrook Pty Ltd, a subsidiary of MAB Corporation Pty Ltd, were also completed in relation to the Meter shop site, involving a price of \$3 million.

4.119 The sale prices achieved in relation to the above sites were consistent with a Valuer-General's assessment of site values provided in January 1997.

Key terms of sales

4.120 In relation to the sale of 3 of the gasworks sites to Port Melbourne Gas Works Developments Pty Ltd, the SECV received a deposit of \$1.7 million in May 1997, with the balance of the purchase price of \$4.9 million payable by January 1999. At the time of preparation of this Report, remediation was effectively completed but settlement had not occurred due to the need to resolve certain objections received by the City of Port Phillip to amendments to the relevant planning scheme associated with the proposed development. In relation to the sale of the Meter shop site, the SECV received a deposit of \$300 000 in June 1997, with the balance of \$2.7 million received in June 1998.

4.121 Under the sale arrangements, final settlement for the sites was conditional upon the SECV obtaining, at its own cost, a Statement of Environmental Audit issued under the *Environment Protection Act 1970*, with the Statement to be provided to the purchasers once the environmental condition of the land becomes suitable for medium density residential purposes in accordance with the agreed project development. This condition precedent was met prior to the settlement of the full purchase price for the Meter shop site in June 1998, but remained outstanding in relation to the other 3 sites.

4.122 Other key terms of the sale arrangements included:

- The purchaser is required to meet the costs associated with the site development, consistent with a development agreement which was executed between the parties;
- Any increase in costs associated with the remediation works resulting from any purchaser amendments to the site development will be the responsibility of the purchaser. In addition, an amount equal to one-third of any reduction in the cost of remediation works incurred by the SECV must be passed on to the purchaser upon settlement;
- The purchaser must not sell the sites without the prior written consent of the SECV, with any subsequent purchaser to abide by the development agreement; and
- As from the date of settlement, the purchaser will provide an indemnity to the SECV for all risks and liabilities resulting from the use of the land during the execution of the project development, except for any loss arising from the remediation works and any groundwater contamination not caused by the purchaser.

4.123 As at June 1998, the projected total costs to be incurred by the SECV for the preparation of the site for residential development purposes was around \$8.5 million, including costs associated with the required remediation works, project management fees payable to the Urban Land Corporation, selling expenses and other related expenditures.

Assessment of sale result

4.124 An analysis of the sale result indicates that:

- the net proceeds from the sale of the gasworks sites, after taking account of the estimated costs of \$8.5 million to be incurred mainly in relation to the required remediation works, will be around \$1 million;
- the gross sale price of \$9.6 million which was achieved for the sites was consistent with property valuations provided by the Valuer-General in January 1997; and
- the sale price was \$765 000 higher than the recorded book value of the sites.

Newport railway site

4.125 In January 1991, the former Minister for Transport declared a number of Public Transport Corporation properties as surplus to operational requirements, including a 9 hectare site which previously formed part of the Newport railway workshops and was used for the storage of disused transport vehicles, railway tracks and sleepers. The property had an estimated book value of \$4.5 million at that time.

4.126 Following discussions between the former Department of Finance and the former Urban Land Authority regarding the future development of the site, in early June 1992 the Department sought a valuation of the site from the Valuer-General on the basis that the Authority had agreed, in principle, to purchase the property by 30 June 1992. However, the purchase was subject to a satisfactory feasibility analysis of the proposed development and an agreeable market valuation of the site, taking into account the risks to be taken on by the Authority associated with the required land remediation to facilitate the site's subdivision into residential allotments. The related costs of remediation at that time were estimated at \$1.1 million.

4.127 Subsequently, in March 1993, the Minister for Planning sought the approval of the Minister for Finance for the vesting of the site in the Urban Land Authority, advising that:

- the development of the site for industrial or commercial purposes was considered inappropriate and the site was better suited to a residential development, a view also held by the local municipal council;
- the estimated cost of site remediation works was re-assessed at \$3 million, which approximately equated to the value of the land; and
- the Urban Land Authority would be prepared to develop the site and bear all re-development costs, with any surplus returned to the Consolidated Fund.

4.128 However, in April 1993, the Minister for Finance did not accept this proposal, advising that the substantial cost of the required site remediation works to allow the residential subdivision of the site was unlikely to enable the achievement of an adequate financial return for the Government.

4.129 Following the expression of interest in the site by a developer for the purpose of constructing a shopping centre, in June 1993, the Department of Finance lodged a rezoning application with the local council for this development. However, the re-zoning application was not successful. Due to the low property values, limited action was taken in relation to the sale of this property until 1997.

4.130 Resulting from a dramatic rise in land values in the Williamstown and Newport area, in July 1997 a property development consultant engaged by the Department of Treasury and Finance advised that a residential development would be the most viable use of the site, with an estimated return to the Government of between \$3.5 million and \$4 million after taking account of the cost of the completion of the required remediation works. Subsequently, in October 1997, the Department of Treasury and Finance advised the relevant local council, the City of Hobsons Bay, that:

- the future of the site had remained unresolved for a number of years principally due to the significant costs associated with its potential clean-up;

- the Department was unsuccessful in placing a restricted business zone over the site in order to facilitate the development of a shopping centre, due to the perceived economic impact of such action on the existing shopping centres at Newport and Williamstown; and
- the Department received advice from a firm of property consultants recommending that the Department should seek rezoning of the site for residential development as the market value of residential land in the area had improved, further increasing the viability of the project.

4.131 In December 1997, the site was formally rezoned by the local council from *Reserved Land Railways - Existing Zone* to *Urban Residential 1 Zone with a potentially contaminated land overlay* and, in February 1998, the Department received the following formal valuations for the site:

- *\$7.75 million* - provided by a contract valuer on behalf of the Valuer-General based on the sub-division of the site into residential allotments, incorporating a mix of high, medium and low density living, including consideration of estimated subdivision costs and the prices achieved from the sales of nearby residential lots; and
- *\$7.2 million* - provided by a private valuer based on the market values of comparable properties.

4.132 Subsequently, the Government sought tenders for the sale of the site, which resulted in the receipt of 5 confirming bids in March 1998, ranging from \$4.1 million to \$8.1 million. Shortly thereafter, **the Minister accepted the highest bid lodged by a private developer at a price of \$8.1 million.**

Contract of sale

4.133 Under the terms of the sale agreement, the price of \$8.1 million was paid to the Department as follows:

- a deposit of \$800 000 paid in March 1998; and
- the balance of \$7.3 million paid in July 1998.

4.134 Under the terms and conditions of the sale agreement:

- the purchaser acknowledged the contents of various environmental reports in relation to the site for which the State provided no warranty as to their accuracy;
- the purchaser assumed all the risks of loss or damage to any person or business from the use of the land, or the existence of any underground storage tanks or the presence of any contaminants on the site; and
- the purchaser indemnified the State against any future claims as a result of the presence of any site contaminants.

4.135 The audit analysis of the sale indicated that the price achieved by the State compared favourably with available property valuations and was \$3.6 million above the estimated book value of the site at the date of sale.

Redevelopment of Roads Corporation precinct in Carlton

4.136 The *Roads Corporation Metropolitan Accommodation Strategy 1995* provided for the consolidation of the organisation's corporate headquarters, either within the Melbourne central business district or at Kew, and the operation of regional offices within the western and eastern suburbs. The implementation of the strategy resulted in a decision to vacate and dispose of a 1.5 hectare property and associated office complex at Lygon Street, Carlton, which was previously utilised by the Corporation.

4.137 The property incorporates 2 substantial office buildings constructed in the 1960s and the associated car parking, situated on a parcel of Crown land which is located 1.8 kilometres north of the central activities district of the City of Melbourne and is situated close to the University of Melbourne and certain other public institutions, including a number of public hospitals.



Former VicRoads property, Carlton.

Sale process

4.138 Under the *Accommodation Strategy*, it was anticipated that the buildings would be vacated by mid-1996 and the property offered for public sale on the basis of vacant possession.

4.139 Given that the property comprises substantial land and building areas, it was considered appropriate that the site's development potential be ascertained prior to any sale process. Consequently, in September 1995, the Department of Treasury and Finance engaged the services of a consultant to prepare a site development concept in order to determine the optimum development capacity of the property. The former Department of Planning and Development was also consulted as there was potential for the utilisation of the property as part of a redevelopment of the public housing complex bounded by Drummond, Princes and Rathdowne Streets. At that time, the property was valued by the Corporation at \$3 million.

4.140 In November 1995, the consultants provided an initial evaluation of the development potential of the site. In particular, it was determined that a residential conversion of the existing buildings and the construction of an additional new building represented the most feasible form of development for the site in order to yield the highest value for the Department. It was also indicated that a more detailed analysis of this option and other development alternatives, such as sub-division of the land for residential allotments, and retaining the existing buildings for commercial redevelopment, would result in the most suitable range of options available to maximise the return from this property.

4.150 In further evaluating the options available to the Department, in April 1996, the consultant concluded that the conversion of the existing buildings and the development of residual land fronting Lygon Street for residential use, afforded the greatest opportunity to maximise the property's value to the Department. It was identified that a major commercial development of the site was unlikely to be feasible given the economic conditions at that time. In addition, the consultants identified that, if an educational institution could be identified to utilise the buildings for office and educational purposes, the institution would likely pay a premium price for the property.

4.151 While the Roads Corporation had earlier advised the Department that the site would be vacated by mid-1996 to enable the property to be sold on the basis of vacant possession, it subsequently advised the Department that the premises could not be fully vacated until June 1997, which would delay the sale process for the property.

4.152 By December 1996, the Department had developed a view that the property should be sold by way of public auction or tender, even though the University of Melbourne had expressed an interest in purchasing the site for possible future use as student accommodation. At that time, the Department requested the Valuer-General to provide an estimate as to the value of the property.

4.153 In January 1997, the Valuer-General indicated that the highest value and best use of the site would be obtained, based on various scenarios, from a residential conversion of the existing buildings plus a new residential development. If this option was selected, the Valuer-General estimated the value of the property to be \$7.5 million. However, this estimate was subject to a certificate of title being issued prior to settlement, the termination of all current leases associated with the property and the provision of vacant possession on sale.

4.154 Following the Valuer-General's assessment, in March 1997, the consultants previously engaged by the Department further advised that the conversion of the existing buildings to student accommodation and the development of residential land fronting Lygon Street for residential use, was the best option which would maximise the value of the site, given the proximity of the property to the University of Melbourne and the lack of adequate student housing. It was also considered by the consultants that the Melbourne City Council would support such a development.

4.155 Based on the above concept, in April 1997, the Department engaged the services of another consultant to undertake a feasibility analysis of the proposed development in order to arrive at a value which may be used by the Department for the purposes of negotiations for the sale of the property to a major educational institution. It was concluded by the consultant that a realistic price for the site, for the use contemplated, was \$4.5 million.

4.156 In May 1997, subsequent to the issue of the consultant's report and after taking into account the prospective use of the property, the Valuer-General reduced the valuation of the property to \$4.45 million, which was consistent with the consultant's valuation. However, the Valuer-General considered that, in his opinion, the revised development scenario provided by the consultants was not the best use of the site. Consequently, the Valuer-General advised the Department that the previous valuation of \$7.5 million provided in January 1997 should be adopted as the appropriate valuation for the property.

4.157 At this time, the Minister for Finance provided an in-principle approval for the direct sale of the property to the University of Melbourne for use as student accommodation. Certain provisions of the *Land Act* 1958 allowed the Minister to sell the property directly to the University, on terms and conditions as the Minister sees fit, if it was deemed that the property was required for public purposes.

4.158 While negotiations for the sale of the property were in progress, the Corporation advised that the premises were still occupied and were not likely to be vacated until February 1998, and not by June 1997 as previously advised.

4.159 In June 1997, the University made an offer to purchase the property for \$7.5 million, in accordance with the Valuer-General's valuation, subject to the determination of an agreed date for vacant possession and the development of an interim occupancy agreement.

Key terms of the sale

4.160 In June 1997, the Minister for Finance approved the sale of the property to the University of Melbourne for a purchase price of \$7.5 million, with a deposit of \$750 000 to be paid on execution of the sale agreement and the balance of \$6.75 million payable within 60 days. The key terms of the proposed sale arrangements were as follows:

- the purchaser to acknowledge that the Roads Corporation will remain in possession of the property, without payment of any rental or other fee, until early March 1998;
- the Minister to endeavour to have the Corporation vacate the premises by the above date, but not to be liable to the purchaser if vacation does not occur by that date;
- the sale to be subject to the surrender of the property by the Corporation; and
- from the date of sale of the property, the Minister will not prohibit the purchaser, the property developer or any related entity, from carrying out any development, demolition, construction or other works to the property.

4.161 However, in October 1997, the University requested certain amendments to the agreed purchase terms, namely, that the Department agree to the deferment of payment of the balance of the purchase price until the end of June 1998 with no adjustment to the price, and that the developer be allowed to provide a performance bond in lieu of payment to allow the transfer of title to the land to occur.

4.162 In response to this request, in November 1997, the Department advised the University that deferment of the payment could not occur without necessitating an adjustment to the agreed purchase price and that the proposed performance bond contravened the requirement of the *Land Act* 1958, which provided that all conditions of the sale, including the full payment of the purchase price, must be complied with prior to the Governor-in-Council granting the land to the purchaser.

4.163 However, in December 1997, the Department, under the authority of the Minister for Finance, approved revised terms of payment of the purchase price, being a 10 per cent deposit on exchange of contracts and the balance due on receipt of the Governor in Council's approval of the sale and the revocation of the temporary reserve status relating to part of the property. Consequently, a deposit of \$750 000 was paid by the University in December 1997.

4.164 In April 1998, on the recommendation of the Minister for Finance, the Governor in Council approved the sale of the property to the University for a public purpose, with **the balance of the purchase price of \$6.75 million subsequently paid to the Department, some 8 months after the initially agreed settlement date in August 1997.**

4.165 However, 4 months prior to the Governor in Council approving the sale of the property to the University, in December 1997 the University entered into a contract for the sale of the property to a private sector developer for a price of \$7.5 million, on the condition that the property is developed for the purpose of student accommodation, with a completion date prior to the commencement of the 1999 academic year.

Assessment of sale result

4.166 An analysis of the sale to the University of Melbourne indicates the following:

- the sale proceeds of \$7.5 million were consistent with the valuation provided by the Valuer-General in January 1997;
- the sale proceeds equated with the book value of the asset at the time of sale; and
- the net proceeds of the sale were \$7.4 million, after taking into account costs associated with the sale of \$67 000.

4.167 While the return obtained from the sale of this property by the Department of Treasury and Finance and ultimately the State was consistent with the valuation provided by the Valuer-General, the return to Victorian taxpayers may not have been maximised as the sale was not subject to a competitive process.

Wellington Parade property

4.168 Since the mid-1970s, the Government had utilised a commercial building located on the north end of Wellington Parade, East Melbourne, for office purposes. The property comprises a net lettable area of around 5 900 square metres, including 2 levels of car parking, a ground level retail service area and 11 upper office levels.

4.169 Between September 1991 and May 1992, a series of valuations of the property were undertaken to facilitate its sale as part of the previous Government's *Assets Sale Program*. Table 4C below provides a summary of these valuations, which were provided on the basis that the State would enter into a sale and lease-back agreement in relation to the building with the prospective purchaser.

TABLE 4C
EARLY VALUATIONS OF WELLINGTON PARADE PROPERTY
(\$million)

<i>Valuer</i>	<i>Date of valuation</i>	<i>Market valuation</i>	<i>Annual rental value before refurbishment</i>	<i>Annual rental value after refurbishment (a)</i>
Valuer-General	September 1991	9.1	0.8	0.9
Independent valuer	March 1992	8.0	0.9	1.0
Valuer-General	May 1992	7.7	0.8	1.0
Independent valuer	May 1992	7.3	(b)	(b)

(a) In the initial valuation provided by the Valuer-General, it was concluded that the property was well suited to a refurbishment program and would provide a sound investment opportunity with the security of a strong cash flow under a Victorian Government lease for a minimum period of 10 years.

(b) No rental assessments were made by the independent valuer at that time.

4.170 Following a re-assessment of the *Assets Sale Program* by the current Government, the property continued to be utilised for operational purposes by the Government between 1991 and 1997.

4.171 In February 1997, the Department of Treasury and Finance recommended to the Minister for Finance that surplus government-owned office buildings within the central business district should be sold, with core government-owned offices refurbished and fully utilised in accordance with the *City Precinct Office Accommodation Strategy*. While the said property was considered for possible refurbishment and occupancy by government tenants, given the high capital cost of a refurbishment and the availability of alternative good quality leased office accommodation within the central business district, such action could not be justified and was therefore not supported by the Department.

4.172 Due to the planned vacation of the property by the end of June 1997, the suitability of the property for residential conversion or office use, and the declaration of the property as surplus to government operational requirements, in February 1997, the Minister for Finance approved the sale of the site by public tender, with vacant possession. To facilitate the sale, in June 1997 the Valuer-General provided a valuation of the property at \$3.75 million, which was consistent with an estimate of \$3.7 million provided by an independent valuer at that time.

Sale process

4.173 Between March 1997 and April 1997, a number of consultants from varying disciplines were engaged to facilitate the sale of the property and, in July 1997, the Minister for Finance agreed to proceed with a sale based on a target price of \$3.75 million.

4.174 A total of 11 tenders for the purchase of the property were received in August 1997, of which 7 were conforming tenders, with bids ranging from \$4.3 million to \$6.5 million. Later that month, the Minister for Finance confirmed the sale of the site to a property developer - Cavendish Properties, for a sale price of \$6.5 million.

4.175 Consistent with the terms of the sale agreement, a deposit of \$650 000 was paid to the Department in August 1997, with the balance of \$5.85 million paid in October 1997.

Assessment of sale result

4.176 An analysis of the sale result indicates that:

- the sale proceeds of \$6.5 million were \$2.75 million higher than the property valuation of \$3.75 million provided by the Valuer-General in June 1997;
- after taking account of the costs of approximately \$51 000 incurred in relation to the sale, the net proceeds of the sale were \$6.45 million; and
- the sale proceeds were \$2.9 million higher than the book value of the property at the time of sale.

Spring Street property

4.177 In September 1991, the former Department of Finance invited the State Superannuation Board of Victoria to enter into a sale and lease-back arrangement in relation to a publicly-owned commercial office building located at 49 Spring St, Melbourne. The property which was constructed in 1973, includes 11 upper levels, a ground floor and a basement car park, and is adjacent to an office building situated at 35 Spring Street which is owned and partly occupied by the Board.

4.178 The key elements of the Department's proposal included:

- the Board to acquire the property in its existing condition for a purchase price of \$8.9 million, which was consistent with a valuation of the Valuer-General, and enter into a lease back arrangement with the State for the period July 1992 to December 2003, involving total rentals of \$10.6 million; and
- the Board to finance a program of refurbishment estimated to cost \$1.1 million.

4.179 However, the Board declined the Government's offer to acquire the building and, consequently, the Government decided to retain the property at that time for its operational requirements.

4.180 In March 1997, the Department of Treasury and Finance re-commenced action for the disposal of the building and, in May 1997, engaged a firm of property consultants for its public sale. Subsequently, in July 1997, the Minister for Finance approved a target price of \$3.3 million for the sale of this property, based on a valuation received from the Valuer-General. The book value of the property, at that time, was \$2.7 million.

4.181 Following the marketing of the property, in July 1997 the Department received 7 tenders, of which 6 were regarded as conforming bids. The conforming bids ranged from \$3.3 million to \$5.3 million for the purchase of the building. The Minister accepted a bid submitted by Primavera Venture Pty Ltd, involving a purchase price of \$5.3 million.

4.182 As part of the process associated with the sale of the property, the Department received a number of valuations, which are outlined in Table 4D.

TABLE 4D
49 SPRING STREET,
PROPERTY VALUATIONS
(\$million)

<i>Valuer</i>	<i>Date</i>	<i>Valuation amount</i>
Valuer-General	December 1991	(a) 8.9
Independent valuer	March 1992	5.9
Valuer-General	April 1995	(b) 3.1
Valuer-General	June 1997	3.3
Independent valuer	June 1997	3.3

(a) Valuation based on planned sale and lease-back arrangements between the former Department of Finance and the State Superannuation Board of Victoria.

(b) According to the Valuer-General, the reduction from his previous valuation reflected the general slowdown in the number of properties purchased for residential conversion due to interest rate uncertainty and the number of developments on the market at the time.

Assessment of sale result

4.183 Consistent with the terms of the sale arrangements, the total proceeds to the Department from the sale of the property was \$5.3 million, with a deposit of \$526 000 paid in July 1997 and the balance of \$4.7 million paid in September 1997. An analysis of the sale result indicated that:

- the net proceeds from the sale of the property, after taking account of costs of around \$58 000 associated with the sale, were \$5.2 million;
- the sale proceeds were \$1.9 million higher than the target price of \$3.3 million; and
- the sale proceeds were \$2.5 million higher than the book value of the property.

Melbourne Magistrates' Court site

4.184 Following the relocation of the Melbourne Magistrates' Court to a new site situated on the corner of Latrobe and Queen Streets, Melbourne, and the relocation of the police headquarters to the World Trade Centre, the historic legal precinct located at Russell Street which comprised the former Melbourne Magistrates' Court and police complex, became surplus to the Government's operational requirements.

4.185 Given that the land surrounding these properties was either permanently or temporarily reserved for educational purposes, in July 1993 a report prepared by the former Department of Property and Services supported the sale of the properties to the Royal Melbourne Institute of Technology (RMIT), provided that the land parcels and buildings were no longer required for court or police purposes, and that the purchaser offered sufficient protection regarding the historical significance of the buildings.



Former Melbourne Magistrates' Court site.

4.186 While RMIT had expressed an interest in the purchase of these properties, their sale could not proceed as the Attorney-General had also expressed an interest in the use of the properties for the development of an Institute of Constitutional Law and Legal Museum at a cost of approximately \$7 million.

4.187 Following the failure to secure adequate financial support from the Community Support Fund to allow the refurbishment of these premises for the proposed development of an Institute of Constitutional Law and Legal Museum, in June 1997, the Attorney-General advised the Minister for Finance that the sale of the properties to RMIT should proceed, subject to an undertaking from RMIT to preserve the right of the Attorney-General to undertake the above development on part of the site, should funds subsequently become available.

4.188 At that same time, RMIT offered to purchase the site at a price of \$2.5 million and agreed to preserve its heritage. Subsequently, in July 1997, the Minister for Finance approved the sale of the property to RMIT.

4.189 In late 1996, the Valuer-General had provided an initial valuation for the property for an amount of \$2.7 million. However, at the time of sale, this valuation was revised downward to a value of \$2.5 million, due to the physical deterioration of the buildings since vacation of the site.

Key terms of the sale

4.190 Consistent with the terms and conditions of the sale agreement, an amount of \$2.5 million was paid to the Government as follows:

- a deposit of \$500 000 paid in December 1997; and
- the balance of \$2 million paid in June 1998.

4.191 The sale agreement disclosed that the Department of Justice, the National Trust and the purchaser had entered into a heads of agreement to establish a historic legal precinct via the implementation of a precinct development plan which, inter alia, provided for:

- incorporation of the properties within the RMIT precinct;
- establishment of a Constitutional Law and Legal Museum; and
- refurbishment of the “City Watch House” in a manner which is complementary to the Old Melbourne Jail.

4.192 Furthermore, the agreement provided that:

- in the event that funds become available from the Community Support Fund or from other sources within 2 years from the date of sale, the purchaser is required to implement the agreed precinct development plan; and
- for a period of 2 years from the date of sale, the purchaser must not undertake any works to the buildings on these sites which may prejudice the implementation of the plan.

4.193 An analysis of the sale result indicated that the sale proceeds were consistent with the Valuer-General’s valuation of the site, but were \$1.3 million greater than its book value of \$1.2 million as at the date of sale.

PART 5

Revenue



STATE REVENUES

5.1 The operating revenues of the State totalled \$25.6 billion during the 1997-98 financial year, which was \$258 million higher than the revenues raised in the previous year.

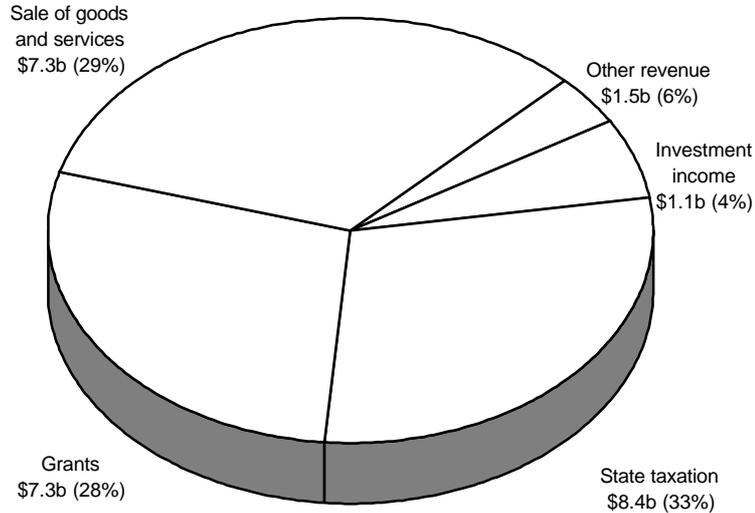
5.2 Taxation collections, grants from the Commonwealth Government and proceeds from the sale of goods and services, represented the major sources of State revenues. Collections from these sources in the 1997-98 financial year accounted for around 90 per cent of total operating revenues before abnormal items.

5.3 Table 5A provides a summary of operating revenue collections for the year, while Chart 5B illustrates the contribution of the major revenue sources to total State collections.

TABLE 5A
OPERATING REVENUES OF THE STATE
((\$billion))

<i>Item</i>	1997-98	1996-97
State taxation	8.4	8.1
Sale of goods and services	7.3	7.7
Grants	7.3	7.5
Investment income	1.1	1.0
Other	1.5	1.1
Operating revenue before abnormal items	25.6	25.4

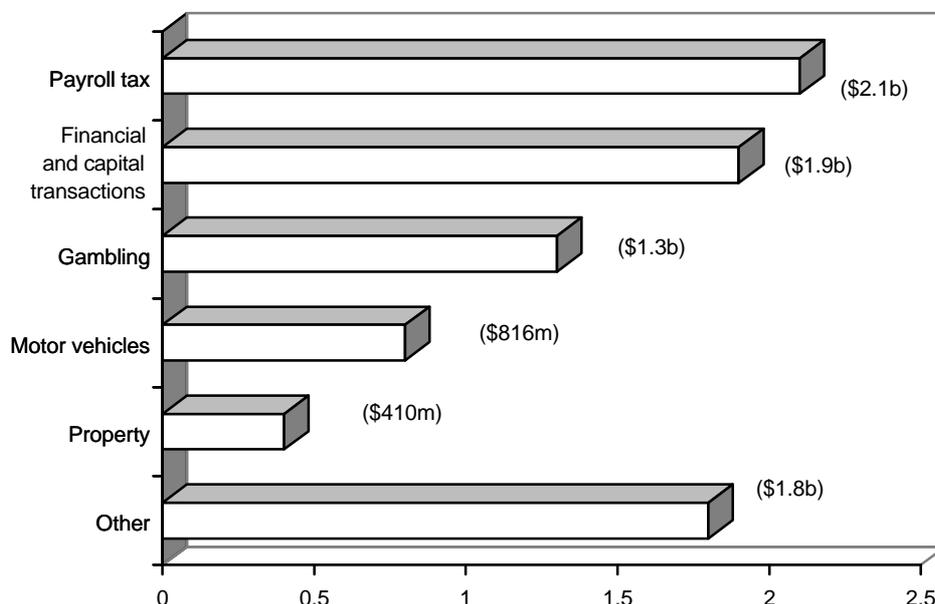
CHART 5B
MAJOR SOURCES OF STATE REVENUE, 1997-98
 (\$billion)



Taxation revenues

5.4 Taxation represents the largest source of State revenues and principally comprises payroll tax, various stamp duties and taxes on financial and capital transactions, taxes on property holdings and gambling activities, motor vehicle fees, and other licences and levies. **In the 1997-98 financial year, taxation collections totalled \$8.4 billion, representing an increase of \$236 million since the previous year.** The major items contributing to the increase in the year were increased payroll tax collections, higher revenues raised from gambling activities (mainly electronic gaming machines and casino operations), and increased collections from stamp duties and fees levied on financial and capital transactions. Chart 5C illustrates the key taxation categories.

CHART 5C
KEY TAXATION CATEGORIES
(\$million)



5.5 Over recent years, my Reports to the Parliament and the Government's Budget Papers have highlighted the Government's longer-term aim of reducing the taxation burden on Victorian taxpayers by *bringing the State's tax effort into closer alignment with the average of the Australian States*. To assist in the achievement of this aim, over a number of years, the Government introduced various tax reduction and expenditure management measures.

5.6 In the *1998-99 Budget Papers*, the Government announced further tax relief measures with an estimated full year benefit to taxpayers of around \$132 million, including a reduction in the payroll tax rate, stamp duty relief on conveyancing transactions, an expansion of stamp duty concessions for pensioners and first home buyers, and certain exemptions for taxpayers from financial institutions duty and debits tax.

5.7 The Government estimated that, after taking account of the tax relief measures announced in its *1998-99 Budget*, the State's tax raising effort was more than \$350 million below that of New South Wales, but was still around \$220 million above the national average. However, this position represents a substantial improvement for the State, when compared with recent years when the State's tax effort was estimated by the Government to be around \$900 million higher than the national average.

Business franchise fees

5.8 For many years, the States and Territories of Australia have imposed franchise fees on tobacco and liquor merchants, and fuel distributors, in return for granting licences to trade in such goods. My October 1997 *Report on the Government's Annual Financial Statement, 1996-97*, commented on the impact of a High Court decision on franchise fee collections. Specifically, in August 1997, the High Court ruled that the New South Wales tobacco franchise fee legislation was unconstitutional, which cast doubt on the validity of the collection of other "like" taxes, such as liquor and petroleum fees, by the States and Territories.

5.9 Following legal advice received by the States and Territories subsequent to the court ruling, the collection of such taxes, in their current form ceased. At the request of State and Territory Governments, arrangements were established whereby the Commonwealth Government agreed to use its taxing powers to collect revenues previously raised by the States for business franchise fees on liquor, tobacco and petroleum, ensuring that the States' revenue base was not eroded. Under these arrangements, the Commonwealth Government has imposed equivalent taxes, which have been passed-on to the States and Territories to compensate for the loss of tax receipts relating to these franchise fees. In addition, the Commonwealth has introduced a 100 per cent "windfall tax", so that the States' exposure to liabilities associated with possible claims for refunds of fees previously paid by licence holders is minimised.

5.10 Given that the replacement taxes that were imposed by the Commonwealth were applied at uniform rates across all Australian jurisdictions, the State received increased franchise fee collections from certain liquor products and petroleum excise duties. In such cases, the State has agreed to provide refunds to the relevant wholesalers to avoid increases in the prices of these products.

5.11 Under the above arrangements, during the 1997-98 financial year, the State received \$1.1 billion in replacement taxes from the Commonwealth Government, of which \$132 million was refunded back to liquor and petroleum wholesalers. Notwithstanding these arrangements, franchise fee collections during the year were \$151 million below the budget estimate. The major reasons for this shortfall were:

- timing differences in the collection of the taxes, resulting in a deferral of fuel tax revenues of around \$41 million, which will be collected in the following financial year, and one-off revenue losses of approximately \$71 million which are not recoverable in future periods; and
- actions taken by tobacco manufacturers and importers to minimise their taxation liabilities at the time of the change of the collection arrangements, resulting in a loss of around \$45 million in taxation revenues.

5.12 As outlined in the *1998-99 Budget Papers*, these "safety net" arrangements are only a temporary measure and are expected to remain in place at least until the end of the 1998-99 financial year. However, longer-term revenue replacement options are being considered by all Australian jurisdictions as part of the reform of the national tax system.

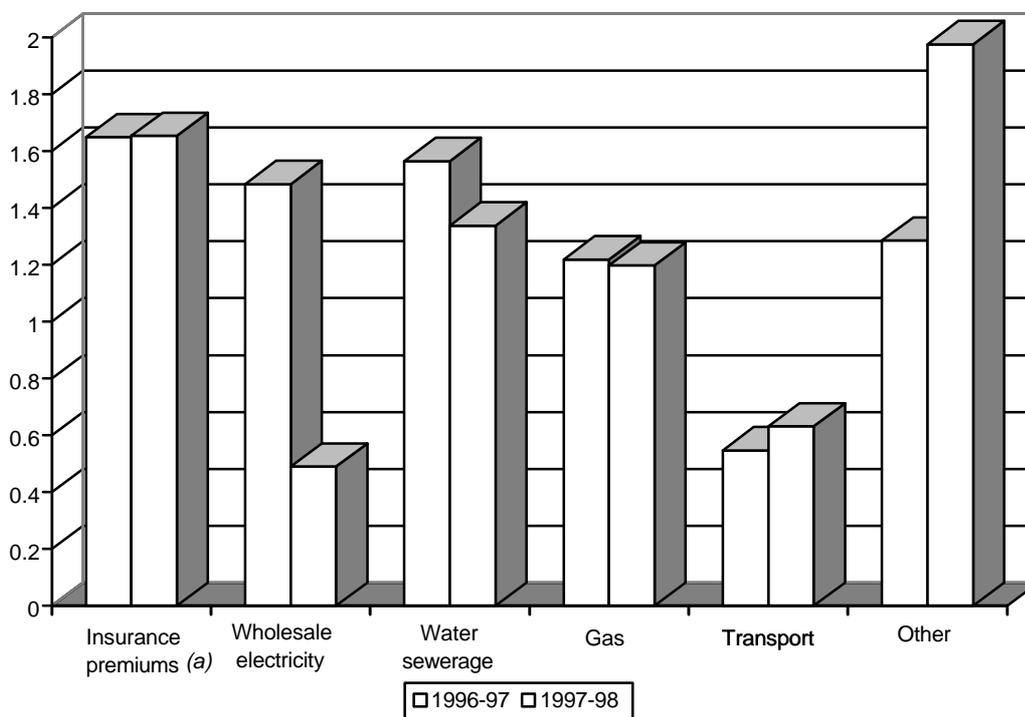
Sale of goods and services

5.13 Revenues from the sale of various goods and services by public sector bodies accounts for around 29 per cent of the State's total operating revenues and mainly comprises gas sales, transport fares, wholesale electricity charges mainly raised from private sector electricity distribution companies, and water and sewerage charges.

5.14 During the 1997-98 financial year, the revenue earnings of the State from the sale of goods and services totalled \$7.3 billion, representing a decrease of \$466 million since the previous financial year. The key factors contributing to the reduced revenues in the year was the privatisation of electricity businesses during the 1996-97 and 1997-98 financial years, and the Government's water industry reform program which has contributed to a reduction in revenues generated from water and sewerage charges during the 1997-98 financial year. However, the lower revenues generated from the electricity and water sectors were to some extent offset by increased collections by various other areas of government activity.

5.15 Chart 5E illustrates the contribution of the key activities associated with the sale of goods and services.

CHART 5E
REVENUE FROM THE SALE OF GOODS AND SERVICES
((\$billion))



(a) Mainly relates to transport accident charges and workers' compensation premiums.

Summary of Consolidated Fund transactions

5.16 As outlined earlier in this Report, the Consolidated Fund is the Government's main operating account and records the collection of all departmental revenues such as State taxes, Commonwealth grants and asset sale proceeds. Accordingly, the receipts of the Consolidated Fund represent a key element of the State's financial operations and substantially influence the Government's capacity to finance present and future programs.

5.17 Given the continuing importance of the Consolidated Fund to government operations and the established parliamentary appropriation and accountability process, in this Part of my Report, I have provided an analysis of the year's Consolidated Fund receipts outcome compared with that budgeted.

5.18 Table 5F provides a summary of the receipts (excluding borrowings) of the Consolidated Fund for the year.

TABLE 5F
BUDGETED AND ACTUAL CONSOLIDATED FUND RECEIPTS
(\$million)

<i>Item</i>	<i>1996-97 Actual (a)</i>	1997-98 Actual	<i>1997-98 Budget (b)</i>	Variance from Budget	Variance from 1996-97 Actual
Current -					
Taxation	9 000	(c) 8 678	8 643	35	(322)
Commonwealth	5 633	5 740	5 734	6	107
Public authorities	1 999	1 157	675	482	(842)
Other	1 022	1 350	1 104	246	328
Total current	17 654	16 925	16 156	769	(729)
Capital -					
Commonwealth	475	332	315	17	(143)
Sale of assets	143	294	124	170	151
Other	3 101	2 245	279	1 966	(856)
Total capital	3 719	2 871	718	2 153	(848)
Total receipts (excluding borrowings)	21 373	19 796	16 874	2 922	(1 577)

(a) 1996-97 comparatives have been adjusted to reflect the re-classification of certain items in 1997-98.

(b) Budget Estimates, 1997-98 Budget Paper No. 3.

(c) Includes \$1.1 billion of taxes collected by the Commonwealth Government on behalf of the State under the "safety net" arrangements established following a High Court ruling in August 1997 which questioned the power of States and Territories to levy franchise fees.

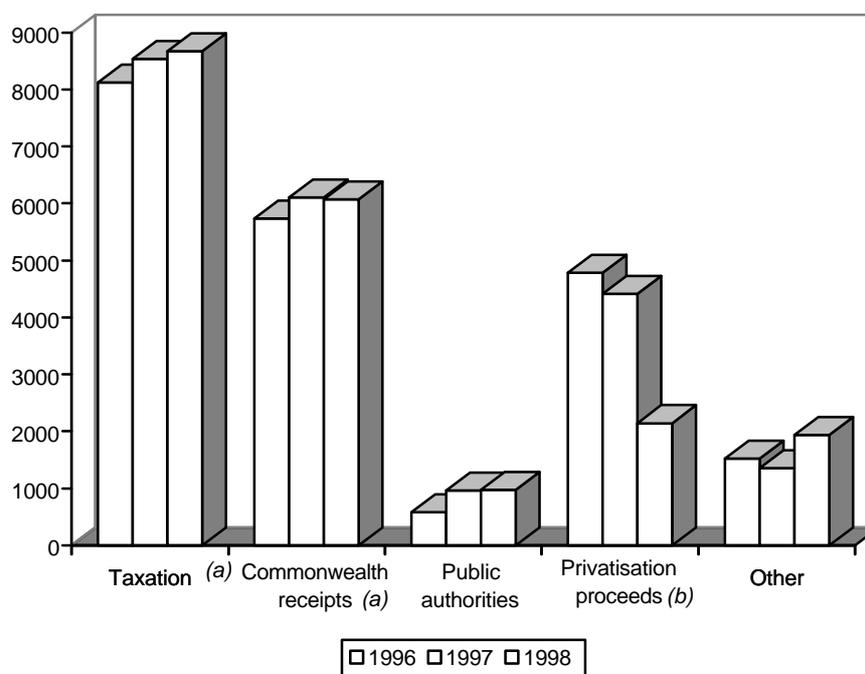
5.19 The Consolidated Fund gross receipts for the year totalled \$19.8 billion, which was \$2.9 billion above budget expectations. The major factor contributing to this positive outcome was the receipt of \$2.1 billion from the sale of 2 State-owned enterprises, namely, PowerNet Victoria and Southern Hydro Ltd, which were not fully provided for in the budget estimates.

5.20 When these privatisation proceeds are excluded, the Consolidated Fund receipts were \$837 million better than the budget estimates. The key factors contributing to this favourable budgetary outcome were increased receipts from Public Authorities (\$304 million), higher than expected receipts from property and equipment sales (\$170 million) and higher collections from the repayment of loans and advances by public bodies (\$271 million).

5.21 Although actual receipts were lower than the previous year, when the proceeds from privatisation are excluded, the year's receipts were in fact \$694 million higher than the level achieved in the previous year. This result mainly reflects the impact of increased receipts relating to the repayment by public bodies of loans and advances (\$243 million), the sale of the budget sector motor vehicle fleet during the 1997-98 financial year under sale and lease-back arrangements (\$168 million), higher collections from property and equipment sales (\$151 million) and higher net taxation revenues (\$135 million).

5.22 The major revenue sources of the Consolidated Fund are taxation receipts, grants and contributions from the Commonwealth Government, dividends and tax equivalent payments from public authorities, and proceeds from business privatisations. Chart 5G shows the contribution from each of these major sources of revenue to the Consolidated Fund over the past 3 years.

CHART 5G
MAJOR SOURCES OF CONSOLIDATED FUND
RECEIPTS, 1995-96 TO 1997-98
 (\$million)



(a) Commonwealth receipts in the 1997-98 financial year include replacement revenues of \$1.1 billion collected on behalf of the State following the abolition of franchise fees which previously formed part of taxation receipts.

(b) Privatisation proceeds include related public authority contributions and taxation receipts.

Taxation receipts

5.23 After taking account of “safety net” taxes of \$1.1 billion received by the State from the Commonwealth Government during the 1997-98 financial year to replace petroleum, tobacco and liquor franchise fee revenues which the State is no longer able to collect, due to the previously-mentioned High Court ruling, **taxation receipts in 1997-98 were \$35 million above the budget estimate and \$322 million lower than the previous year.** Table 5H details the major variances between current year receipts and budget projections and previous year receipts.

TABLE 5H
MAJOR VARIANCES
(\$million)

<i>Revenue sources</i>	<i>1996-97 Actual</i>	1997-98 Actual	<i>1997-98 Budget</i>	Variance from Budget	Variance from 1996-97 Actual
Stamp duties on land transfers and marketable securities	1 300	1 161	878	283	(139)
Electronic gaming machines	626	704	657	47	78
Land tax	437	264	427	(163)	(173)
Public authority contribution	317	188	333	(145)	(129)
Tobacco franchise fees	634	<i>(a)</i> 596	625	(29)	(38)

(a) Includes replacement taxes collected by the Commonwealth Government on behalf of the State (\$544 million).

5.24 The key factors contributing to the major taxation variations, as advised by the Department of Treasury and Finance, were as follows:

- *Stamp duties on land transfers and marketable securities* - higher than budgeted collections mainly due to the strengthening of the property market together with greater than expected share and capital market activity. The decrease in collections since the previous year mainly reflects the reduced level of receipts from privatisations;
- *Electronic gaming machines* - increased collections mainly reflect the higher than expected use of electronic gaming machines in the year;
- *Land tax* - lower revenues mainly reflect the impact of the Government’s package of land tax reforms which was introduced in November 1997, and the impact of reductions in the assessable valuations of certain higher valued properties;
- *Public authority contribution* - lower than expected due to the abolition of this contribution from GASCOR as from December 1997. However, this revenue loss was partly offset by increased dividends paid by gas entities, which are disclosed as part of public authority income; and
- *Tobacco licences* - reduced collections due to actions taken by tobacco manufacturers and importers to minimise their taxation liabilities at the time of the change in the taxation arrangements in August 1997.

Gambling fees and taxes

5.25 Fees and taxes collected in relation to gambling activities conducted within the State, which form part of taxation receipts, represent a significant component of Consolidated Fund revenues in recent years. The major sources of such revenue include fees and taxes levied on electronic gaming machine operations, private lotteries, racing and casino operations. **During 1997-98, the total receipts of the Consolidated Fund from gambling activities totalled \$1.3 billion, an increase of around \$142 million since the previous year.**

Casino revenues - deferment of liquidated damages associated with postponement of proposed development

5.26 My May 1996 *Ministerial Portfolios Report* commented on the granting of a licence in 1993 to Crown Limited for the purposes of operating a casino in Melbourne. The casino complex was to be constructed by the company on public land located at Southbank which is leased from the Government for a period of 40 years, with a nominal annual rental of \$1 payable by the company.

5.27 The proposal upon which the casino licence was initially granted provided for the development of a 361 room hotel on the site which was estimated to cost \$146.4 million, extensive entertainment facilities, a retail precinct and undercover parking for 3 000 cars. However, since the granting of the licence, the associated agreement has undergone a number of amendments which, over a period of 5 years, have significantly altered the size and development of the complex.

5.28 In particular, in January 1994, Crown sought the approval of the Government to increase the size of the hotel from the initial proposal of 361 rooms to 1 000 rooms. This proposal was subsequently approved by the Minister for Gaming in August 1994 and is reflected in the drawings attached to a deed of variation to the *Casino (Management Agreement) Act 1993*, which was enacted by the Parliament in November 1994. The commitment by Crown to further extend the development of the complex was based on the company's assessment of the financial viability of the casino.

5.29 The design changes to the internal layout of the hotel resulted in an increase in the number of hotel rooms to 535 and a need for the construction of a second hotel tower with 465 rooms to enable Crown to comply with the revised proposal. Consequently, a second deed of variation to the agreement, dated October 1995, provided for the construction of a hotel tower of not less than 465 rooms on the south-west corner of Queensbridge Street and Whiteman Street to be completed by December 1997, or at a later date, as agreed by the State.

5.30 In June 1996, a third deed of variation to the agreement reaffirmed the development of the second Hotel Tower, comprising not less than 465 rooms, and the construction of the Lyric Theatre with a seating capacity of at least 1 800, to be completed by November 1999. **Under the agreement, in the event that the agreed completion date is not met, liquidated damages representing the loss or damage to be suffered by the State if the company breached its contractual obligations, would apply at a rate of \$50 000 per day.**

5.31 However, in July 1997, Crown requested the removal of its obligation to construct the Lyric Theatre as part of the Casino complex, on the following basis:

- The complex was considered to already provide substantial live entertainment venues, including the “Palladium” with the capacity to seat 1 500 patrons, which are supported by smaller entertainment and function rooms within the complex;
- The City of Melbourne is well serviced with a range of world class theatres and live entertainment outlets, including the Regent, Princess, Forum, Comedy, State, Playhouse and Malthouse theatres;
- Crown did not consider that Melbourne possessed the capacity to support an additional theatre to seat 1 800 persons. The existence of an additional theatre could result in the deterioration and financial viability of the existing theatre and the live entertainment network, inadvertently impacting on the city’s position as the principal cultural capital of Australia; and
- Increased competition among theatre venues would either threaten their viability or increase their dependence on government grants.

5.32 In February 1998, the company advised the Minister for Gaming that it could not proceed with the construction of either the Lyric Theatre or the second hotel Tower of the Hotel and sought further amendments to the Management Agreement for the Melbourne Casino project, which would require ratification through amendment of the *Casino (Management Agreement) Act 1993*. In particular, the company advised that it was not in a financial position to undertake such a development and that, due to the current uncertainty associated with the Asian economic crisis and the downward effect on tourism, such a development was considered to be commercially unviable. Consequently, the Minister for Gaming referred this matter to the Victorian Casino and Gaming Authority for advice.

5.33 A subsequent submission made by Crown to the Government in June 1998 requested that the obligation to complete the Casino complex by the construction of the second Hotel Tower be deferred for a further 4 years until November 2003.

5.34 Information obtained by the Victorian Casino and Gaming Authority from a number of sources within the tourism and leisure industry, as part of its consideration of this matter, indicated that there was already an adequate supply of hotel accommodation within Melbourne for gaming clients and, consequently, it was unlikely that there would be an adverse effect on State revenues from Crown not proceeding with the construction of the second hotel Tower. Given these circumstances, it was considered questionable by the Authority whether liquidated damages would be applicable in the event that Crown failed to construct the second Hotel Tower by 30 November 1999.

5.35 In relation to the proposed Lyric Theatre, the information gathered by the Authority indicated that the construction of the theatre may have an adverse impact on the financial viability of existing theatres in Melbourne. In addition, as there is an oversupply of theatre seats and a shortage of new theatrical products, it was considered that the construction of another venue could not be sustained by the market place.

5.36 Following the above assessment, in June 1998, the Authority advised the Minister for Gaming that the deferral of the obligation to construct the second Hotel Tower and the Lyric Theatre for 4 years to November 2003, would result in the best outcome for the State and the Victorian community. The Authority also advised that if the State pursued the option of requiring Crown to pay liquidated damages for the delay, the State's method of enforcement would be to sue, with the eventual outcome of such action uncertain.

5.37 In July 1998, the Minister advised Crown that he intended to recommend that the Government agree to extending the date of completion in accordance with the advice received from the Authority.

5.38 A fifth deed of variation to the Management Agreement has been executed to defer the completion date of the construction of the second Hotel Tower and the Lyric Theatre to November 2003. The impact of the recent amendment which deferred the obligation by Crown is equivalent to the waiver by the State of up to \$73 million in liquidated damages payable from November 1999 to November 2003, in the event that the tower and the theatre are not constructed prior to the revised completion date.

□ *RESPONSE provided by the Secretary, Department of Treasury and Finance*

The Auditor-General's reference to a "waiver" being granted to Crown is inappropriate as the Government's arrangement is in the nature of a deferment and not a waiver. The second hotel tower and theatre project were supposed to have been completed by 30 November 1999, after which liquidated damages of \$50 000 per day would have become payable. The Government has deferred this obligation to 30 November 2003, when liquidated damages will again become payable. However, the second hotel tower and theatre projects have not been abandoned and the Government has not waived its right to liquidated damages.

The amount up to \$73 million which the Auditor-General claims the Government has "waived" is based on the product of 4 years x 365 days x \$50 000 (liquidated damages per day). While this amount is arithmetically correct, this amount of damages is quite notional as: (a) it is based on the assumption that the second hotel tower and theatre would only have been completed at 30 November 2003, which is unrealistic. That is, had the Government not granted the deferment, Crown may have proceeded to build the hotel and theatre projects as rapidly as possible, consistent with their contractual obligations thereby limiting the extent of damages; and (b) the VCGA has advised that even if the State were to pursue the option of Crown to pay liquidated damages for the delay in constructing these facilities, the State's method of enforcement would be to sue with the eventual outcome of such action uncertain.

Commonwealth receipts

5.39 In the 1997-98 financial year, grants and other contributions from the Commonwealth Government to the Consolidated Fund totalled \$6.1 billion and were consistent with budget expectations. However, as mentioned earlier in this Report, the above amount does not include \$1.1 billion of “safety net” payments to the State under the arrangements established in the year following a High Court ruling, whereby the Commonwealth Government passed-on to the State amounts collected from new taxes that were established to replace petroleum, tobacco and liquor franchise fees which were previously levied by the State.

Public authority income

5.40 Public authority income, which totalled \$1.2 billion during the 1997-98 financial year, mainly represents dividends and tax equivalent payments from various government business enterprises, which are collected under the authority of the *State Owned Enterprises Act 1992* and other specific legislation, and by virtue of the State’s interest in certain publicly-owned companies.

5.41 During the 1997-98 financial year, the Consolidated Fund revenue from this source was \$482 million greater than that budgeted for the year and \$842 million lower than the revenue received in the previous year. Table 5I provides a summary of public authority payments received by the Consolidated Fund in the past 2 years.

TABLE 5I
RECEIPTS FROM PUBLIC AUTHORITIES,
1996-97 AND 1997-98
((\$million))

<i>Business enterprises</i>	<i>Actual 1996-97</i>	Actual 1997-98	<i>Budget 1997-98</i>	Variance from Budget	Variance from 1996-97 actual
Electricity sector	1 290	293	86	207	(997)
Gas sector	105	153	84	69	47
Public financial institutions	206	175	121	54	(31)
Water sector	318	363	315	48	45
Port authorities	42	26	23	3	(16)
Other	38	147	46	101	110
Total (a)	1 999	1 157	675	482	(842)

(a) Excludes franchise fees received from privatised electricity companies and statutory contributions relating to a share of natural gas revenues from GasCor which are disclosed as taxation revenue, and capital repatriation payments and special dividends by various public authorities which are disclosed as part of capital receipts.

5.42 The reduction in receipts from public authorities compared with the previous financial year was mainly due to the receipt of higher tax equivalent payments during the 1996-97 financial year arising from privatisations.

5.43 The substantial increase in public authority income during the year compared with budget was mainly due to:

- additional tax equivalent receipts arising from the sale of 2 State-owned electricity businesses, namely, PowerNet Victoria and Southern Hydro Ltd;
- increased dividends from Gascor, offsetting a reduction in taxation revenues resulting from the abolition, as from December 1997, of statutory contributions by GASCOR relating to its natural gas revenues;
- higher dividends from a number of businesses within the Melbourne metropolitan water sector due to their increased profitability, and increased income tax equivalent payments from the Melbourne Water Corporation;
- incorporation of Aluminium Smelters of Victoria Pty Ltd (Aluvic) into Victoria's tax equivalent regime, resulting in higher income tax equivalent receipts;
- increased dividends from electricity businesses; and
- additional dividends from the Transport Accident Commission, due to its increased profitability.

5.44 However, these increased receipts compared with budget were, to an extent, offset by lower dividends from the Gas Transmission Corporation and non-metropolitan water authorities.

Contributions from Treasury Corporation of Victoria

5.45 The Prudential Supervision Framework established by the Treasurer in 1994 over the operations of the Treasury Corporation of Victoria provides for the maintenance of an adequate level of capital by the Corporation to ensure it is able to withstand any potential losses arising from credit exposures and market risk. The level of capital held by the Corporation during the 1996-97 financial year was assessed by the Department of Treasury and Finance to be in excess to its requirements, which allowed a dividend payment of \$22.5 million to be made to the Consolidated Fund together with a proposed special dividend in the form of a capital repatriation payment of \$27 million during the 1997-98 financial year.

5.46 In March 1998, the Corporation advised the Department of Treasury and Finance that the proposed capital repatriation payment of \$27 million was considered imprudent, however, a payment of \$13 million to the Consolidated Fund could be supported by the Corporation. In particular, the Corporation highlighted that the initially proposed payment of \$27 million was a preliminary estimate only and that the lower proposed amount, inter alia, took into account the financing strategies of the Corporation and provided for an appropriate level of conservatism to allow for the uncertainties of financial markets.

5.47 Following consideration of the above advice, **in April 1998, the Treasurer directed the Corporation to pay to the Consolidated Fund an amount of \$13 million, representing a special dividend in the form of a repatriation of capital from the Corporation's retained earnings.** The Treasurer advised the Corporation that the level of this payment would allow the Corporation to maintain an adequate level of capital, including a contingency margin over and above the prudential requirements.

5.48 The capital repatriation payment of \$13 million in June 1998, together with the dividend payment of \$22.5 million in September 1997 relating to the 1996-97 financial year, brought the total of contributions made by the Corporation to the Consolidated Fund during the 1997-98 financial year to \$35.5 million.

Urban Land Corporation contributions

5.49 In my October 1996 Report to the Parliament on the Government's *Statement of Financial Operations, 1995-96*, I commented on a contribution of \$50 million to be made by the former Urban Land Authority to the Consolidated Fund over a 3 year period, in the form of a dividend, to assist in the funding of the development of the Federation Square project. Under the arrangements, an initial instalment of \$30 million was paid by the Authority in March 1996, with further yearly instalments of \$10 million required to be paid in the 1996-97 and 1997-98 financial years from the Authority's retained earnings.

5.50 In October 1997, the Treasurer advised the Urban Land Authority that the final \$10 million contribution under the above arrangements was payable in November 1997, as part of the de-capitalisation of the Authority's retained earnings. At the same time, following consultation with the Board of the Authority and the Minister for Planning and Local Government, the Treasurer also sought the payment of an ordinary dividend of approximately \$3 million, representing 50 per cent of the Authority's 1996-97 net profit after tax. Furthermore, the Treasurer advised the Authority of an intention to seek the payment of interim dividends in April of each financial year and final dividends in October of each financial year, consistent with the Government's dividend payment regime for public business enterprises.

5.51 Following a formal determination of dividends by the Treasurer in November 1997, in respect to the 1996-97 financial year, an amount of \$13 million was paid by the Authority to the Consolidated Fund. Furthermore, in May 1998, following advice from the Treasurer regarding the interim dividend payable by the Corporation in respect to the 1997-98 financial year, the Urban Land Corporation (the successor body of the Urban Land Authority) paid an interim dividend of \$5.7 million to the Consolidated Fund, based on 80 per cent of the Corporation's net profit after tax for the 6 months ended 31 December 1997. Accordingly, **during the 1997-98 financial year, the Urban Land Corporation (and its predecessor body) paid a total of \$18.7 million to the Consolidated Fund.**

Rural Finance Corporation capital repatriation

5.52 Based on an assessment undertaken by the Department of Treasury and Finance which indicated that the level of capital held by the Rural Finance Corporation exceeded a prudentially required level, in March 1997 the Treasurer approved a capital repatriation of up to \$150 million from the Corporation.

5.53 In particular, the Treasurer was advised by the Department that the return on equity (after tax) of 7.5 per cent achieved by the Corporation for the 1995-96 financial year was significantly below the result achieved by the major Australian banks of between 12.5 per cent and 17.9 per cent for the same period. The comparatively low return achieved by the Corporation was mainly due to its high capitalisation level, with higher returns available to the Government if the surplus capital was applied to other investment projects funded by the State's capital budget.

5.54 Following the issue of formal determinations by the Treasurer in December 1997 and May 1998, respectively, the Consolidated Fund received 2 equal instalments of \$75 million from the Corporation.

5.55 After taking account of a dividend of \$9.5 million paid by the Corporation in November 1997, based on 50 per cent of the Corporation operating surplus in the 1996-97 financial year, and a State tax equivalent payment of \$10.4 million, **the Consolidated Fund received a total of \$170 million from the Corporation during the 1997-98 financial year.**

National Competition payments

5.56 As part of the National Competition Policy Agreement which was established in April 1995 between the Commonwealth Government and the States and Territories of Australia, Victoria undertook to implement certain micro-economic reforms within an agreed timetable in return for the receipt of financial assistance (known as annual competition payments) from the Commonwealth Government for the implementation of these reforms.

5.57 The annual competition payments to the State were due to commence in the 1997-98 financial year, provided that certain reform objectives and conditions were met by the State. These payments were to be adjusted for any movements in the consumer price index and the State's population.

5.58 **During the 1997-98 financial year, \$52.9 million was received by the Consolidated Fund from the Commonwealth Government under these arrangements, compared with a budget estimate of \$53.4 million.**

5.59 For the 1998-99 financial year, the Department of Treasury and Finance anticipates to receive a further competition payment of \$54 million from the Commonwealth, with this payment doubling as from the 1999-2000 financial year under the second tranche of payments, and then trebling in 2001-02 under the agreement.

PART 6

Expenditure



SUMMARY OF STATE EXPENDITURE

6.1 The operating expenses of the State totalled \$23.7 billion during the 1997-98 financial year, which was \$152 million lower than the expenditure incurred in the previous year. The key factor contributing to this outcome was the reduction in the level of interest and other financing costs incurred in the year, mainly arising from the application of electricity business privatisation proceeds over recent years towards the retirement of State debt.

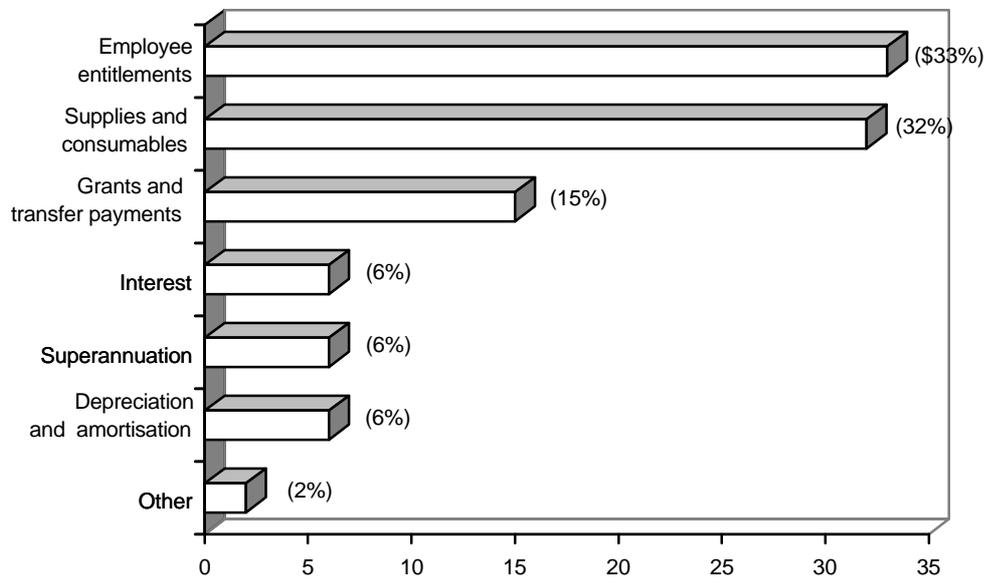
6.2 The major components of expenditure were costs associated with employee remuneration and related leave and superannuation entitlements, the purchase or production of supplies and consumables, debt financing costs, and grants and other transfer payments to external organisations. Table 6A provides a summary of the operating expenditure for the year.

TABLE 6A
STATE OPERATING EXPENDITURE
(\$billion)

<i>Item</i>	1997-98	<i>1996-97</i>
Employee entitlements	7.8	7.7
Supplies and consumables	7.5	7.1
Grants and other transfer payments	3.5	3.4
Interest and other financing costs	1.4	2.1
Superannuation	1.4	1.5
Depreciation and amortisation	1.4	1.5
Other expenses	0.7	0.5
Operating expenses before abnormal items	23.7	23.8

6.3 As shown above, the costs associated with employee entitlements, the purchase of supplies and consumables, interest, and grants to external organisations account for around 85 per cent of total operating expenses. Chart 6B further illustrates the contribution of the major expenditure categories to the total operating costs incurred by the State for the year.

CHART 6B
MAJOR OPERATING EXPENDITURE
CATEGORIES, 1997-98
(per cent)



Summary of Consolidated Fund transactions

6.4 As outlined earlier in this Report, the Consolidated Fund is the Government's main operating account and records the expenditure incurred by government departments under the authority of parliamentary appropriations, associated with the funding of programs and other financial obligations of the State.

6.5 In this Part of my Report, I have provided a high level analysis of the year's payments outcome for the Consolidated Fund. In this regard, Table 6C provides a summary of the gross payments for the year.

TABLE 6C
1997-98 ACTUAL AND BUDGETED PAYMENTS
(\\$million)

<i>Item</i>	<i>1996-97 Actual (a)</i>	1997-98 Actual	<i>1997-98 Budget</i>	Variance from Budget
Current -				
Annual appropriations	12 794	12 795	12 893	(98)
Special appropriations	1 807	2 543	1 885	658
Total current	14 601	15 338	14 778	560
Capital -				
Annual appropriations	1 833	1 537	1 820	(283)
Special appropriations	5 482	3 230	276	2 954
Total capital	7 315	4 767	2 096	2 671
Total payments	21 916	20 105	16 874	3 231

(a) 1996-97 comparatives have been adjusted to reflect the re-classification of certain items in 1997-98.

6.6 The table shows that the Consolidated Fund payments for the year totalled **\$20.1 billion**, which was \$3.2 billion greater than budget expectations. However, these payments included the allocation of the proceeds received from the privatisation of State-owned enterprises and a further amount of \$1.1 billion to the Treasury Corporation of Victoria for the progressive retirement of budget sector debt. When these transactions are excluded, **the year's Consolidated Fund payments were \$287 million above budget expectations.**

6.7 The following expenditures were made in the year under Special Parliamentary Appropriations that were not specifically provided for in the budget:

- payment of \$410 million to non-metropolitan urban water authorities under the Government's water industry reform program, for the purpose of accelerating the achievement of water quality and environmental objectives, and to facilitate price reductions;
- refund of \$132 million to taxpayers subject to Commonwealth taxes that were established under "safety net" arrangements to replace the petroleum, tobacco and liquor franchise fees that were previously levied by the State;
- refund of \$49 million tax equivalent payments previously made by public authorities to the Consolidated Fund, which were assessed to be overpaid; and
- increased contributions of \$43 million to the Hospitals and Charities Fund, due to higher than expected collections from gambling activities.

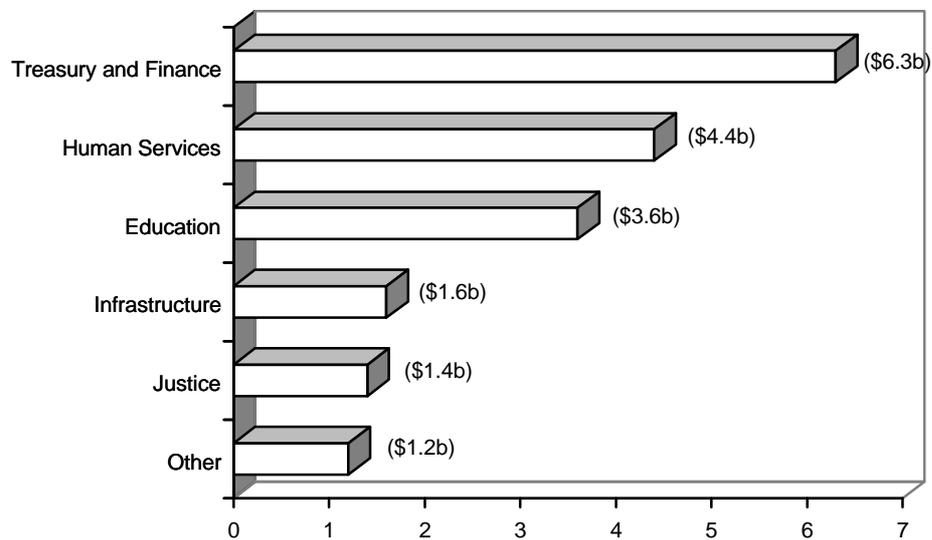
6.8 However, departmental expenditure under the parliamentary authority of annual appropriations was \$381 million below budget expectations which, to some extent, lowered the impact of the above additional payments. The following expenditures were below budget expectations:

- a budget allocation of \$28 million associated with the relocation of the Coode Island Chemical Storage Facility to Point Lillias was not utilised due to a government decision not to proceed with this project;
- an amount of \$27 million associated with the restructuring of the World Congress Centre financing arrangements was not utilised in the year and was carried forward into the 1998-99 financial year; and
- expenditure on various capital projects was less than anticipated and certain projects did not commence during the year as planned.

Major spending departments

6.9 The key portfolios accounting for Consolidated Fund expenditure in the year were Treasury and Finance, Human Services, Education, Infrastructure and Justice. As illustrated in Chart 6D below, these portfolios collectively represent 93 per cent of total Consolidated Fund payments.

CHART 6D
DEPARTMENTAL EXPENDITURE LEVELS, 1997-98 (a)
 (\$billion)



(a) Represents total net appropriation payments.

State's credit rating

6.10 As highlighted in my previous Reports to the Parliament, the State's credit rating is a major determinant of the level of finance charges that are payable by the Government on borrowings, and on financial market and investor assessments of the strength and stability of State finances. In this regard, over a number of years, my Reports have tracked the Government's progress towards achieving one of its key long-term financial targets, that is, to "*... reduce the State's debt and debt servicing ratios to levels consistent with the restoration of Victoria's former AAA credit rating*".

6.11 It is pleasing to report that, following the tabling in the Parliament of the 1998-99 Budget by the Treasurer in April 1998, the credit rating agency Standard and Poor's upgraded the State's credit rating from AA+ to AAA, reflecting "*... the moderate and still falling levels of the Victorian Government's debt burden, the very strong position of its ongoing finances, and the State's broad economic base, which should be durable and diverse enough to cope with the impact of the east Asian economic crisis without undue stress*". However, the agency noted that "*... much uncertainty exists as to the eventual impact of the east Asian economic situation on the Australian and Victorian economies*".

6.12 As at the date of preparation of this Report, the credit rating of the State as determined by another major rating agency, Moody's Investors Service, remained at a Aa1 level which is one rung below its highest rating of Aaa.

6.13 The upgrade of the State's credit rating to AAA by a major rating agency during the 1997-98 financial year, represents a substantial achievement by the Government and the realisation of one of its key long-term targets, reflecting the positive impact of the financial management strategies implemented over recent years.

Additional financing costs associated with taxation ruling

6.14 My previous Reports on the Government's *Statement of Financial Operations* have commented on **2 financial arrangements established in 1986 and 1987** by the former Victorian Public Authorities Finance Agency (VicFin) to raise funds from a major insurance institution (the investor) through the issue of a 12 year fixed rate *annuity* with a value of \$92 million and *gold loans*, mainly comprising floating rate instruments with a value of \$200 million maturing in 2002. The arrangements were structured to raise such funds at a cost below the prevailing market rates, while enabling the investor to receive a required rate of return through the realisation of tax benefits. Under the arrangements, VicFin and ultimately the State, guaranteed the after-tax rates of return to the investor.

6.15 As from 1988, the Australian Taxation Office (ATO) commenced issuing amended taxation assessments to the investor associated with these financial arrangements. **The impact of the taxation assessments relating to these arrangements resulted in an increase in financing costs of up to \$154 million.**

6.16 To facilitate the payment of these taxation liabilities, the Treasury Corporation of Victoria, the successor of VicFin, advanced an interest-free loan of \$84 million to the investor with the Government reimbursing the Corporation for these loans, with the balance of the taxation assessments of \$70 million either under review or held in abeyance by the ATO, pending the outcome of an appeal lodged by the investor.

Gold loan arrangements

6.17 In May 1996, the Treasurer approved the termination of the gold loan arrangement due to the unfavourable impact of its taxation status on financing costs, resulting in the issue in June 1996 of a termination notice to the investor. The Corporation then lodged a statement of claim against the investor with the Supreme Court of Victoria. **The Corporation's claim provided that the estimated termination amount associated with this arrangement was approximately \$213 million, including a termination payment of \$171 million and an additional amount of \$42 million required to meet future taxation payments if the investor's appeal against the taxation assessments was unsuccessful. However, the investor claimed that the estimated termination cost of the financial arrangement should be in the vicinity of \$355 million.**

6.18 In September 1996, a payment of \$178.8 million was made by the Corporation to the investor, comprising an amount of \$171 million associated with the financing of maturing bank bills under the financing arrangements, with the remainder relating to other scheduled fees payable under the arrangements.

6.19 Legal proceedings to determine the termination value of the gold loan arrangements commenced in the Supreme Court of Victoria in February 1998. However, at the date of preparation of this Report, the court judgement was pending.

Annuity arrangements

6.20 Prior to the maturity of the previously mentioned annuity arrangements in June 1998, as part of the previously referred interest-free loan of \$84 million, the Treasury Corporation of Victoria had paid \$55.7 million to the investor, which was reimbursed by the Government, on account of the investor's taxation liabilities associated with the arrangements for the period 1986 to 1994.

6.21 However, in May 1998, the Corporation advised the investor that a substantial amount was required to be refunded to it, in order to maintain the investor's agreed return. However, the investor considers that, in fact, it is owed an amount of \$11 million by the Corporation in relation to these arrangements.

6.22 At the date of preparation of this Report, these matters were the subject of ongoing discussion between the Corporation and the investor.

6.23 It is my intention to comment, in a future Report to the Parliament, on the additional taxation costs and other termination costs incurred by the State in relation to the gold loan and annuity arrangements, following the finalisation of the current legal proceedings and the associated taxation matters.

Australian Grand Prix Corporation

6.24 My previous Reports to the Parliament have outlined the State's financial commitments and exposures under the financial arrangements entered into by the Government for the staging of the Formula One Grand Prix event in Melbourne, and the Australian Motorcycle Grand Prix event at Phillip Island.

6.25 During the 1993-94 financial year, the State secured the Formula One Grand Prix race for Melbourne for a period of 6 years to the year 2001, with the promotion and staging of the event subsequently assigned to the Australian Grand Prix Corporation, which was established in October 1994 under the provisions of the *Australian Grand Prix Act* 1994. In May 1995, the Government announced the return of the Australian Motorcycle Grand Prix to Phillip Island until the year 2001, with this event also to be managed by the Australian Grand Prix Corporation. More recently, in July 1998, the Government announced that, following the successful completion of negotiations between the Victorian Government, the Corporation and Formula One Administration, Melbourne will host the Formula One Grand Prix event for a further 5 years, until the year 2006.

6.26 To facilitate the annual staging of the 2 Grand Prix events, the Government has undertaken to underwrite any deficits incurred by the Corporation in relation to the events.

6.27 A study undertaken by a consultant at the request of the Department of State Development to assess the impact of the 1996 Formula One Grand Prix event on the Victorian economy, concluded that substantial economic benefits to the State, which were estimated to be in the order of \$95.6 million, including an estimated \$6.9 million generated from additional taxation receipts to the State, were provided by the 1996 event. The conclusions of this study were not subject to my Office's scrutiny. A similar study was not undertaken for the 1997 or 1998 Formula One Grand Prix events. The Corporation advised that it is not industry practice to conduct such studies on an annual basis.



Melbourne Formula One Grand Prix event.

6.28 An evaluation by a consultant of the impact of the Australian Motorcycle Grand Prix event on the Victorian economy, conducted in May 1995 on behalf of the Department of Treasury and Finance, estimated a \$63 million economic benefit to the State, and \$3.7 million in State Government tax receipts, attributable to the 1997 event. A further study was undertaken by a consultant on behalf of the Government in relation to the 1997 Australian Motorcycle Grand Prix event, which estimated a \$54 million economic benefit to the State, including an estimated regional benefit to the Bass Coast Shire of \$22.6 million and \$3.7 million in State Government tax receipts. The conclusions of these evaluations were also not subject to my Office's scrutiny.

Financial outcome of the Corporation for the 1997-98 financial year

6.29 The costs incurred by the State in relation to the set-up and staging of the first 2 Formula One Grand Prix events in Melbourne in March 1996 and March 1997 were outlined in my previous Reports to the Parliament. An analysis of the third Formula One Grand Prix event which was staged in Melbourne in March 1998, and the first Australian Motorcycle Grand Prix event which was staged at Phillip Island in October 1997, is outlined below.

6.30 The net operating costs incurred by the State on the Formula One and Motorcycle Grand Prix projects, determined on an accrual basis, relating to the 1997-98 financial year were \$8.9 million, including depreciation and amortisation of \$1.6 million relating to the utilisation of associated infrastructure and other assets, and net costs of \$384 000 met by public sector agencies in relation to the events, including VicRoads and the Victoria Police.

6.31 Since the inception of the events, the net aggregate operating costs incurred by the State were \$27.4 million, which included set-up and establishment costs of an operating nature of \$4.8 million, and depreciation and amortisation of \$8.2 million.

6.32 Table 6F illustrates the outcome achieved in staging the Grand Prix events for the 1997-98 financial year.

TABLE 6F
COSTS INCURRED BY THE STATE IN RELATION
TO THE STAGING OF THE FORMULA ONE AND MOTORCYCLE
GRAND PRIX EVENTS, 1997-98
((\$million))

<i>Item</i>	<i>Formula One event</i>	<i>Motorcycle event</i>	<i>Total</i>
Operating loss in staging the event, excluding other costs detailed below	1.8	5.1	6.9
Net operating costs incurred by other public sector agencies (a)	0.2	0.2	0.4
Operating cost, excluding depreciation	2.0	5.3	7.3
<i>Add - Depreciation and amortisation costs</i>			1.6
Net operating cost to the State (b)			8.9

(a) Additional costs of \$240 000 were incurred by the Victoria Police in policing the events and \$144 000 was incurred by VicRoads in relation to associated roadworks.

(b) A further amount of \$835 000 was contributed by public sector agencies relating to sponsorships which were negotiated on a commercial basis.

6.33 In relation to Formula One Grand Prix events, the Corporation's objective is to make a direct positive contribution to Government, taking into account the taxation receipts generated by the event. In relation to motorcycle events, the Corporation's objective is to maximise revenues and minimise expenditure in order to achieve or improve on the budget result as approved by the Government.

6.34 The operating loss of \$2 million, excluding depreciation and amortisation costs, incurred during the 1997-98 financial year in relation to the Formula One event, represented a substantial overall improvement when compared with the equivalent loss of \$3.5 million in the previous year. The major factors impacting on this outcome were reduced direct costs associated with the staging of the event by the Corporation and reduced transport costs which were adversely impacted in the previous year due to a transport strike. In addition, there was a decline in revenues associated with the March 1998 event due to reduced ticket sales.

6.35 On the other hand, the operating loss of \$5.3 million, excluding depreciation and amortisation costs, incurred during the 1997-98 financial year in relation to the motorcycle event, was higher than an initially estimated deficit of \$3.2 million for the event. The major factor contributing to this outcome was the lower than expected revenues raised from the event. The Corporation advised that this was due to an over-estimation of attendances when the event was planned, resulting from its reliance on previously estimated attendance levels at the 1989 and 1990 Phillip Island motorcycle events which were, in fact, overstated.

6.36 In addition to the operating costs associated with the staging of the Formula One Grand Prix event, during the 1997-98 financial year, capital costs were incurred by the Corporation under licence for Parks Victoria at a cost of \$1 million, which were funded by the State and the related assets transferred to Parks Victoria. Further costs of \$78 000 associated with race infrastructure were also funded by the Government.

6.37 In relation to future Formula One Grand Prix events, as outlined in my previous Reports to the Parliament, there are a number of inherent risks that could potentially have an adverse impact on the Corporation's financial projections, including exchange rate movements relating to fees payable to the international bodies involved in the promotion of the Formula One championship; poor weather on race days impacting on attendances and possibly causing race cancellation; tobacco advertising restrictions possibly resulting in the cancellation of the event; any revisions to the contractual arrangements between the international bodies involved in the promotion of the Formula One championship and racing teams, resulting in event cancellation or otherwise impacting on the Corporation; and delays in the establishment of the required temporary facilities.

6.38 However, consistent with previous years, the Corporation has taken action to address certain of these risks through:

- maintenance of insurances relating to certain commercial risks;
- establishment of a hedging contract to manage its exposure to exchange rate movements impacting on fees payable to the international bodies involved in the promotion of the Formula One championship; and
- maintenance of close liaison with individuals and organisations involved in the Formula One World Championship to protect the State's interests in the event.

6.39 As also indicated in my previous Reports, the Treasurer in March 1996 approved the provision by the Corporation of an indemnity in favour of the race promoter against any costs arising from certain third party actions against the promoter, employees, agents and race drivers. However, the State's exposure was to a large extent mitigated by the Corporation's acquisition of public liability insurance for the 1998 Grand Prix event. Nevertheless, the State retained certain exposures, including claims in excess of the insurance policy limits and certain commercial risks.

6.40 The financial risks in relation to the Australian Motorcycle Grand Prix event are similar to those relating to the staging of the Formula One Grand Prix. The Corporation has taken similar steps to those taken in relation to the Formula One Grand Prix to manage the key risks associated with the staging of this event.

□ **RESPONSE** by the Secretary, Department of Treasury and Finance

The Auditor-General's attempt to assess the impact of the Grands Prix on the State only considers the aggregated costs of running these events. To make a balanced assessment of the economic viability of the Grands Prix from a State perspective, it is necessary to consider the overall economic benefits of these events along with the associated costs.

Funding of teachers in excess of requirements

6.41 In March 1998, the Treasurer provided an in-principle approval for the provision of additional funding of \$10 million to the Department of Education to meet the salary costs of up to 400 equivalent full-time teachers considered to be in excess of requirements. This approval was subject to an assessment of the Department's funding needs, which was to be undertaken towards the end of the 1997-98 financial year with reference to the actual expenditure levels and budget position of the Department. The Treasurer was advised that an "... *excess staff situation arises where a school has a greater number of employees than is necessary for the efficient and economic working of the school as identified in the school's preferred staffing profile*".

6.42 In May 1998, the Treasurer formally approved the additional funding of \$10 million to the Department of Education to meet the associated costs of excess teachers, given that the budget of the Department was assessed to be unable to absorb these additional costs which were considered unavoidable due to the imposition of inflexible staff management practices under the Victorian Teachers Redundancy Award 1994.

6.43 The Treasurer was advised by the Department of Treasury and Finance that the number of excess teachers was expected to be reduced by around 200 by 30 June 1998, and by a further 100 in the 1998-99 financial year.

6.44 However, in October 1998 the Minister for Education announced that up to 2 600 teaching jobs will be available in Government primary and secondary schools in 1999. Around 1 000 of the new jobs will be created as part of the Government's \$102 million per year early literacy initiative.

□ **RESPONSE** provided by the Secretary, Department of Education

The reference to a reduction "by a further 100 in the 1998-99 financial year" does not accurately describe the situation. The projected level of excess teachers immediately prior to the 1999 school year is estimated to be around 220 FTE, but this should decline early in Term 1 1999 to around 150 FTE as a result of the influence of budget initiatives and internal workforce management strategies.

There will always be a structural imbalance in the teaching workforce due to geographic and curriculum factors. Excess teacher situations will continue to arise in some schools throughout the year due to:

- *teachers returning from unpaid leave, including Family Leave;*
- *declining student enrolments;*
- *the need to employ new teachers in some schools for curriculum areas of high demand due to shifts in student subject preference; and*
- *the inability to compulsorily redistribute or redeploy excess teachers between the schools, as a last resort after all other attempts have failed.*

□ **RESPONSE** provided by the Secretary, Department of Education - continued

Although the Victorian Teachers Redundancy Award 1994 was amended in late 1997, the Department's inability to compulsorily redeploy excess teachers between schools continues to restrict opportunities to minimise structural imbalance and impacts on the achievement of salary budget targets. It is acknowledged, however, that the redeployment of excess staff remains a viable workforce management strategy in most instances.

It needs to be stressed that the additional 2 600 teaching jobs to be advertised comprise positions to cover normal replacement (for the taking of leave and attrition), increased student enrolments in individual schools and the additional funding provided in the 1998-99 State Budget. In particular, the additional funding and consequent staffing requirements for the Victorian Early Years Literacy Program and the Commonwealth's Youth Allowance were announced in the 1998-99 State Budget after the approval of the additional \$10 million. This has required a revision of employment projections.

Up to 1 000 new employments may arise in primary schools as a result of principals appointing additional teachers to replace experienced teachers who are released from current class teaching responsibilities to act as Early Years Literacy coordinators. This will depend on decisions taken by principals. It is anticipated that up to 300 employment opportunities will arise in secondary colleges as a result of the Youth Allowance initiative.

Winter Power Bonus Scheme

6.45 My May 1998 *Report on Ministerial Portfolios* commented on the Government's plans, which were announced in February 1998, to provide households and small business electricity customers in Victoria with a winter power bonus in the form of a \$60 yearly reduction on winter electricity accounts over the next 3 years. The Government estimated that this initiative would deliver savings of around \$360 million to consumers over the 3 year period, through the passing-on to customers of:

- reductions in franchise fees payable by the distribution businesses to the State; and/or
- specific payments to these businesses from the Consolidated Fund.

6.46 Following negotiations with the distribution businesses, in July 1998 the Government entered into agreements with these businesses to implement the Winter Power Bonus Scheme. Under the terms of these agreements, the distribution businesses agreed to reduce the accounts of individual franchise customers who are separately metered and paying a "service to property charge" by \$60 on 15 August 1998, 15 August 1999 and 15 August 2000.

6.47 **The total cost of the Scheme to the State over the 3 year period will be around \$370 million, comprising a reduction in franchise fees of \$58 million and specific payments to be made by the Consolidated Fund of \$312 million.** Table 6G outlines the cost to the State associated with the Scheme, relating to each distribution business.

TABLE 6G
COST TO THE STATE,
WINTER POWER BONUS SCHEME
(\$million)

<i>Distribution business</i>	<i>Reduction in franchise fees</i>	<i>Consolidated Fund payments</i>
Citipower	0.05	45.15
Eastern Energy	12.45	80.68
Powercor	-	106.54
Solaris	45.04	-
United Energy (a)	0.05	(b) 80.41
Total	57.59	312.78

(a) Now known as Power Partnership Pty Ltd.

(b) Amount is net of \$20 million paid by Power Partnership Pty Ltd to the State as a result of the implementation of the Scheme, as commented in my May 1998 Report on Ministerial Portfolios.

Termination of sales tax reimbursements

6.48 My May 1996 *Report on Ministerial Portfolios* outlined the implications of certain sales tax agreements which were entered into between the State Electricity Commission of Victoria (SECV) and the purchasers of the electricity distribution businesses, which formed part of the sale arrangements for these businesses. Under these agreements, the SECV on behalf of the State, agreed to reimburse the businesses for the costs associated with their sales tax obligations. This financial assistance was provided to ensure that electricity consumers were not disadvantaged by the passing-on of sales tax costs through higher electricity charges.

6.49 As part of the Winter Power Bonus Agreements, the distribution businesses agreed to terminate the previously established sales tax agreements with effect from 1 July 1998. **The total cost to the State associated with the termination of these agreements during the 1998-99 financial year was around \$67 million, comprising a one-off payment by the SECV of \$42 million and a \$25 million reduction in franchise fees previously payable by the distribution businesses.** Table 6H outlines the cost to the State associated with the termination of the arrangements, relating to each distribution business.

TABLE 6H
COST OF SALES TAX AGREEMENT TERMINATION
(\$million)

<i>Distribution business</i>	<i>Reduction in franchise fees (a)</i>	<i>Payments by the SECV</i>
Citipower	5.58	-
Eastern Energy	4.60	21.87
Powercor	-	19.98
Solaris	8.30	-
United Energy (b)	6.50	-
Total	24.98	41.85

(a) While the introduction of the Winter Power Bonus Scheme and the termination of sales tax reimbursements resulted in a reduction in franchise fees payable by distribution companies, franchise fees with a nominal value of around \$240 million still remain payable by these companies.

(b) Now known as Power Partnership Pty Ltd.

6.50 Under the termination arrangements, the businesses have undertaken not to pass-on to customers the cost of any sales tax incurred on goods acquired up until 31 December 2000, except where the rate of sales tax is increased for these goods, or where goods which are currently exempt or not subject to sales tax become taxable as a result of changes in relevant legislation, or where there are other changes in sales tax law which effect sales tax payable. Other key terms of these arrangements were as follows:

- the businesses agreed to lodge with the SECV by 30 September 1998 a final claim for sales tax incurred for the period to 30 June 1998;
- the businesses agreed not to acquire goods on or before 30 June 1998 that would not have been acquired but for the termination of the sales tax agreement; and
- certain refunds paid to the businesses for sales tax associated with goods purchased on or before 30 June 1998 must be repaid to the SECV, however, the businesses are entitled to retain sales tax refunded relating to transactions post-1 July 1998.

6.51 The SECV has recognised a provision of \$47 million in its financial statements as at 30 June 1998 relating to estimated sales tax reimbursement claims from the businesses for goods acquired on or before 30 June 1998.

Reporting of consultancy and contractor services

6.52 My May 1995 *Report on Ministerial Portfolios* outlined the results of an audit review of the utilisation of consultants within the Victorian public sector. That review identified that inconsistencies existed at agency level regarding the interpretation of what constituted “consultancy services” compared with “contractor services”, which resulted in some uncertainty regarding the actual level of expenditure incurred by agencies on consultants, which is required to be reported within agency annual reports.

6.53 Subsequently, in June 1995, the Government revised its *Guidelines for the Engagement and Management of Consultants* and enhanced the definition of consultancy and contractor services, including the illustrative examples of such services included in the guidelines to assist agencies in the interpretation of the definition. However, as identified in my May 1996 *Report on Ministerial Portfolios*, prior to the revision of the guidelines, my Office raised certain concerns relating to one example which was included in the guidelines, which was considered to be ambiguous and could lead to an understatement of reported expenditure on consultancy services. The example referred to, which was classified within the guidelines as a contractor service, was as follows:

“An organisation engaged to implement government decisions to corporatise or privatise a government business enterprise”.

6.54 It was recommended by audit that the Department should clarify the abovementioned illustrative example within the government guidelines as, in audit opinion, the example was ambiguous, in that private providers could be engaged to implement high level privatisation, corporatisation or other policy decisions, involving the provision of expert advice or analysis of various implementation options. In cases involving the provision of expert advice or analysis of options, it was audit's view that such engagements would be more appropriately classified as consultants. **At the date of preparation of this Report, this matter had not been clarified within the Government's guidelines.**

6.55 In relation to the reporting of consultancy services, the government guidelines and ministerial directives issued under the authority of the *Financial Management Act* 1994 require public sector agencies to disclose the following information within their annual reports to the Parliament:

- for consultancies during the year costing in excess of \$50 000, a schedule listing the consultants engaged, particulars of the project involved, the total fees incurred and future commitments in relation to each consultancy; and
- for consultancies during the year costing less than \$50 000, the aggregate number and cost of these engagements.

6.56 Similar annual reporting requirements have not been established for contractor services engaged by public sector agencies. However, the Victorian Government Purchasing Board, within the Department of Treasury and Finance, advised that during the 1998-99 financial year it is intended to seek an amendment to the Directions of the Minister for Finance under the *Financial Management Act* 1994 to require departments to report on all contracts with a value in excess of \$100 000, including consultancy and contractor services.

6.57 Given the increasing trend within the public sector for service delivery through contractor services and outsourcing arrangements, and the increasing impact of such services on agency financial operations, it is important that appropriate annual reporting requirements be introduced in relation to contractor and outsourcing services, to complement the existing reporting requirements relating to consultancy services.

□ **RESPONSE** by the Secretary, Department of Treasury and Finance

The 1997-98 Annual Report of the Victorian Government Purchasing Board recently tabled in the Parliament contains extensive data on the contracts issued in the State.

This initiative recognises the growing significance of contracted services to the operation of State-funded services.

As indicated by the Auditor-General, proposals for broadening the scope of annual reporting in respect of contract services is under consideration. The VGPB Annual Report 1997-98 is the first manifestation of this approach. Implementation of more detailed reporting should only proceed once the volume of contracts to be reported and the utility of the information provided has been assessed. Such an assessment should also consider the merit of maintaining a distinction between the concepts of “contractors” and “consultants”. This could overcome the Auditor-General’s concerns about possible ambiguity in application of the definition.

A review of the relevant Ministerial Directions is scheduled to be conducted in the course of the year with a view to making any amendments in sufficient time for incorporation in annual reporting requirements for 1998-99.

PART 7

Assets of the State



STATE ASSETS

7.1 Assets represent the resources that are controlled by the Government which, together with the resources provided by employees and other service providers, are available for application towards the provision of services and the delivery of programs. The assets of the State mainly comprise physical assets (including Crown and freehold land, buildings, plant and equipment, roads and other infrastructure), investments, receivables and cash-at-bank.

7.2 The Government's Annual Financial Statement discloses that, at 30 June 1998, assets with an aggregate value of \$77.1 billion were controlled by the Government, representing an increase of \$6.8 billion since the previous year. The major factors contributing to the improved reported asset position were:

- \$1.4 billion increase in land and buildings assets, mainly resulting from the revaluation of asset holdings by public sector agencies during the year and the first time recognition of certain assets, including native forests and minor parcels of Crown land;
- \$1.5 billion increase in roads assets, mainly resulting from the recognition of additional earthworks associated with the construction of roads; and
- \$3.8 billion increase in financial and other non-physical assets, mainly due to increased cash and investment balances held by the Treasury Corporation of Victoria as at 30 June 1998 associated with electricity business privatisations, which had not been applied towards debt reduction as at balance date. In addition, a receivable of \$894 million was raised by the State Electricity Commission of Victoria (SECV) as at 30 June 1998, representing the present value of amounts receivable over future periods mainly from electricity distribution businesses, from a levy established by the Government to assist in meeting its exposure under the flexible electricity tariff arrangements relating to the Portland and Point Henry aluminium smelters.

7.3 Table 7A presents a summary of the assets controlled by the Government.

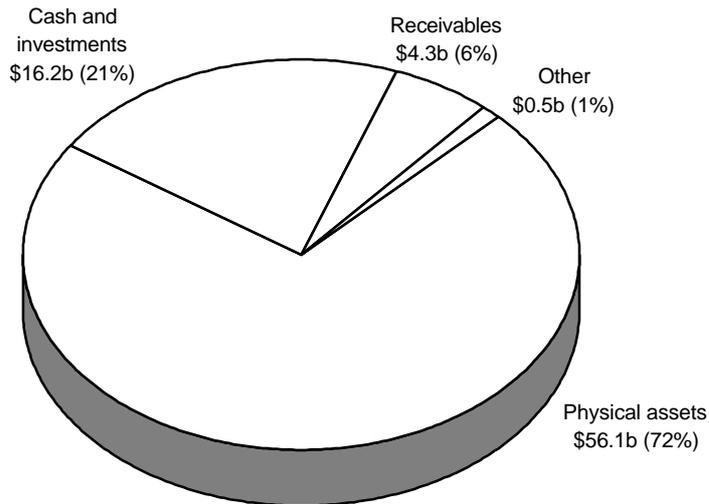
TABLE 7A
SUMMARY OF STATE ASSETS
((\$billion))

<i>Type of assets</i>	1997-98	1996-97
Physical assets -		
Land and buildings	21.9	20.5
Plant, equipment and infrastructure	19.1	18.9
systems	13.6	12.1
Roads		
Other	1.5	1.6
	56.1	53.1
Financial and other non-physical assets	21.0	17.2
Total State assets (a)	77.1	70.3

(a) The total balances are presented net of inter-entity eliminations, i.e. after deducting amounts relating to other public sector agencies.

7.4 As shown in the table, physical assets represent by far the largest asset category, accounting for around 72 per cent of total assets. This substantially reflects the State’s responsibilities in relation to Crown land, and the provision of public infrastructure and services. Chart 7B further illustrates the major components of the State’s assets.

**CHART 7B
COMPOSITION OF STATE ASSETS
(\$billion)**



Physical assets

7.5 The State’s physical assets mainly comprise Crown and freehold land, buildings, roads, infrastructure systems and other plant and equipment. The enhanced management of these resources has been a major focus of government reforms over many years, upon which comment has been made in my previous Reports to the Parliament.

7.6 A key part of the Government’s agenda for improving the management and accountability of departments for the total resources they control has been the implementation of the asset identification, valuation and reporting program. Under this program, the major assets of the State have been identified and recognised in departmental financial statements and in the Government’s Annual Financial Statement.

7.7 During the 1997-98 financial year, the value of certain assets was recognised in the financial statements of the relevant government agencies for the first time. These assets, which have also been recognised in the Government's Annual Financial Statement, include:

- earthworks associated with the construction of roads (\$1.4 billion);
- commercial native forests and certain minor parcels of Crown land managed by the Department of Natural Resources and Environment (\$230 million);
- Melbourne Exhibition and Convention Centre (\$154 million);
- certain properties financed under the Government's Accelerated Infrastructure Program which are subject to finance lease arrangements (\$104 million);
- Museum of Victoria (\$105 million); and
- Melbourne Sports and Aquatic Centre (\$65 million).

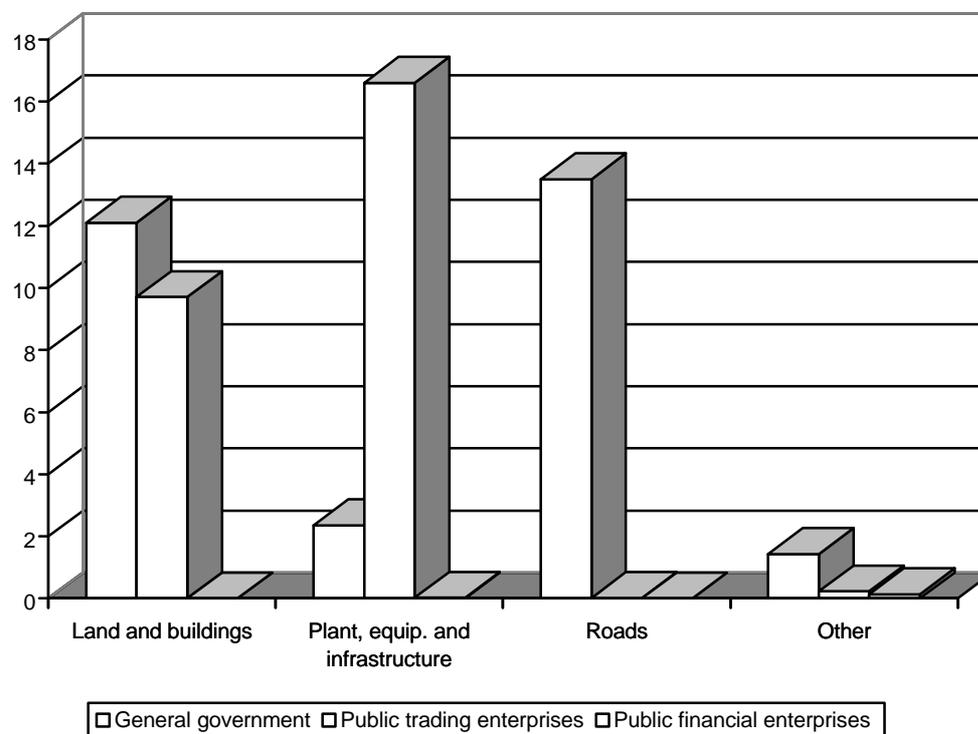
7.8 In addition, the reported value of assets was significantly impacted by asset revaluations performed by public sector agencies during the 1997-98 year. The net impact of such revaluations was to increase the reported value of the State's assets by around \$1.6 billion.

7.9 Certain assets of the State are yet to be recognised by the relevant agencies, including certain parcels of Crown land managed by Committees of Management which come under the ultimate responsibility of the Department of Natural Resources and Environment, the State's share of assets managed by the Murray-Darling Basin Commission and land under roads.

7.10 In addition, while supplementary information is provided in note 31 to the Government's Annual Financial Statement on funds held in trust by State Trustees, information is not disclosed on the extent of funds held in trust by the courts.

7.11 Chart 7C illustrates the value of physical assets recognised in the Government's Annual Financial Statement, attributable to the major government sectors as at 30 June 1998.

CHART 7C
PHYSICAL ASSET HELD BY THE STATE, 30 JUNE 1998
 (\$billion)



7.12 The chart shows that, while the general government and public trading enterprises sectors are responsible for the control and management of the vast majority of land and buildings, the majority of plant, equipment and infrastructure assets are held by the public trading enterprises sector, reflecting their role in providing key services to the community, including water, gas and public transport.

□ **RESPONSE** provided by the Secretary, Department of Natural Resources and Environment, and the Secretary, Department of Treasury and Finance

(a) *Crown land managed by Committees of Management*

In order to remedy this situation, the Department of Natural Resources and Environment will request committees managing significant parcels of Crown land to obtain land valuations to ensure that these assets are recognised in the Annual Financial Statement.

(b) *Assets of the Murray Darling Basin Committee*

A forthcoming Australian Accounting Standard will address the issue of entities subject to joint control. The Department of Treasury and Finance will review the nature of the State's interests in the Murray Darling Basin Commission in the light of the forthcoming Standard and make an assessment of what assets should be recognised in the Annual Financial Statement.

- **RESPONSE** provided by the Secretary, Department of Natural Resources and Environment, and the Secretary, Department of Treasury and Finance - continued

(c) *Land under roads*

As noted in the Annual Financial Statement, the Department of Treasury and Finance is monitoring the work being undertaken by the Public Sector Accounting Standards Board (PSASB) on the recognition and measurement of land under roads. Once the PSASB has determined a position, the Department will form its view on the appropriate treatment of land under roads in the Annual Financial Statement.

Level of financial and other non-physical assets

7.13 Financial assets included in the Government's Annual Financial Statement can be broadly described as those assets that can be readily liquidated by public sector agencies and generally do not include items of a fixed asset nature. The major categories of financial assets include investment holdings, receivables from external parties, and cash and deposit balances.

7.14 The Government's Annual Financial Statement discloses that financial and other non-physical asset holdings of the public sector at 30 June 1998 stood at \$21 billion, representing an increase of around \$3.8 billion when compared with the previous year. Table 7D shows the composition of these balances as at 30 June 1998.

TABLE 7D
FINANCIAL AND OTHER NON-PHYSICAL
ASSETS OF THE STATE
((\$billion))

Type	1997-98	1996-97
Investments	14.9	11.3
Receivables	4.3	3.3
Cash	1.3	1.9
Other assets	0.5	0.7
Total State assets (a)	21.0	17.2

(a) The total balances are presented net of inter-entity eliminations, i.e. after deducting amounts relating to other public sector agencies.

7.15 As was previously commented in this Part of the Report, the increase during the year in the level of the State's financial assets was mainly attributable to:

- higher cash and investment balances held by the Treasury Corporation of Victoria (\$2.3 billion), mainly on account of privatisation proceeds awaiting application towards the retirement of State liabilities; and
- recognition of levies receivable by the SECV mainly from electricity distribution companies for application towards the reduction of the State's exposure arising from the onerous flexible electricity tariff arrangements relating to the Portland and Point Henry aluminium smelters (\$894 million).

7.16 The Government's Annual Financial Statement for the current financial year includes a number of additional disclosures compared with the 1996-97 financial year in relation to financial assets and liabilities. These disclosures have been made under the requirements of new Australian Accounting Standard AAS33 *Presentation and Disclosure of Financial Instruments*, which aims to provide additional information to users of general purpose financial reports, to enhance their understanding of the significance of financial instruments to the entity's financial position and performance, including the timing and certainty of future cashflows associated with these instruments.

7.17 The additional disclosures for the 1997-98 financial year should enhance the Parliament's understanding of the key arrangements and policies established within Government for the management of key risks associated with financial assets.

Financial performance of the Transport Accident Commission

7.18 The Transport Accident Commission (TAC) commenced operations in January 1987 with the responsibility of managing the State's Transport Accident Scheme as effectively and economically as possible. Given that the TAC inherited \$1 billion of accumulated losses from the previous third party scheme, at the time of its establishment, the Government of the day indicated that transport accident charges would be set at a level which would enable the Scheme to be fully-funded by 1997.

7.19 My previous Reports to the Parliament have commented on the strong financial performance of the TAC, which culminated in the Scheme becoming fully funded during the 1989-90 financial year, some 7 years ahead of the government target.

7.20 Given that the TAC represents one of the State's major public financial enterprises, which significantly impacts on the financial outcomes and financial position of the State, I have presented below an analysis of its financial performance over the past 6 years, highlighting the impact of transactions undertaken with other public sector agencies on the operating results and financial position achieved by the TAC.

Summary of performance

7.21 The financial performance of the TAC is dependent upon various factors, including the level of claims incurred and returns achieved on investments, which are susceptible to significant volatility arising from injury rates and financial market conditions. Table 7E outlines the financial performance of the Scheme over the 6 year period of July 1992 to 30 June 1998.

TABLE 7E
FINANCIAL PERFORMANCE OF THE TRANSPORT ACCIDENT SCHEME,
FOR THE 6 YEAR PERIOD ENDED 30 JUNE 1998 (a)
(\$million)

<i>Items</i>	1992-93	1993-94	1994-95	1995-96	1996-97	1997-98
Premium revenue (b)	717	684	643	661	694	734
Investment revenue	479	454	237	338	604	342
Claims expenditure	243	666	683	753	1 090	809
Operating profit before income tax and abnormal items	924	436	224	234	255	286
Investments	4 222	3 159	3 150	3 492	3 885	4 378
Outstanding claims	2 027	2 118	2 317	2 501	3 006	3 259
Net assets	1 317	367	463	571	595	728
Solvency margin (c) (%)	65.0	13.2	16.0	19.4	16.2	18.2
Return on investments (%)	12.6	10.9	8.0	10.8	18.4	8.6

(a) Source: TAC annual financial statements.

(b) The growth in premium revenue was mainly due to an 8 per cent increase in the number of vehicles registered in Victoria during the 6 year period.

(c) Source: TAC records. Solvency margin represents the ratio of net tangible assets to outstanding claims liabilities.

7.22 The above table highlights that, over the past 6 years, the TAC has achieved strong financial results and has maintained a strong financial position. The key factors impacting on these outcomes have been the achievement of high investment returns and the effective management of claims liabilities. Further comments on some of the key factors impacting on these outcomes are provided below.

Premium revenue

7.23 The Transport Accident Scheme is primarily funded from third party premiums which are paid by around 3 million Victorian registered vehicle owners, with premium rates determined at levels which ensure that sufficient funds are available to meet all compensation benefits payable by the Scheme. During the 1997-98 financial year, premium revenue represented 67 per cent of the TAC's total revenue base.

7.24 While, under the governing legislation, premium rates may be indexed in line with movements in the consumer price index, the strong financial performance of the Scheme in recent years has enabled the movements in premium levels to be maintained below the movements in the consumer prices index. In particular, the premium per vehicle for the Melbourne metropolitan area was \$275 as at July 1998, compared with a potential premium of \$311 per vehicle if it was fully indexed to movements in the consumer prices index since July 1992.

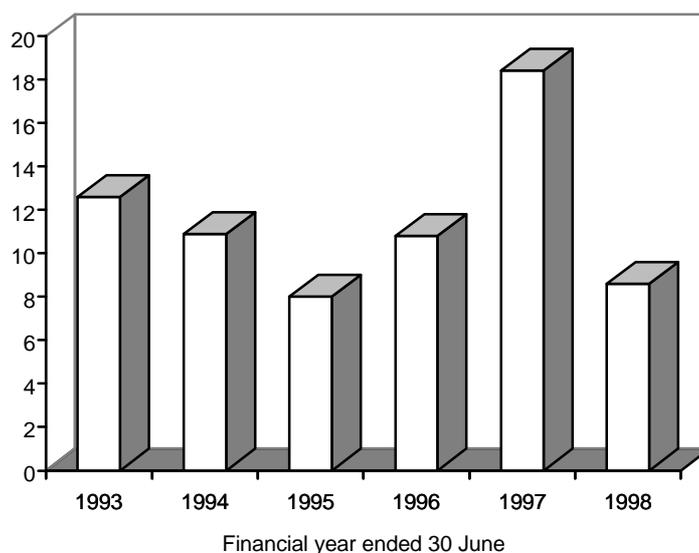
7.25 The TAC's actuary has advised the Commission that the premium level for the 1998-99 financial year makes sufficient provision for the expected cost of claims and associated administration expenses.

Investment performance

7.26 The overall investment strategy employed by the TAC is designed to achieve the objective of generating investment returns which, combined with premium revenue, meet the estimated future short and long-term funding needs associated with outstanding claims liabilities. The investment portfolio mainly comprises equities, short-term money market products and property trusts. During the 1997-98 financial year, investment revenue represented 32 per cent of the TAC's total revenue base.

7.27 Over the 6 year period subject to audit review, the TAC has managed an average investment base of \$3.7 billion, which has generated on average investment earnings of around \$410 million per annum, with an average rate of return on investments of around 11.55 per cent. Chart 7F illustrates the investment performance of the TAC over the past 6 years.

CHART 7F
RATES OF RETURN ON INVESTMENTS,
1992-93 TO 1997-98
 (per cent)



7.28 The key reasons for movements in the level of investment earnings during the 6 year period subject to review were:

- substantial decline in earnings in the 1994-95 financial year, compared with each of the previous 2 financial years, mainly due to a decrease in the TAC's asset base in the 1993-94 financial year, which was principally brought about by the payment of a special dividend of \$1.2 billion by the TAC to the Consolidated Fund;
- major increase in earnings in the 1996-97 financial year, mainly due to strong returns achieved by the TAC from most investments, reflecting buoyant world financial markets and the restructuring of the investment portfolio; and

- substantial decrease in earnings achieved in the 1997-98 financial year, mainly reflecting the relatively weaker performance of the Australian equities market in that year.

Outstanding claims liability

7.29 The core business of the TAC is the management of claims made by persons injured in transport accidents. A number of schemes are being managed by the TAC, including the no-fault accident scheme, common law scheme and the residual claims relating to the previous Victorian no-fault and common law scheme, and the journey to work compensation scheme. The injured person's entitlements and benefits differ under each of the schemes, depending on the nature of the impairment.

7.30 Since July 1992, the TAC has incurred claims expenditure totalling \$4.2 billion, comprising actual payments of \$2.6 billion to injured persons, increases in the level of the outstanding claims liabilities of \$1 billion and costs of around \$600 million relating to claims administration and accident prevention. Generally, the benefits paid under the no-fault accident scheme have included income replacement, medical and rehabilitation treatment, ambulance transport, and lump sum and weekly payments. These benefits are indexed annually for movements in the consumer price index or average weekly earnings.

7.31 The outstanding claims liability is actuarially determined each year and represents the present value of claims incurred but not yet paid, claims incurred but not yet reported and the anticipated level of costs associated with the settlement of these claims. The level of outstanding claims has increased at an average rate of 6.4 per cent per annum over the 6 year period subject to audit review. The key factors contributing to this movement, as advised by the Commission, were.

- on average, approximately 22 000 new accident claims were lodged per year with the Commission; and
- re-assessments by actuaries of projected claims liabilities to reflect current economic and claims experience, leading to an increase in the estimated present value of amounts payable to claimants.

7.32 Consistent with the practice adopted in prior years, the level of outstanding claims as at 30 June 1998 includes the sum of \$712 million, comprising a prudential margin of 15 per cent (\$425 million) and an expense allowance associated with the estimated future costs of administering claim payments (\$287 million). According to the TAC's actuary, the prudential margin is required because, although the central estimate of the liability represents a best estimate of the Scheme's future obligations, the ultimate amount of payments in respect of accidents will not be known until the last claim is settled by the TAC.

Solvency margin

7.33 The solvency margin represents the ratio of net tangible assets to outstanding claims liabilities and is a key indicator of the financial standing of the TAC. The margin has fluctuated considerably since the inception of the Scheme, however, over the past 6 years the solvency margin has averaged 24.7 per cent. **The solvency margins achieved by the TAC over the period subject to this audit review, as depicted in Table 7E, have consistently exceeded the non-mandatory minimum solvency requirement of 15 per cent per annum as established by the Australian Prudential Regulation Authority, formerly known as the Insurance and Superannuation Commission.**

Transactions with other public sector agencies

7.34 Over recent years, the TAC's operating results and financial position have been significantly impacted by major decisions of Government, or transactions with other public sector agencies, requiring the TAC to incur significant expenditure. The financial impact on the TAC for such payments, which are detailed in Table 7G, has been around \$3 billion.

TABLE 7G
TRANSACTIONS WITH OTHER PUBLIC SECTOR AGENCIES,
1992-93 TO 1997-98
(\$million)

<i>Item</i>	<i>92-93</i>	<i>93-94</i>	<i>94-95</i>	<i>95-96</i>	<i>96-97</i>	<i>97-98</i>	<i>Total</i>
Farrow Group (net) (a)	521	12	(42)	2	(32)	(17)	444
Funding of programs - (b)							
Road Trauma Centre	9	8	8	9	8	6	48
VicRoads Safety Programs	8	6	-	-	-	-	14
Police Road Safety Programs	-	3	1	1	1	1	7
Black Spot Accident Trust Account	37	37	5	5	-	-	84
Road Accident Rescue	3	3	3	4	5	4	22
Total	57	57	17	19	14	11	175
Payments to the Consolidated Fund (a)							
Dividends	92	1 274	90	96	223	132	1 907
State equivalent taxes	-	-	88	8	33	(11)	118
Stamp duty on premiums	4	59	65	67	71	76	342
Total (c)	96	1 333	243	171	327	197	2 367
Total payments to public sector agencies	674	1 402	218	192	309	191	2 986

(a) Source: Annual financial statements of the TAC, representing impact on the TAC's operating results.

(b) Source: Data provided by the TAC.

(c) Does not include fees paid to VicRoads relating to the collection of premiums from motorists, fees paid to the Victorian Funds Management Corporation associated with the management of the Commission's investments, and sponsorships provided to public sector organisations.

7.35 In January 1993, the Government transferred to the TAC substantial liabilities associated with the failed Farrow Group of Building Societies (Pyramid, Geelong and Countrywide) together with the right to receive distributions from the liquidator and any outstanding amounts relating to the former petrol levy. As a result of this transfer, the TAC incurred an extraordinary loss of \$521 million in the 1992-93 financial year. However, following **the receipt of distributions from the progressive liquidation of Farrow assets over the period of the audit review, the TAC has been required to meet net expenditure of \$444 million relating to the Farrow Group obligations.**

7.36 In addition, **the TAC has funded expenditures totalling \$175 million for various accident prevention and emergency treatment initiatives provided through other government agencies,** including health treatment facilities for transport accident victims and roadwork safety improvements.

7.37 Furthermore, **the TAC has made contributions to the Consolidated Fund with an aggregate value of \$2.4 billion over the past 6 years, including:**

- special dividends totalling \$1.3 billion in the 1993-94 and 1996-97 financial years following a decision by the Government to reduce the TAC's net assets;
- annual dividends averaging around \$100 million per annum;
- annual income tax equivalent payments, which commenced during the 1994-95 financial year and have totalled \$118 million over the period subject to review; and
- payments to the Consolidated Fund of \$342 million as from July 1993, relating to the introduction of stamp duty of 10 per cent on motorists' annual TAC premiums.

Overall comment

7.38 The audit review has highlighted that the TAC has achieved a high level of financial performance over the past 6 years, which has enabled substantial contributions of around \$3 billion to be made by the TAC to other public sector agencies for application towards funding government programs.

Gas industry assets

7.39 My previous Reports to the Parliament have commented on the status of the Government's extensive reform program for the gas industry. As an initial step in the restructuring of the industry, the *Gas Industry Act 1994* was enacted, with effect from July 1994, with the main purpose of facilitating the disaggregation of the former Gas and Fuel Corporation of Victoria, through the transfer of property, rights and liabilities associated with the gas distribution business to GASCOR, and the transfer of property, rights and liabilities associated with the transmission business to Gas Transmission Corporation (GTC). This resulted in the dissolution of the former Gas and Fuel Corporation, with the transfer of the residual property, rights and liabilities to the State Electricity Commission of Victoria.

7.40 Further reforms were announced by the Government in March 1997 following the resolution of the petroleum resource rent tax (PRRT) dispute between GASCOR, Generation Victoria and the gas producers, Esso and BHP. In particular, it was announced that the distribution and retail operations of GASCOR would be unbundled into 3 "stapled" gas businesses, each comprising a gas distributor and a gas retailer. These businesses became operational as defined divisions of GASCOR as from July 1997, however, were established as separate legal entities in December 1997. Under the gas supply agreement between GASCOR and Esso and BHP, GASCOR is responsible for the purchase of gas and its sale to customers, with retail companies assisting GASCOR in this process as agents and earning commission for services provided.

7.41 Under these new arrangements, each gas retailer services a geographically defined franchise customer base, with full contestability to occur by September 2001. A brief profile of each of the retail company's service responsibilities is as follows:

- *Kinetik Energy* - services approximately 398 000 customers, covering a distribution area including Melbourne's north-eastern and outer western suburbs, and western and north-central Victoria. This business is attached to the gas distributor known as Westar;
- *Energy 21* - services approximately 517 000 customers, covering the eastern Melbourne areas, the Mornington Peninsula, and northern and eastern Victoria. This business is attached to the gas distributor known as Stratus; and
- *Ikon Energy* - services approximately 504 000 customers, covering western, central and south-eastern Melbourne. This business is attached to the gas distributor known as Multinet.

7.42 My previous Reports to the Parliament have also commented on other key elements of the reform process, including the establishment of a gas services company to provide centralised services to the new businesses, the separation of the ownership and management of the transmission assets, resulting in the establishment of Transmission Pipeline Australia Pty Ltd (TPA), and the creation of the Victorian Energy Networks Corporation (VENCorp) to assume responsibility for system and market operating functions within the wholesale gas market.

Deferral of the privatisation program

7.43 To establish the operating environment under which a gas privatisation program could proceed, the Department of the Treasury and Finance, on behalf of the gas businesses, in November 1997 submitted for the approval of the Office of the Regulator-General (ORG) and the Australian Competition and Consumer Commission (ACCC), the proposed Access Arrangements which were to be established for the gas industry, including the terms and conditions under which gas transmission and distribution services would be provided to users of the system, and the basis on which future prices would be determined by the respective regulators. The ORG has responsibility for the regulation of the gas distribution businesses, while the ACCC has responsibility for the regulation of Transmission Pipeline Australia Pty Ltd. The Department also submitted the Gas Market and System Operating Rules which were developed by the Government, to the ACCC for authorisation under the Trade Practices Act.

7.44 Subsequently, in April 1998, the Government approved, in-principle, the sale of the 3 “stapled” gas distribution and retail businesses, subject to their sale being demonstrated as being of public benefit, the satisfactory preparation of the businesses for sale and the timing of the sale to confer with appropriate market conditions. On this basis, the privatisation process was commenced with the issue to interested parties in May 1998 of an Information Memorandum for the Kinetik Energy/Westar “stapled” business, which resulted in the receipt by the Government of a number of indicative bids for this gas business.

7.45 However, in May 1998, the ACCC and ORG released draft decisions on the proposed access arrangements. While the majority of the draft decisions were acceptable to the Government, the main area of concern was draft decisions which required a reduction in the rates of return which are to be applied to set the regulated revenues of the gas distribution and transmission businesses. The regulators believed that the reduced rates of return more accurately reflected the appropriate cost of funds for these businesses. Comments were invited by the regulators from interested parties on the draft decisions.

7.46 In June 1998, on behalf of all applicants, the Department of Treasury and Finance lodged further submissions with the ACCC and the ORG, including submissions from a number of expert advisers, which questioned the reduction in the rates of return.

7.47 In July 1998, the Treasurer publicly announced the deferral of further steps to introduce competition into the Victorian gas industry and the privatisation of the gas entities, pending the resolution of the above matters and other associated issues with the regulators.

7.48 A final decision on the Victorian gas distribution access arrangements was issued by the regulators in October 1998, which requires a rate of return of 7.75 per cent to be applied in setting the regulated revenues of the gas businesses, compared with a rate of 10.16 per cent proposed by the Government. At the date of preparation of this Report, the impact of this decision was under consideration by the Government.

Transfer of loan portfolio by Rural Finance Corporation

7.49 The Rural Finance Corporation is a public body which aims to promote Victorian rural industries and rural economic growth by providing loan finance to the State's rural sector.

7.50 Over a number of years, the Corporation had developed a significant exposure to the dairy industry, with outstanding loans to this industry in January 1994 comprising 48 per cent of its total loan debtors portfolio, which compared with a prudentially established exposure limit of 50 per cent. Given the proximity of the Corporation's exposure to the dairy industry to the prudential limit, in February 1995, the Corporation advised the Treasurer that it would be necessary to cease lending to the Victorian dairy sector by mid-March 1995 unless approval was provided to increase the exposure limit for this industry.

7.51 Subsequently, the Treasurer agreed to increase the exposure limit for the dairy industry portfolio to 52 per cent for a period of one year to April 1996, with a reversion to the previous limit thereafter. This temporary increase was intended to allow the Corporation time to plan a restructure of its loans portfolio and lending to the dairy sector without having to cease lending to the sector. Subsequently, the Treasurer advised the Corporation that its exposure to the industry should be reduced to 40 per cent of its loan debtors portfolio within the following 12 month period.

7.52 In December 1995, the Corporation canvassed a number of options with the Treasurer which could be pursued by it to assist in meeting the reduced exposure levels. In the main, these options included the sale of a portion of dairy loans to third parties, which would involve the transfer of the ownership and administration of the ongoing mortgages, or the negotiation of securitisation arrangements whereby the credit risk associated with the loans would be transferred to a third party, with the control and administration of loans remaining the responsibility of the Corporation.

7.53 The latter option was preferred by the Corporation as it was considered that it would minimise adverse reaction from farmers and industry groups. However, following consideration of the alternatives, the Department of Treasury and Finance advised that its preferred option would be to implement a phased reduction over a 3 year period in lending to the dairy sector, together with risk transfer arrangements covering the exposure to this sector which was in excess of the 40 per cent limit.

7.54 Following the consideration of various proposals received by the Corporation from a number of financiers for reducing its exposure to the dairy sector, in May 1996, the Corporation was approached by a subsidiary of an Australian regional-based bank (the company) regarding the possibility of transferring the credit risk for a parcel of dairy loans to the company. Subsequently, **the Treasurer provided an in-principle approval for the Corporation to negotiate with the company for the sale of a beneficial interest in a parcel of loans, on the basis that the Corporation would remain responsible for the management and administration of these loans.**

7.55 During subsequent deliberations between the Department of Treasury and Finance and the Corporation regarding the structure of the proposed arrangements for the securitisation of dairy loans, the Department was advised by the Treasury Corporation of Victoria that:

- The proposed arrangements primarily represented a credit risk transfer, with the Corporation retaining the interest rate risk of, and management responsibilities for, the transferred loans;
- The credit risk transfer created an interest rate mis-match for the Corporation, given that the Corporation would receive fixed monthly principal and interest payments from the borrowers (the dairy farmers) but would make payments to the company based on a variable interest rate. However, it was acknowledged that the Corporation could enter into an interest rate swap agreement with the Treasury Corporation of Victoria to manage this interest rate exposure; and
- Based on data provided by the Corporation, the loans proposed to be transferred were mature loans which were less likely to default, with the aggregate balance outstanding being 75 per cent of the value of loan security held, which would act as a buffer for the company and reduce the probability of a non-performing loan becoming unrecoverable.

7.56 In March 1997, the Treasurer provided an approval for the Corporation to enter into a loan portfolio sale and management agreement with the company, relating to dairy loans with an estimated face value of \$45 million. In providing this approval, the Treasurer referred to advice given by the Department of Treasury and Finance and the Corporation's prudential advisers which indicated that the arrangement effectively transferred the credit risk associated with the loan portfolio from the Corporation to the company. However, **the Treasurer indicated that the pricing of the arrangement may not have been as competitive as may be possible, given the interest margin that was payable to the company under the arrangements.** Nevertheless, the following factors were taken into account in support of the transaction:

- the Corporation's preference not to conduct a tender process for the transaction due to its desire to protect its existing client relationships with the affected borrowers;
- the sale was expected to result in a decrease of the Corporation's exposure to the dairy sector to approximately 37 per cent of its total loan portfolio; and
- an interest rate swap agreement would be entered into with the Treasury Corporation of Victoria to manage the risk associated with the mis-match of interest rates in the proposed transaction.

Terms of agreement

7.57 In July 1997, the Corporation entered into a **Loan Portfolio Sale and Management Agreement with the bank for the sale of the rights to a defined loan portfolio with an aggregate value of \$43.5 million. The sale was based on a price equivalent to the sum of principal loan amounts and interest outstanding at the date of transfer.**

7.58 The agreement provides that, while the Corporation will continue to collect interest payments from borrowers (dairy farmers) based on fixed interest rates, it will be required to make interest payments to the purchaser which are determined on the basis of variable market interest rates plus a specified margin. Furthermore, the Corporation will remain responsible for the management and administration of the loans, including the recovery of all amounts due in connection with the loans on behalf of the purchaser, for which the purchaser is required to pay a management service fee to the Corporation.

7.59 In accordance with the terms of the agreement, the purchaser is entitled to request the Corporation to accelerate the payment of sums due to the Corporation from borrowers if the purchaser is able to demonstrate that the Corporation is applying its prudential credit management practices and policies to the securitised portfolio in a manner which is materially different to that in which it manages its own loans. In particular, if the purchaser's request is proven valid, then the Corporation must recover, on the purchaser's behalf, all moneys recoverable in respect of that loan within a period of 2 years or buy-back the benefits in respect of the loan at the expiration of that 2 year period. In the event of a loan buy-back, the Corporation must pay the purchaser the market value of the loan (however, if the collection of the loan is doubtful, a lesser amount may be paid) and the Corporation will offer to transfer to the purchaser the benefits in respect of an additional loan with a principal sum equal to the market value of the loan brought back.

7.60 Other key terms of the agreement include:

- If a borrower is in default for a period greater than 180 days, the Corporation may, at its discretion, purchase the benefits in respect of such a loan by paying the purchaser 75 per cent of the principal sum outstanding at the date of the buy-back. However, within a period of 2 years after such an event, the Corporation will be required to pass-on remaining outstanding loan balances actually realised from the borrower's assets;
- The Corporation may at its discretion suspend the payment of interest by a borrower on a particular loan which has been in default for a period exceeding 180 days, until the borrower is no longer in default. When such a borrower ceases to be in default, then the Corporation will pay the purchaser a sum equal to the interest amount it would have received on those balances as accrued over time;

- Either party may terminate the agreement if the other party commits a material default and fails to remedy such a breach, where requested, within 7 days. In addition, each party may terminate the agreement in the following circumstances:
 - The purchaser may terminate the agreement if the Corporation ceases to be a statutory authority or is prevented or hindered by government action from the provision of financial services to rural industries; and
 - The Corporation may terminate the arrangements for a number of reasons, including the company becoming insolvent, sells its assets to a third party or there is a significant change in the majority ownership of the company. Where the Corporation terminates the agreement, it is required to buy-back the loans from the purchaser for a price equal to the total market value of the loans; and
- Either party may request a review of the variable interest rate payable by the Corporation on the principal balances of the loans by notice to the other party requesting the negotiation of a new variable rate, at the expiration of 2 years and every second anniversary thereon. If the parties are unable to agree on the prevailing new rate, an adjudicator will be appointed to determine an appropriate rate with regard to the market conditions at the time and the essence of this agreement, which is to transfer the credit risk in respect of the loan portfolio to the purchaser.

Assessment of loan securitisation

7.61 The loan transfer arrangements were not subject to a contestable process, although the Corporation did consider various proposals from a number of financiers. While legal title to the subject loan portfolio has remained with the Rural Finance Corporation, the risk associated with its realisation (commonly referred to as credit risk) has been transferred to the purchaser. In return for transferring this risk, the Corporation has agreed to pay the purchaser a margin to take account of this risk.

7.62 Furthermore, the Corporation has retained the risks associated with any mis-match in interest costs between the rates received from dairy farmers and those payable to the purchaser (commonly referred to as “interest rate risk”). However, the Corporation has entered into an interest rate swap contract which minimises the extent of the risk associated with the mis-match in interest costs.

7.63 As at 30 June 1998, the financial statements of the Corporation disclosed that the balance of the loan portfolio under this arrangement had reduced from \$43.5 million to \$35 million. Furthermore, the Corporation’s “on-balance sheet” loans with the dairy industry represented 38 per cent of its total loan debtors.

□ **RESPONSE** provided by the Secretary, Department of Treasury and Finance

The Treasurer gave the RFC, in principle, approval for the transaction reviewed by the Auditor-General, but indicated that the pricing of the transaction may not have been as competitive as possible. Because of this concern, the Treasurer also advised RFC that he was approving the transaction subject to a limit of \$45 million, although RFC had sought approval for a transaction of up to \$70 million, and that a further sale of RFC dairy assets would be subject to the achievement of a finer margin.

The Department was aware that as no comparable transaction had occurred, the issue of pricing is difficult to be definitive about. For example, the transaction did not involve a transfer of title to the private bank and represented a concentrated industry and geographic risk. Given the unique nature of the transaction and the fact that it was not subject to competitive tender for the reasons outlined above, the Department was sensitive to the need for the pricing of the transaction to be reasonable. Analysis undertaken by the Department concluded that the pricing was reasonable.

As noted in the Auditor-General's report, even though the transaction was not conducted through a tender process, RFC sought and received advice from commercial advisers other than the successful party, for reducing its exposure to the dairy sector. This advice also provided indicative pricing for a range of possible transactions which was subsequently used by RFC in negotiating the pricing of the transaction. After careful consideration, it was judged that subjecting the credit risk transfer to tender would jeopardise the confidences of RFC's clients and threaten relationships that RFC had built up with its dairy clients over a long period of time.

PART 8

Liabilities and Commitments



AGGREGATE LIABILITIES OF THE STATE

8.1 In recent years, a major goal of the Government's budgetary policies has been to enhance financial management within the State. The achievement of this goal has involved the pursuit of a number of long-term targets, including the strategic target of reducing State debt to a level consistent with the restoration of the State's AAA credit rating.

8.2 My previous Reports to the Parliament have tracked the Government's progress towards achieving its debt reduction target. In particular, the Reports have provided detailed comment on the significant improvements in liability management, combined with the implementation of a substantial privatisation program and various other initiatives, that have been implemented in recent years which have been pivotal to the substantial reduction in the level of State liabilities and the improvement in the budgetary position of the State.

8.3 In this Part of the Report, I have presented an analysis of the State's financial obligations and commitments, including an assessment of the impact of the year's developments on the State's financial position.

8.4 **The Government's Annual Financial Statement discloses liabilities of the State totalling \$49.1 billion at 30 June 1998**, mainly comprising borrowings, payables, unfunded superannuation and other employee related entitlements. This position represents **a reduction of \$317 million in the level of liabilities when compared with the previous year, which is mainly due to a reduction of State debt and unfunded superannuation liabilities which, to some extent, has been offset by an increase in the level of outstanding claims liabilities, mainly relating to the State's transport accident and workers' compensation schemes.**

8.5 Table 8A illustrates the composition of the State's liabilities at 30 June 1998.

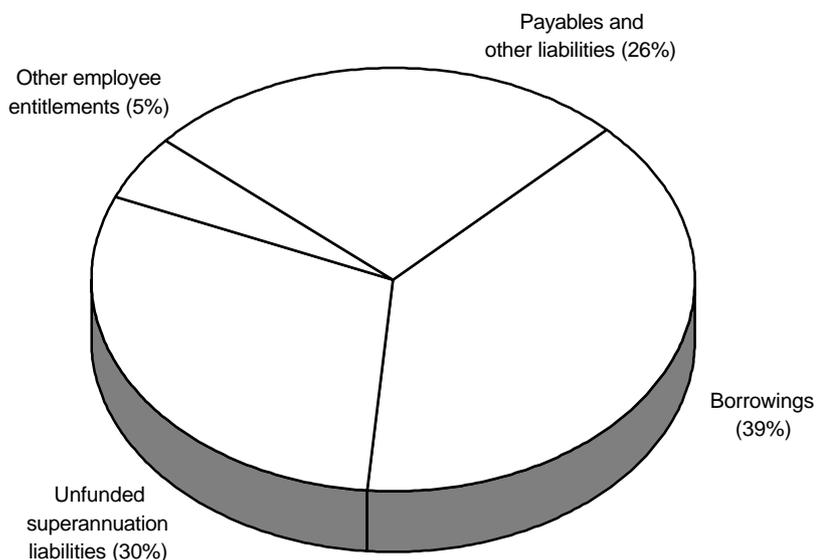
TABLE 8A
COMPOSITION OF STATE LIABILITIES
((\$billion))

<i>Type</i>	<i>General government</i>	<i>Public trading enterprises</i>	<i>Public financial institutions</i>	Total June 1998	<i>Total June 1997</i>
Borrowings	11.2	4.9	21.0	19.0	19.8
Unfunded superannuation liabilities	14.8	0.1	-	14.9	15.2
Other employee entitlements	2.1	0.4	-	2.5	2.4
Payables and other liabilities	2.1	3.4	8.5	12.7	12.1
Total State liabilities	30.2	8.8	29.5	(a) 49.1	(a) 49.5

(a) The total balances are presented net of inter-entity eliminations, ie. after deducting amounts payable to other public sector agencies.

8.6 As the table indicates, **as at 30 June 1998, borrowings and unfunded superannuation liabilities were the largest components of the State's liabilities, with these items collectively accounting for 69 per cent of total liabilities.** Chart 8B further illustrates this position.

CHART 8B
COMPOSITION OF STATE LIABILITIES,
AT 30 JUNE 1998
(per cent)



8.7 In addition to the liabilities disclosed above, **the State also has quantifiable contingent liabilities of around \$1.4 billion** (1996-97, \$1.3 billion). These liabilities, which are contingent in nature, represent potential commitments the occurrence of which is dependent on future events or outcomes.

8.8 Furthermore, the State has entered into various arrangements giving rise to operating lease and capital commitments, which are not included as part of State liabilities as the relevant goods or services had not been received or consumed at balance date. **The aggregate value of the State's operating lease and capital commitments as at 30 June 1998 were \$2.9 billion (30 June 1997, \$2.6 billion). However, these do not include all the State's commitments under outsourcing contracts entered into for the provision of services to the public sector, such as health services.**

BORROWINGS

8.9 Borrowings represent the largest component of State liabilities and predominantly comprise public sector debt raised domestically and overseas through the Treasury Corporation of Victoria, loans and advances from the Commonwealth Government, and finance leases entered into by various public sector bodies. As indicated previously, the reduction of this component of State liabilities has been a key element of the Government's overall financial strategies in recent years.

8.10 The accumulated borrowings of the State at 30 June 1998 stood at \$19 billion, compared with \$19.8 billion in the previous year. Table 8C illustrates the major sectors contributing to this position.

TABLE 8C
STATE DEBT, 1997-98
((\$billion))

Sector	1997-98	1996-97
General government	11.2	12.8
Public trading enterprises	(a) 4.9	7.3
Public financial institutions	21.0	21.2
Inter-sector eliminations	(18.1)	(21.5)
Total State debt	19.0	19.8

(a) The reduction in the public trading enterprises debt portfolio mainly reflects the effect of electricity business privatisations, and the assumption of water sector and housing debt by the budget sector debt portfolio during the 1997-98 financial year. Further comments on these debt assumptions are included in this part of the Report.

8.11 The reduction of \$796 million in the level of State borrowings in the year mainly reflects the impact of the Government's electricity industry privatisation program under which 2 electricity companies were sold and the application of Consolidated Fund receipts towards debt retirement.

8.12 As highlighted earlier in this Report, the Government's Annual Financial Statement for the current financial year includes a number of additional disclosures compared to the 1996-97 financial year in relation to financial assets and liabilities, including borrowings. These additional disclosures have been made under the requirements of new Australian Accounting Standard AAS33 *Presentation and Disclosure of Financial Instruments*, which aims to provide additional information to users of general purpose financial reports, to enhance their understanding of the significance of financial instruments to the reported financial position and performance, including the timing and certainty of future cashflows associated with these instruments.

8.13 In particular, the notes to the Government's Annual Financial Statement outline key details and risks associated with borrowings of the State and related derivative instruments, risk management policies and arrangements, and the weighted average interest rates attributable to the State's financial liabilities. The analysis provided in this Report is intended to supplement the information provided in the Government's Annual Financial Statement.

Borrowing composition and maturity profile

8.14 The mix and maturity structure of the borrowings portfolio are significant determinants of the State's financing requirements in any one year, the level of financing costs and the State's exposure to adverse movements in interest rates. Accordingly, the effective management of the portfolio mix and maturity structure is critical to the achievement of the debt management objectives established at an individual public agency level in relation to the specific portfolios managed such agencies and, at a Statewide strategic level, by the Government.

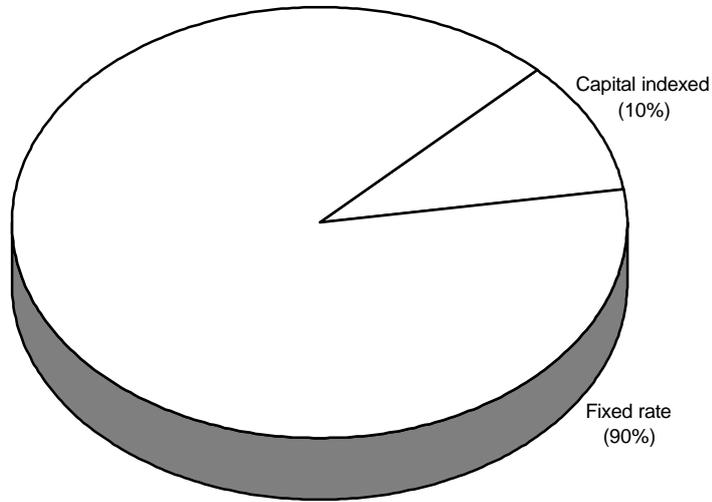
8.15 While individual public authorities establish specific debt management objectives within predetermined risk parameters relating to the borrowing portfolios they manage, the overall Government objectives relating to the management of the budget sector portfolio are as follows:

- achievement of relative certainty of interest cost over the budgeting period, while minimising the net borrowing costs;
- minimisation of refinancing risk; and
- identification and management of the financial and operational risks of budget sector treasury operations in a conservative manner.

8.16 To minimise interest costs and exposures to specific financial markets, the State borrows domestically and overseas, and in various forms, commonly referred to as fixed rate, floating rate and capital indexed borrowings. These borrowings are complemented, as deemed appropriate, by the use of various debt management instruments. Debt maturities are also spread over future years to minimise the State's exposure to adverse interest rates that may prevail in any particular year in which debt is due for refinancing or retirement.

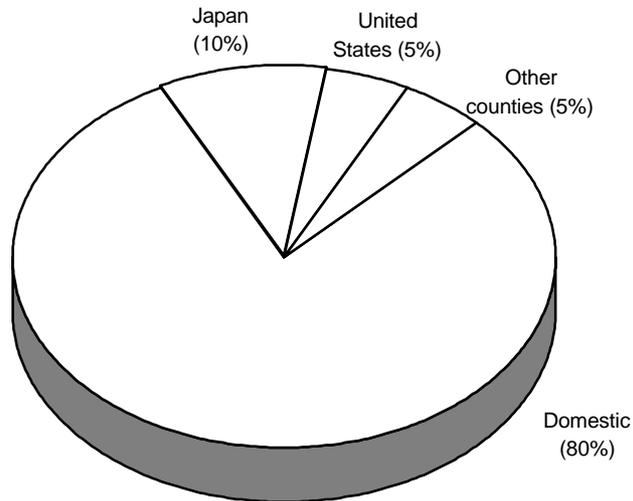
8.17 Charts 8D and 8E show the composition of State debt at 30 June 1998 in terms of the types of borrowing, and the markets in which they are raised.

CHART 8D
COMPOSITION OF STATE DEBT,
BY INSTRUMENT TYPE, AT 30 JUNE 1998 (a)
 (per cent)



(a) Based on market value.

CHART 8E
COMPOSITION OF STATE DEBT,
BY MARKET IN WHICH RAISED,
AT 30 JUNE 1998
 (per cent)

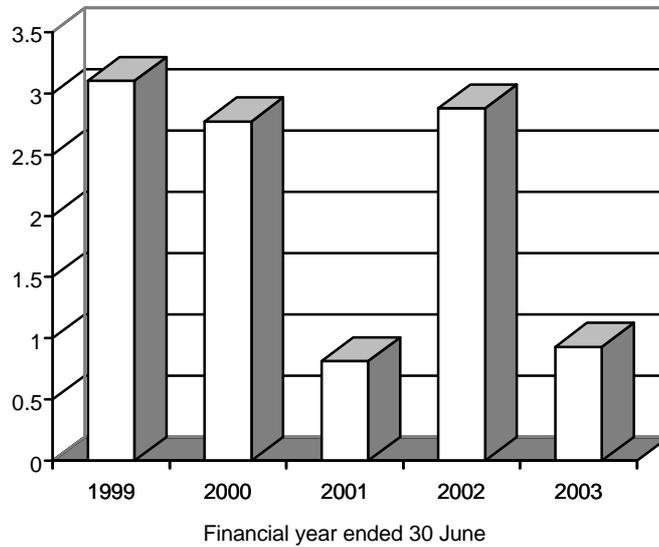


8.18 As illustrated above, the State's debt portfolio predominantly comprises fixed rate instruments, which account for 90 per cent of the debt portfolio at 30 June 1998. As a result of holding this type of instrument, the State's exposure to increases in interest rates has been minimised. While borrowings have been raised in both domestic and foreign markets, the State's exposure to foreign currency fluctuations has been minimised through the establishment of appropriate hedging arrangements.

State debt maturity profile

8.19 An analysis of the State debt portfolio at 30 June 1998 indicates that around 53 per cent or \$10.5 billion (market value) of the portfolio will mature and require repayment or refinancing in the next 5 years. **During the 1998-99 financial year, \$3.1 billion will require repayment or refinancing.** Chart 8F illustrates the maturity for the next 5 years.

CHART 8F
STATE DEBT MATURITY PROFILE FOR THE NEXT 5 YEARS,
AT 30 JUNE 1998 (a)
 (\$billion)



(a) Borrowings are shown in the chart at their market value.

8.20 My October 1997 Report to the Parliament on the Government's Annual Financial Statement outlined the restructuring of the budget sector debt portfolio by the Government during the 1996-97 financial year, which aimed to enhance the management of the conflicting risk management objectives associated with the early retirement of debt and the ongoing financing requirements of the budget. The restructuring involved the separation of the overall budget sector debt portfolio into 2 distinct portfolios, namely:

- *Core Borrowing Portfolio*, comprising that part of the portfolio intended to be held to maturity and used to meet the day-to-day requirements of the Public Account. The objective of this portfolio is to achieve certainty of borrowing costs, with an even spread of debt maturities to minimise the interest rate and re-financing risk; and
- *Debt Retirement Portfolio*, comprising that part of the portfolio intended to be retired prior to maturity through the application of privatisation proceeds. The objective of this portfolio is to ensure that interest rate movements or other market forces do not increase the buy-back price of the debt.

8.21 Consistent with the objectives of the above restructuring, in its *1998-99 Budget Papers*, the Government has stated that future budget sector debt management activities will continue to focus on increasing the flexibility and lengthening the maturity of the funding facilities provided by the Treasury Corporation of Victoria.

Water reform program

8.22 As part of the Government's reform of Victorian government business enterprises, the April 1994 *Autumn Economic Statement* outlined a major reform program for the Victorian water sector. A major aspect of the Government's reform program involved the disaggregation of the metropolitan water authorities and the amalgamation of the rural water authorities, which led to the following outcomes:

Metropolitan

- Establishment of 3 geographically based State-owned companies, namely, City West Water Ltd, Yarra Valley Water Ltd and South East Water Ltd, with responsibility for the retail supply of water, and for sewerage services. These entities were created from the former regional divisions of the Melbourne Water Corporation;
- Establishment of the Melbourne Water Corporation to act as the wholesale provider of water and sewerage services to the above-mentioned companies and to retain responsibility for drainage services; and
- Melbourne Parks and Waterways (now called Parks Victoria) to maintain responsibility for the maintenance and development of Melbourne's parks, waterways and bayside areas.

Non-metropolitan

- Reduction from 83 to 15 in the number of non-metropolitan urban water authorities which service Victoria's provincial towns. In addition, the former Rural Water Corporation was disaggregated into 4 independent water authorities, namely Goulburn-Murray Rural Water Authority, Wimmera-Mallee Rural Water Authority, Sunraysia Rural Water Authority, and Gippsland and Southern Rural Water Authority.

8.23 As part of the reform process, in October 1997, the Government announced a \$1.3 billion Statewide package involving the assumption by the Government of \$850 million of metropolitan water industry debt to enable the delivery by water authorities of an average 18 per cent reduction in water bills to most domestic consumers, and a \$450 million funding allocation for capital projects outside the metropolitan area. In particular, under this package:

- The Department of Treasury and Finance would enter into agreements with each of the metropolitan water authorities to facilitate the assumption of a portion of their debt by the Government. In return, the Government was to be provided with equity in these organisations. The impact of this arrangement would be a net increase of \$850 million in the level of budget sector debt in January 1998, together with an estimated interest cost of \$52 million per annum (\$26 million for 1997-98), with the Department of Treasury and Finance absorbing the book losses associated with the debt restructure;
- Non-metropolitan water authorities would receive capital contributions totalling \$410 million, funded by cash surpluses within the Consolidated Fund; and
- A further \$40 million in financial assistance would be provided to the rural water authorities for application towards the funding of capital works.

8.24 Consistent with the reform program and the *Water Acts (Further Amendment) Act 1997*, in December 1997 the Treasurer approved the appropriation of \$410 million from the Consolidated Fund to the non-metropolitan water authorities for the purpose of "accelerating the achievement of the Government's water quality and environmental objectives, and to facilitate price reductions". Table 8G identifies the amount of financial assistance paid to each water authority.

TABLE 8G
FINANCIAL ASSISTANCE TO NON-METROPOLITAN
WATER AUTHORITIES
(\$million)

<i>Non-metropolitan water authority</i>	<i>Amount of financial assistance</i>
Barwon	86
Central Gippsland	17
Central Highlands	50
Coliban	61
East Gippsland	17
Glenelg	8
Goulburn Valley	39
Grampians	26
Lower Murray	5
North East	25
Portland Coast	4
South Gippsland	16
South West	13
Western	28
Westernport	15
Total	410

8.25 At the same time, the Treasurer and the Treasury Corporation of Victoria (TCV) entered into a debt restructure agreement with the Melbourne Water Corporation, and debt and equity restructure deeds with City West Water Ltd, Yarra Valley Water Ltd and South East Water Ltd, to effect the delivery of the Government's \$850 million financial assistance package to these entities by way of debt assumption.

8.26 Consistent with the terms of these agreements, in January 1998, the State accepted and assumed all of the borrowings of the metropolitan water bodies, which had a market value of \$3.2 billion (book value, \$2.8 billion) and then immediately transferred borrowings amounting to \$2.3 billion back to these entities, comprising:

- allocation of debt with a market value of \$1 billion to the 3 metropolitan water companies; and
- the provision of debt with a market value \$1.3 billion to the Melbourne Water Corporation.

8.27 Table 8H provides a summary of the debt assumed by the State and transferred back to the individual entities.

TABLE 8H
METROPOLITAN WATER AUTHORITY DEBT TRANSFERS
(\$million)

<i>Water body</i>	<i>Debt assumed by Government</i>	<i>Debt transferred to water bodies</i>	<i>Increase in budget sector debt</i>
Melbourne Water Corporation	1 830	1 280	550
City West Water Ltd	237	197	40
South East Water Ltd	509	349	160
Yarra Valley Water Ltd	602	502	100
Total(a)	3 178	2 328	850

(a) Debt recorded at market value.

8.28 In consideration for the debt assumed by the Government, the State Trustees Limited, on behalf of the State, was issued with shares in the 3 metropolitan water companies with a value of \$178 million and the Government increased its level of contributed capital in the Melbourne Water Corporation by \$337 million. The difference of \$334 million between the value of debt assumed and equity acquired by the budget sector by way of shares and contributed capital was reflected as an abnormal loss by the Department of Treasury and Finance.

8.29 While the arrangements with the metropolitan water authorities did not result in a change in the overall level of State debt, it did cause an increase in the value of the Government's Budget Sector Debt Portfolio by \$850 million, which was offset by a reduction in the Public Trading Enterprise Debt Portfolio by the same amount.

Debt allocation to gas businesses

8.30 My October 1997 *Report on the Government's Annual Financial Statement, 1996-97*, outlined the key reforms that were initiated by the Government in March 1997 involving the restructure of the Victorian gas industry.

8.31 In particular, as from July 1997, the operations previously undertaken by GASCOR were unbundled to create 3 new 'stapled' gas businesses, each comprising a gas distributor and a gas retailer. The distribution companies own and maintain the existing low pressure distribution network, purchase gas through the wholesale gas market and are responsible for the construction of network extensions, whereas the retailers sell gas directly to consumers as agents of GASCOR. In addition, the Gas Transmission Corporation, which was principally responsible for the transportation of gas through the transmission pipelines, the storage of gas for transport customers and the construction and operation of transmission pipelines and storage facilities, was disaggregated in July 1997 into 2 companies which are controlled by Transmission Pipelines Australia Holdings Pty Ltd.

8.32 Following advice from the Government's gas reform advisers and the Department of Treasury and Finance regarding the financial structure to be established for the new gas entities, in June 1997, the Treasurer agreed to a restructure of the existing debt portfolio held by GASCOR, the transfer of additional debt to GASCOR and the subsequent allocation of the entity's total debt portfolio to the successor gas businesses. This approach was based on the principle that the debt profiles of the new entities should align with their asset profiles. Furthermore, as the debt held by GASCOR at that time was considered insufficient to provide the desired gearing levels required to be held by the new gas businesses, additional debt from the budget sector was allocated to the new businesses.

8.33 Following a Treasurer's Direction to the Administrator of GASCOR, in July 1997, GASCOR's debt portfolio was revalued to its market value of \$909.9 million, resulting in a mark-to-market loss in GASCOR's financial statements as at 30 June 1998 of \$42.8 million. This debt together with an allocation of additional debt of \$346 million from the Budget Sector Debt Portfolio, involving an aggregate debt portfolio of \$1.26 billion, was immediately allocated to GASCOR's successor bodies as follows:

- Multinet (Assets) Pty Ltd - \$460.3 million;
- Westar (Assets) Pty Ltd - \$418.4 million; and
- Stratus Networks (Assets) Pty Ltd - \$376.9 million.

8.34 In relation to the Gas Transmission Corporation, the entity's debt was similarly recognised at its market valuation of \$148 million, resulting in a mark-to-market loss in its financial statements as at 30 June 1998 of \$9 million. The Corporation was also allocated additional debt of \$71 million from the Budget Sector Debt Portfolio in July 1997, thereby increasing its total debt position to \$219 million. This debt was then allocated to Transmission Pipelines Australia (Assets) Pty Ltd, one of the Corporation's successor bodies.

8.35 From a whole-of-government perspective, while the above transactions represented no change in the overall level of State debt, their impact was to reduce the value of the Government's Budget Sector Debt Portfolio by \$417 million through the allocation of debt to the new gas entities which formed part of the Government's Public Trading Enterprises sector.

Centralisation of Housing Debt

8.36 In July 1997, the Department of Treasury and Finance advised the Director of Housing that it was assessing a proposal whereby the debt portfolio held by the Director of Housing could be centralised and managed as part of the Budget Sector Debt Portfolio under the State's centralised treasury management policy. It was considered by the Department that such action would enable the Director of Housing to concentrate wholly on its core business, that is, to maximise the availability of appropriate housing options for its clients and the management of its mortgage and rental assets in the most efficient manner. In addition, the Department considered that such action would remove the dual management of the State's debt by the Director of Housing and the Department of Treasury and Finance.

8.37 The debt subject to the proposed centralisation arrangements comprised borrowings associated with the Housing Rental Portfolio (\$1.1 billion of Commonwealth debt) and the Home Finance Portfolio (\$416 million of Commonwealth debt and \$457 million of indexed debt).

8.38 In June 1998, a Deed of Assumption was entered into between the Director of Housing, the Department of Treasury and Finance and the Treasury Corporation of Victoria, with an effective date of 1 July 1997. The key terms of the deed were as follows:

- The Department of Treasury and Finance to assume the liabilities and obligations relating to payments previously made by the Director of Housing to the Treasury Corporation of Victoria in relation to the indexed debt, with this assumption to be treated by the Director of Housing as an interest free advance of \$457 million made by the Treasurer;
- The Department of Treasury and Finance to assume the liabilities and obligations associated with the repayment of debt under the Commonwealth State Housing Agreement and the Emerald Hill Agreement. Under the arrangements, the assumption of the Commonwealth debt which had a book value of \$1.1 billion was required to be treated by the Director of Housing as a capital grant made by the Treasurer, and the amount relating to the Housing Finance Portfolio was required to be regarded as an interest free advance by the Treasurer of \$416 million;
- The Director of Housing to make annual payments to the Treasurer, as determined by the Treasurer after consultation with the Director and Minister for Housing, with a value not exceeding amounts specified in the deed, representing the State's obligations to the Commonwealth associated with the parcel of the debt assumed by the Treasurer relating to the Commonwealth Agreements. These annual payments are to continue to the year 2042; and
- The Director of Housing to repay to the Treasurer the interest free advances totalling \$873 million from surpluses arising over future years from mortgage repayments within the Home Finance Portfolio.

8.39 During the 1997-98 financial year, an amount of \$299 million was paid by the Director of Housing into the Consolidated Fund in accordance with the above arrangements, representing a repayment of a portion of the interest free advances provided by the Treasurer. A further amount of \$49 million was paid by the Director of Housing directly to the Treasury Corporation of Victoria prior to the finalisation of the arrangements, leaving an outstanding balance of \$525 million of interest free advances owing to the Department of Treasury and Finance as at 30 June 1998.

8.40 Furthermore, in June 1998, the Consolidated Fund received an amount of \$67.3 million, representing the first annual payment by the Director of Housing under the terms of the debt assumption deed.

8.41 While this debt assumption has facilitated the consolidation of the Housing debt portfolio with the budget sector debt portfolio, it has resulted in reduced transparency associated with the net costs of providing housing rental and finance assistance.

□ **RESPONSE** provided by the Secretary, Department of Treasury and Finance

As the debt assumed by DTF represents only a small portion of the total assets managed by the Director of Housing, the interest costs associated with the assumed debt did not provide an accurate assessment of the net costs of providing housing rental and finance assistance. Further, the intention of the centralisation of the debt from the Director of Housing to the Department of Treasury and Finance was to remove management duplication and allow the Office of Housing to concentrate on its core business, asset management. The capital asset charge which has been recently introduced provides a better basis for assessing the costs of the services provided by the Office of Housing.

The centralisation of housing debt is also in line with government moves to full output reporting for all major services. One element of the move to output reporting is to include a capital asset charge as part of operating costs to reflect the cost of debt and government funds incorporated in assets being used to produce government services. The inclusion of such a charge as part of output reporting for housing assistance would introduce double counting if its costs continued to include interest costs for Office of Housing debts.

Because the Office of Housing is a public trading enterprise, there is no current requirement for it to be included in the operating statement of the Department of Human Services even though it is operationally part of that Department. The intention is that special reporting arrangements be introduced so that it is treated as if it were part of the budget sector allowing it to be fully incorporated in the Budget Papers. The move to centralisation of all debts of the Office of Housing is, therefore, a prerequisite to introduction of such reporting arrangements.

Motor vehicle sale and lease-back arrangements

8.42 My October 1997 Report to the Parliament provided detailed comment on the complex financial arrangements that were established between the Government and the Commonwealth Bank of Australia (the CBA) in July 1997 in relation to the sale and leaseback of the budget sector vehicle fleet. The arrangements are expected by the Government to generate substantial savings through the improved management of the motor vehicle fleet and reduced interest costs resulting from the application of the proceeds received by the Consolidated Fund towards debt retirement.

8.43 The Master Lease Agreement is the key document setting-out the terms and conditions relating to the sale and lease-back of the vehicle fleet. The agreement is operative in perpetuity, however the State has the right to give notice to terminate the financing facility, which is capped at \$220 million, either at the end of its third anniversary, the end of its sixth anniversary or at annual intervals after its seventh anniversary. Once the non-renewal option is activated, the CBA is entitled to progressively reduce and cancel the facility limit over a 7 year wind-down period to enable the satisfactory management of the residual value of the vehicle fleet from CBA's perspective. However, the CBA is not able to terminate the financing facility prior to the seventh anniversary, other than in the event of a default by the State.

8.44 Under the agreement, in July 1997, the State sold and leased back around 7 200 vehicles at a value of \$168 million, which was paid into the Consolidated Fund. Subsequent tranches of vehicles to be leased by the State will comprise new vehicles acquired by CBA from suppliers, with the State not having any right or option to purchase the leased vehicles.

8.45 The term of the individual vehicle leases funded under the CBA financing facility will depend on the particular vehicle and usage thereof. Broadly, the rental term will expire when the vehicle has reached 40 000 kilometres or 2 years service from its purchase date or, in respect of special equipment fitted to a vehicle (eg. police lights) a term of 80 000 kilometres or 5 years service. The vehicle lease may be terminated if the State no longer requires the use of the vehicle.

Assessment of sale and lease-back arrangements

8.46 In my October 1997 Report to the Parliament it was concluded that, **in my opinion, the key obligations associated with the financing of the fleet remained with the State and, accordingly, these arrangements in substance constitute a financing transaction which should be included as part of the State's liabilities in the 1997-98 financial year.** The major considerations in support of this view included:

- the facility is effectively non-cancellable for the first 3 years of its term;
- the lease payments over the facility term are intended and designed to ensure the achievement of a required rate of return on the CBA financing, with minimal risk to the CBA; and
- The State is effectively required to absorb the residual value risk where there is an early termination of the transaction.

8.47 It is pleasing to Report that, consistent with the above assessment, the Government's rights and obligations under the arrangements have been recognised in the Government's Annual Financial Statement as part of the assets and liabilities of the State. In particular, liabilities of the State include an amount of \$201 million, representing the lease liabilities under the arrangements, whereas the assets of the State include an amount of \$207 million, representing the value of leased assets.

Accelerated Infrastructure Program

8.48 My previous Reports to the Parliament have commented on the steps initiated by the Department of Treasury and Finance to wind-up the Accelerated Infrastructure Program, mainly due to the significant financial exposures to the State associated with the Program.

8.49 The Program was established in the 1990-91 financial year by the previous Government, in conjunction with a private sector company, to provide accommodation for certain government agencies, principally police stations and law courts. The financing arrangements involved the leasing by the Government of buildings constructed by the company, with the construction costs funded through the issue of capital indexed bonds maturing over a 20 year period. The provision of a government indemnity to bondholders effectively transferred the financing risk associated with the arrangements to the State.

8.50 As an initial step to the wind-up of the financing arrangements, between June 1995 and November 1996 payments totalling \$258 million were made from the Consolidated Fund to finance the acquisition by the State of all bonds issued by the company. **The value of these bonds as at 30 June 1998 (\$258 million) is disclosed as part of the State's non-current assets in the Government's Annual Financial Statement, in addition to the value of the State's lease liabilities and leased assets under the Program.**

8.51 In July 1997, responsibility for the Program was assigned to a team within the Department of Justice, with the aim of improving the Government's current position with respect to its financial and contingent exposures, and maintaining the involvement of the private sector in the Program. The team's activities were overseen by a Steering Committee comprising of representatives from the Departments of Treasury and Finance, Justice and Human Services, and legal and corporate consultants.

8.52 In January 1998, the Steering Committee was advised by a property consultant that the market value of the property portfolio associated with the Program was unlikely to be sufficient to enable the company to meet its future financial obligations. Subsequently, in May 1998, the Department of Justice team received a joint report from its legal and corporate consultants which concluded that there were financial advantages to the Government in pursuing a winding-up of the Program.

8.53 In June 1998, the Treasurer was advised by the Department of Treasury and Finance that the early termination of the Program arrangements and the subsequent sale of the properties provided the highest net present value benefit to the State. Based on this advice, the Treasurer approved a strategy for the wind-up of the Program.

8.54 The Treasurer noted that the **direct net costs associated with the approved option were estimated to be \$86 million**, after taking into account the cost of purchasing the bonds less the value of cash reserves held by the company and the estimated value of the properties. **However, these costs may increase if potential risk exposures are realised and if certain other fees associated with the early termination of the arrangements become payable.**

8.55 As at the date of preparation of this Report, action had commenced by the Department to negotiate a termination strategy for the Program.

Monash Medical Centre financing arrangements

8.56 In 1983, the State entered into a series of complex arrangements with South Eastern Medical Complex Limited (SEMCL), a private company which at that time was controlled by the former State Bank of Victoria, to finance the construction of a new hospital complex in the outer south-eastern region of Melbourne. The construction of the complex was funded from conventional borrowings of around \$120 million, and \$30 million obtained through a unit trust structure. The *Queen Victoria Medical Centre (Guarantees) Act 1982* was passed to enable the Treasurer to guarantee the borrowings undertaken by the private company for the construction of the new hospital complex.

8.57 The arrangements established between the parties provided that the SEMCL would lease a parcel of crown land from the former Queen Victoria Medical Centre, a wholly-owned State entity, for a period of 15 years with a renewal option. In exchange, the company agreed to construct the hospital complex which would be subsequently leased to the Centre. The substance of the leasing arrangement transferred all the risks of ownership and operation of the public hospital to the Centre, and consequently, the State, as the primary stakeholder.

8.58 In December 1986, the Queen Victoria Medical Centre, Prince Henry's Hospital and the Moorabbin Hospital were amalgamated to form the Monash Medical Centre. More recent legislative amendments to the *Health Services Act 1988* have consolidated the Monash Medical Centre to form part of the Southern Health Care Network.

8.59 The Centre which forms part of the Network is the major provider of health care services in the outer south-eastern region of Melbourne and consists of a 747 bed hospital with 7 operating theatres, a modern imaging facility, an emergency ward, an intensive care department, a pathology department and a pharmacy. Furthermore, the Centre is one of the largest teaching hospitals in Victoria.

Recent developments

8.60 In August 1997, the Department of Treasury and Finance assessed the risks associated with the financing and leasing arrangements in place between the Centre and the company, and investigated the option of terminating the arrangements in order to minimise the risks and costs to the State. In particular, the Department identified a number of risks to the State arising from the existing arrangements, which include the Treasurer's guarantees associated with the outstanding borrowings of the company.

8.61 **A departmental analysis undertaken at that time identified that the termination of the financing and leasing arrangements for the Monash Medical Centre would involve a substantial cost to the State** and would include the purchase of the remaining shares in the company by the Treasurer, the repayment of the outstanding debt and the termination of the unit trust arrangements.

8.62 The initial lease relating to the public hospital, between the Monash Medical Centre and the company, was due to expire in June 1998, with the Centre obligated to lease the public hospital component of the Centre for a further 15 year period as long as the company exercised its option to lease the land. In February 1998, based on legal advice, the Southern Health Care Network as the successor in law to the Monash Medical Centre, issued a notice to the company exercising an option to renew the public hospital lease for a further term of 15 years. Annual rental payable by the Network to the company for the lease is around \$21.6 million.

8.63 In May 1998, the Treasurer approved the renewal of the guarantee over the company's outstanding borrowings for a further period of 12 months ending July 1999.

8.64 **The liabilities of the State associated with the Centre's financing arrangements were recognised in the Statement of Financial Position which forms part of the Government's 1997-98 Annual Financial Statement. The Department advised that the termination of the financing arrangements is planned to be finalised by June 1999.**

□ *RESPONSE provided by the Secretary, Department of Treasury and Finance*

The approval to negotiate the early termination of the VAIP and SEMCL structured financing transactions represents a continuation of the Government's policy of reducing the significant contingent liabilities associated with the indemnities and other support mechanisms provided in the past for these types of facilities.

Financial obligations of the SECV

8.65 My previous Reports to the Parliament have tracked the disaggregation of the electricity and gas industries, and the operation of the State Electricity Commission of Victoria (SECV) which has been retained as a so-called *shell* to manage the assets and obligations not allocated to the newly established entities. The role of the SECV Administrator is to effectively manage and, where appropriate, dispose of the assets and resolve the residual obligations of the entity. At the time of preparation of this Report, the key obligations of the SECV included:

- Management of rights and obligations under electricity supply contracts with the wholesale electricity market relating to the Snowy Mountains power entitlement and the electricity arrangements relating to the Portland and Point Henry aluminium smelters;
- Disposal of various properties, including surplus commercial and remediated contaminated vacant land of the former Gas and Fuel Corporation of Victoria;
- Demolition of the former Yallourn Power Station complex, including the removal of hazardous materials including asbestos, and site rehabilitation;
- Resolution of certain other residual issues of the electricity and gas industries, including product and public liability claims (mainly asbestos disease related), and the archival of a significant volume of documents and records for future reference; and

- Resolution of residual issues associated with the Government's port reform program under which, in December 1997, the Portland, Geelong and Melbourne Port Authorities were abolished and all residual assets and obligations were vested in the SECV.

8.66 Based on the SECV's financial statements, after taking account of payments to the Consolidated Fund of around \$200 million during the year and the assumption of the Government's flexible electricity tariff obligations, the entity's equity position as at 30 June 1998 amounted to \$82 million.

Major developments since June 1997

8.67 In my October 1997 *Report on the Annual Financial Statement*, I outlined the major developments and transactions of the SECV during the period July 1996 to June 1997. Further major developments since June 1997 are outlined below:

Asset sales

- The SECV paid \$155 million of the electricity sale proceeds to the Consolidated Fund, relating to the sale of Southern Hydro Ltd, for subsequent application mainly towards budget sector debt retirement;
- As part of the sale arrangements for United Energy Ltd, the SECV provided an indemnity to the purchaser for the deductibility of franchise fees for taxation purposes. In February 1998, the Federal Court upheld a previously issued unfavourable ruling by the Australian Taxation Office in relation to the tax deductibility of these fees. An application to appeal this decision to the High Court was subsequently denied. Consequently, in February 1998 the SECV paid an amount of \$85 million to the purchaser of United Energy Ltd. However, \$20 million of this amount was subsequently repaid to the State, following the Government's introduction of the winter power bonus scheme;
- In August 1998, the SECV sold a building located at 452 Flinders Street, Melbourne, for a gross price of \$119.5 million;
- The SECV received \$7.6 million in December 1997 from the sale of the Victorian electricity metering equipment;
- The Department of Treasury and Finance, on behalf of the Administrator, has undertaken negotiations with Amcor Ltd for the exchange of certain surplus land holdings in the Latrobe Valley. While a Heads of Agreement was signed in April 1997 in relation to this matter, as at the date of preparation of this Report, the formal arrangements associated with the exchange had not been completed;
- The purchaser of the State's remaining interest in the Loy Yang B Power Station lodged certain claims with respect to the completion of the construction of the Loy Yang B Power Station. Subsequent settlement of these claims has mainly involved the release of retention monies to the purchaser for payment to the contractor; and
- The claim period for general warranties and indemnities under the sale agreements for the electricity distribution businesses has expired, with no claims received by the State.

Flexible tariff electricity arrangements

- Under the 1984 flexible tariff electricity supply arrangements relating to the Portland and Point Henry aluminium smelters, up until 30 June 1998 the SECV received subsidies from the Consolidated Fund to offset the lower prices charged to the smelters when aluminium prices fell below a stipulated level. In September 1998, the Treasurer suspended these payments, effective from 30 June 1998. Consequently, the SECV assumed from the Department of Treasury and Finance the estimated net present value of future liabilities under these arrangements of \$1.3 billion and the estimated amounts receivable of \$894 million from a levy mainly on electricity distribution businesses established by the Government to assist in financing these liabilities. This transaction is further discussed later in this Report; and
- Following a review by my Office at the request of the Administrator, in June 1998, I provided a certificate to the Administrator stating that the data and calculations used to determine the tariff prices under the flexible tariff electricity supply arrangements relating to the Portland and Point Henry aluminium smelters, during the 1993-94, 1994-95 and 1995-96 financial years, did not meet the requirements of the agreements, due to certain interpretation issues which were outlined in the certificate. Following discussions with the smelter operators, in May 1998, the SECV received an amount of \$10.7 million from the smelters representing a cost adjustment relating to the period July 1993 and April 1998.

HRL Limited

- In May 1992, the SECV lodged a provisional (Australian) patent request for certain technology and associated unpatented technical information relating to the generation of electricity from brown coal (known as "IDGCC"), which was subsequently licensed to a research and development syndicate. As disclosed in the financial statements of the SECV, the ownership of the patent was subsequently challenged and, in August 1998, a delegate of the Commissioner of Patents determined that the SECV and a third party has a joint entitlement to a patent for the invention. Consequently, the SECV has initiated action in the Federal Court to defend its interest in the technology; and
- On 30 June 1998, the SECV provided a short-term interest bearing advance of a net amount of \$16.7 million to a subsidiary of a bank, with the funds used to terminate a complex series of arrangements associated with the construction of laboratory and research buildings occupied by the HRL Group which are located on land owned by the SECV. The advance was due for repayment in September 1998, however, the Administrator has advised that its term may be extended further due to delays in the resolution of issues associated with third party interests.

Other residual matters

- In May 1997, the SECV terminated an external contract associated with the demolition and clearance of the former Yallourn power station complex due, inter alia, to disputes with the contractor relating to the performance of its obligations. The disputes were settled by mediation in August 1998, with no material financial impact on the SECV. The Administrator appointed another contractor in February 1998 for the completion of the works within 2 years, at a cost to the SECV of \$23.4 million. Detailed comments on these arrangements were included in my May 1998 *Report on Ministerial Portfolios*;
- The SECV has certain residual obligations relating to accident compensation for former employees, contractors and the general public, associated with activities undertaken by the electricity, gas and port entities prior to the commencement of the Government's industry reform program. Since June 1997, the SECV has continued to manage these residual obligations;
- During June and July 1998, the Government entered into agreements with the electricity distribution businesses to implement the Winter Power Bonus Scheme. These agreements also provided for the termination of certain previously established sales tax agreements between the SECV and these businesses, which were entered into as part of the privatisation process, whereby the SECV was required to reimburse the businesses for costs associated with their sales tax obligations. The SECV has recognised a provision of \$47 million as at 30 June 1998 relating to the estimated final sales tax reimbursements. Details of these agreements are provided in Part 4 of this Report; and
- In September 1998, the SECV received \$8 million relating to the cancellation of an agreement with Pacific Power Ltd, which was established in 1957 and was due to expire in 2007, under which the SECV had an entitlement to 50 per cent of the power generated from the Hume Power Station and 50 per cent of its net revenues.

UNFUNDED SUPERANNUATION LIABILITIES

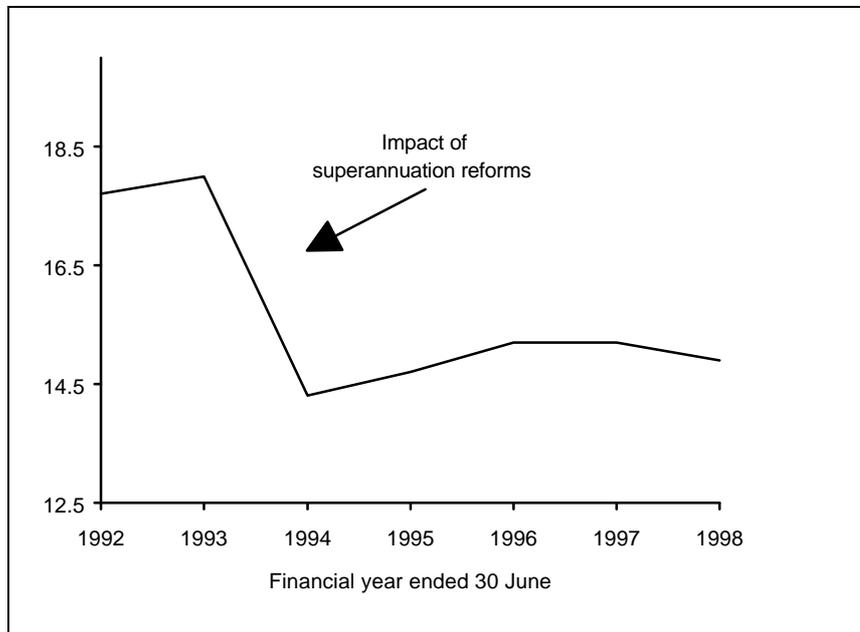
8.68 Unfunded superannuation liabilities represent the second largest component of the State’s liabilities. These financial obligations comprise employer superannuation contributions yet to be paid by the Government and certain public sector bodies to superannuation schemes in respect of services previously provided by employees. The liabilities have arisen as a result of decisions of previous governments to progressively meet the employer share of superannuation benefits after employees retire, rather than as benefits accrue over the working lives of employees.

8.69 The unfunded liabilities of public sector superannuation funds to be met by the Government as at 30 June 1998 totalled \$14.9 billion, compared with \$15.2 billion in the previous year. The unfunded superannuation liabilities relate to the following sectors:

- General Government - \$14.8 billion (30 June 1997, \$15.1 billion); and
- Other - \$97 million (30 June 1997, \$125 million).

8.70 Unfunded superannuation liabilities of \$14.4 billion relate to the State Superannuation Fund. Chart 8I shows the movement in the level of the State's superannuation liabilities since 1992.

CHART 8I
MOVEMENT IN THE STATE'S UNFUNDED
SUPERANNUATION LIABILITIES (a)
 (\$billion)



(a) All figures are presented in nominal values.

8.71 As explained in my previous Reports to the Parliament, the substantial reduction in the overall level of public sector unfunded superannuation liabilities between the 1991-92 and 1993-94 financial years was principally due to the reduction of the budget sector workforce; a low rate of growth in wages and salaries over this period; substantial one-off Consolidated Fund contributions to various superannuation schemes to meet the Government's liability for deferred employer contributions; and the effect of the various superannuation reforms introduced by the Government from the 1993-94 financial year.

8.72 The reason for an overall upward trend in the level of unfunded superannuation liabilities over more recent years, as advised by the Department of Treasury and Finance, was mainly due to Government superannuation contributions failing to keep pace with the increase in the accruing liabilities of the superannuation funds in relation to retired employees.

8.73 During the 1997-98 financial year, the value of the unfunded superannuation liabilities reduced by \$296 million. This reduction was substantially due to additional payments to the superannuation schemes from the Consolidated Fund totalling \$963 million, and a \$216 million decrease in the State's liability to the Commonwealth Government associated with the unfunded liabilities of Universities, which mainly resulted from the establishment of revised cost-sharing arrangements during the year between the State and the Commonwealth Governments. However, these positive factors were offset by the recognition for the first time of pension liabilities totalling \$120 million relating to members of the judiciary and an increase in the value of State Superannuation Fund unfunded liabilities resulting from an actuarial assessment that identified that future superannuation benefit payments are anticipated to be greater than initially projected.

8.74 Certain of the above factors impacting on the level of unfunded liabilities as at 30 June 1998 are further discussed in this part of the Report.

8.75 In the Government's 1998-99 *Budget Papers* it was identified that, on the assumption that the emerging superannuation costs will continue to be funded, the unfunded liabilities associated with the defined benefit schemes are expected to grow on a nominal basis to around \$16.7 billion by 30 June 2002. However, on an unchanged policy basis, the level of the liabilities in real terms (1997 dollars) is expected to fall as from the 1999-2000 financial year.

Additional superannuation payments

8.76 As outlined in my previous Reports to the Parliament, consistent with advice provided in July 1996 and December 1997 by an actuary appointed by the Victorian Superannuation Board, over recent years, the Government has been funding additional contributions to the State Superannuation Fund to assist in reducing the growth in the State's unfunded superannuation liabilities.

8.77 In December 1996, the actuary recommended to the Minister for Finance that an additional payment of \$493 million should be made to the State Superannuation Fund in the 1997-98 financial year. Subsequently, in May 1997 the Minister approved a "top-up" allocation of \$473 million to the Fund for the 1997-98 financial year, comprising \$437 million to be paid in total over the financial year, by way of equal fortnightly instalments and \$36 million in additional funding for approved retrenchment programs.

8.78 In relation to the 1998-99 financial year, the actuary has recommended that the Government should fund additional payments of \$533 million to the State Superannuation Fund. Consistent with this advice, **the Minister for Finance has approved a "top-up" payments of \$533 million to be made to the Board during the 1998-99 financial year.**

Other superannuation payments

8.79 In June 1998, the Treasurer approved additional superannuation payments to be made to the Emergency Services Superannuation Board and the Hospital Superannuation Board during the 1997-98 financial year to reduce the level of their unfunded liabilities. Consistent with this approval, **the Emergency Services Superannuation Board received \$350 million and the Hospital Superannuation Board received \$140 million in additional payments from the Consolidated Fund.**

8.80 The impact of the additional payments to the Emergency Services Superannuation Board was to contribute to a reduction in the level of the unfunded liabilities of the Board to \$365 million as at 30 June 1998. In relation to the Hospital Superannuation Fund, the additional payment resulted in the reduction of the Board's unfunded superannuation liabilities to \$15 million as at 30 June 1998.

State obligations relating to the funding of universities' superannuation

8.81 The unfunded superannuation liabilities of the State as at 30 June 1998, as disclosed in the Government's Annual Financial Statement, include an amount of \$229 million which represents the State's obligation to the Commonwealth Government to contribute towards the funding of the superannuation liabilities of Victorian universities. The aggregate value of Victorian universities' unfunded liabilities as at 30 June 1998 was \$832 million.

8.82 Under the *State Grants (General Purpose) Act 1994*, the State is required to make annual payments to the Commonwealth Government, as determined by the Commonwealth Minister for Education, to assist in the funding by the Commonwealth Government of costs incurred by Victorian universities associated with their unfunded superannuation liabilities for members of Victorian Superannuation Funds. Under the Act, should the State not make the required payments, the Commonwealth Government is empowered to reduce, by an equivalent amount, grants made to the State.

8.83 In recent years, consistent with the established cost-sharing arrangements between the State and Commonwealth Governments, the State's liability to the Commonwealth associated with the universities' unfunded superannuation liabilities was determined on the basis of 50 per cent of the aggregate unfunded liabilities of Victorian universities.

8.84 The Government's *1998-99 Budget Papers* identified that the State and the Commonwealth Governments had reviewed the cost-sharing arrangements, which resulted in the transfer of unfunded superannuation liabilities of approximately \$200 million from the State to the Commonwealth Government during the 1997-98 financial year. Specifically, the review resulted in the State being required to fund only 28 per cent of the total superannuation costs of Victorian universities during the 1997-98 financial year, compared with 50 per cent in the previous years.

8.85 In August 1998, the Commonwealth Department of Employment, Education, Training and Youth Affairs confirmed that, although the State will not be required to fund its share of liabilities until after the Minister's annual determination, the State's underlying obligations to the Commonwealth arise as university employees accrue superannuation benefits.

8.86 The negotiations between the State and the Commonwealth Governments during the 1997-98 financial year resulted in a reduction of the State's share of the universities' unfunded superannuation liabilities from \$445 million as at 30 June 1997 to \$229 million as at 30 June 1998, representing a benefit of around \$190 million to the State, and a corresponding positive impact on the State's operating result.

OTHER EMPLOYEE ENTITLEMENTS

8.87 In addition to the State's obligation to meet unfunded superannuation liabilities in respect of services previously provided by employees, the State has an obligation to meet other employee entitlements, including accrued annual leave and long service leave.

8.88 The State's financial obligations in respect of accrued employee entitlements, excluding unfunded superannuation liabilities, at 30 June 1998 amounted to \$2.5 billion (1996-97, \$2.4 billion). Table 8J outlines the key components of these obligations.

TABLE 8J
OTHER EMPLOYEE ENTITLEMENTS,
AS AT 30 JUNE
((\$billion))

<i>Type</i>	1998	1997
Long service leave	1.7	1.7
Recreation leave	0.5	0.5
Other employee entitlements	0.3	0.2
Total	2.5	2.4

8.89 The consistency in the level of State liabilities relating to employee entitlements between the 1996-97 and 1997-98 financial years broadly reflects the stability in the level of the public sector workforce, following substantial staffing reductions in previous years, and the low movements in the wage and salary rates which impact on the value of these liabilities.

PAYABLES AND OTHER LIABILITIES

8.90 Financial obligations in the nature of payables and other liabilities mainly relate to amounts payable by the State under the flexible electricity tariff arrangements established in relation to the operation of the Portland and Point Henry aluminium smelters, State obligations associated with the development of the St Vincent's Hospital, accrued interest on State debt, outstanding claims for transport accident and workers compensation, amounts owing to creditors, and various other amounts payable and accrued at year-end.

8.91 The State's financial obligations in respect to amounts payable and other liabilities at 30 June 1998 totalled \$12.7 billion, compared with \$12.1 billion in the previous year. Table 8K outlines the key components of these obligations.

TABLE 8K
PAYABLES AND OTHER LIABILITIES,
AS AT 30 JUNE
((\$billion))

<i>Type</i>	<i>Total</i> 1997-98	<i>Total</i> 1996-97
Outstanding claims	7.3	6.6
Flexible electricity tariff obligations	1.3	1.4
Payables and other accrued expenses	4.1	4.1
Total payables and other liabilities (a)	12.7	12.1

(a) The balances are presented net of inter-entity eliminations, i.e. after deducting amounts payable to other public sector agencies.

8.92 The increase of around \$680 million in the year in the level of payables and other liabilities was mainly due to a rise in the level of outstanding claims liabilities relating to the State's transport accident and workers compensation schemes. This increase reflected the results of actuarial re-assessments of outstanding liabilities after taking into account, inter alia, the claims experience of the schemes and movements in the average weekly earnings of claimants.

Flexible electricity tariff arrangements

8.93 My previous Reports to the Parliament have commented on 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 these arrangements, which extend to the year 2016, the Consolidated Fund was responsible for meeting the Government's obligation to make payments to the State Electricity Commission of Victoria (SECV) to subsidise it for lower prices charged for electricity supplied to the smelters when aluminium prices fell below a stipulated level, a situation that has occurred consistently in recent years.

8.94 As at 30 June 1997, the Government's Annual Financial Statement disclosed a liability of \$1.4 billion in relation to the Government's future obligations associated with the above arrangements, after taking into account the State's 25 per cent interest in the Portland smelter. **Payments made by the Consolidated Fund under the flexible electricity tariff arrangements during the 1997-98 financial year totalled \$180 million (1996-97, \$175 million).**

8.95 A number of recent developments have impacted on the value and the reporting of this liability. In particular, in April 1998, the Treasurer agreed to enter into certain deeds to suspend the flexible electricity tariff payments to the SECV by the Consolidated Fund, under which the onerous obligations associated with the flexible electricity tariff arrangements were effectively transferred from the Department of the Treasury and Finance to the SECV as from 30 June 1998. Furthermore, the following arrangements have been enacted to reduce the SECV's, and ultimately the State's exposure associated with the flexible electricity tariff arrangements:

- Establishment in May 1997 of a hedge arrangement between the SECV and Edison Mission Energy Australia Limited, the owner of the Loy Yang B power station, which effectively fixed the price of energy, for a load equivalent to that supplied by the SECV to the aluminium producers from the year 2001 to 2016, at \$23.95 per megawatt hour, indexed to movements in the consumer price index; and
- Establishment of a *smelter reduction amount levy* payable by wholesale electricity market participants (mainly distribution companies) as from 1 July 1997, which will be applied by the SECV in funding part of the future expected losses to be incurred under the flexible tariff arrangements. This levy superseded a previous "energy levy" mainly payable by electricity distributors to the SECV, which was aimed at recovering losses incurred by the SECV in the trading of energy produced by the Loy Yang B power station.

8.96 In addition, the State sold its 25 per cent interest in the Portland Smelter, without divesting that share of the exposure relating to the flexible electricity tariff arrangements.

8.97 Based on current Government expectations of future aluminium prices and inflation levels, and after taking account of the impact of the above hedge and levy arrangements, the financial statements of the SECV and the Government's Annual Financial Statement as at 30 June 1998 disclosed the estimated net present value of the State's future liabilities under the flexible electricity tariff arrangements of \$1.3 billion, and the estimated amount receivable of \$894 million from the levy on distribution businesses established by the Government. Table 8L outlines the key components associated with the calculation of the liabilities under the arrangements.

TABLE 8L
ESTIMATED LIABILITIES OF THE STATE
UNDER THE FLEXIBLE TARIFF ARRANGEMENTS (a)
(\$million)

<i>Item</i>	<i>Amount</i>
Net cost of electricity acquired for re-sale to smelters	2 537
<i>Less -</i>	
Revenue receivable from electricity sales to smelters and related income (b)	1 262
Net present value of liabilities as at 30 June 1998	1 275

(a) All amounts expressed in net present value terms, as determined by the Department's financial consultants.

(b) Includes the impact of the hedge arrangement between the SECV and Edison Mission Energy Australia Limited.

Supplementary power arrangements - Portland aluminium smelter

8.98 Under the electricity supply arrangements relating to the smelters, the SECV is required to supply an annual base load of 520 megawatts to the Portland smelter and up to 375 megawatts to the Point Henry smelter. While additional power of 64 megawatts was annually provided to the Portland smelter to maximise its production capacity, in January 1995, this supplementary supply was terminated by the State. The Government subsequently indicated that it was not prepared to negotiate for the supply of additional electricity to the smelters as Alcoa of Australia Ltd (Alcoa), the smelters' operator, was reluctant to re-negotiate the terms of the agreements under which the substantial flexible electricity tariff payments were required to be made by the State.

8.99 Following a re-assessment of the above position, in September 1996, the Treasurer provided approval for the SECV to enter into an additional supply agreement with Portland Smelter Services Pty Ltd (PSS), the entity through which various joint venture participants hold an interest in the Portland smelter, and a hedge contract with Powercor Australia Ltd (Powercor) - an electricity distribution business, to hedge against the cost of electricity to be purchased from the wholesale electricity market associated with the additional electricity provided to the smelter. At that time, the Department of Treasury and Finance advised the Treasurer that the agreements can be terminated in the event of the SECV's default or insolvency. However, due to the 'pass-through' provisions of the agreements, the SECV exposure to any costs from such an event is minimal.

8.100 The Treasurer was also advised that **the transaction would provide the State with estimated benefits equivalent to \$110 million in net present terms, including a profit surcharge of around \$51 million from PSS and an increase of around \$47 million in the value of Aluminium Smelters of Victoria Pty Ltd (Aluvic), a Government business enterprise through which the State held a 25 per cent interest in the Portland smelter.**

8.101 In September 1997 the Treasurer announced that the Government had reached an agreement with PSS for the provision of additional power to the Portland smelter. The supplementary power arrangements provide for the supply of up to an additional 120 megawatts to the Portland smelter from January 1998 to December 2002, unless one party terminates the agreement earlier due to a material default, insolvency or other specified events.

8.102 PSS is required to pay to the SECV all costs and expenses required to be incurred by the SECV in the provision of the additional supply. These costs include energy costs, transmission costs, wholesale electricity market pool charges, smelter reduction amounts, hedge and administration costs. In addition, the SECV will receive a profit surcharge on the smelter production derived from the additional supply of power, determined by reference to the price of aluminium and the actual or anticipated use of electricity under this agreement. PSS is bound to make these profit surcharge payments whether or not it actually takes any part of the additional supply.

8.103 Other key terms of the additional supply agreement include:

- **PSS acknowledged that the SECV is providing the additional supply on the basis of a full pass-through of all costs, expenses and liabilities associated with the provision of this supply;**
- The parties shall negotiate in good faith with a view to making necessary changes to the calculation of the profit surcharge in the event of an introduction of a new tax such as a carbon tax, or an assessment relating to the emission of carbon or any greenhouse gas into the atmosphere which has the effect of increasing the price of power payable under the hedge contract;
- PSS agreed to comply with the regulatory requirements of the Victorian Power Exchange (operator of the Victorian electricity wholesale market) imposed on the SECV and indemnified the SECV for any failure to do so; and
- PSS has indemnified the SECV against any cost or expense incurred by the SECV in respect of the hedge contract, except in relation to the contract's early termination resulting from the occurrence of an event of default by the SECV.

8.104 As part of the completion of the above arrangements, in March 1998, the SECV, Alcoa and PSS signed a separate interruptibility agreement which provided for the smelter operators to pay the SECV an amount of \$6.5 million in return for the SECV not exercising its rights to interrupt the power supply under the base load contract for commercial reasons. The agreement also provided for the parties to identify arrangements that could be more flexible and would involve a different pattern and frequency of interruptions to those currently permitted under the base contract. This agreement has a term of one year, expiring in December 1998, however it requires the parties to commence discussions in October 1998 for the review and extension of this agreement.

Auditor-General's certificate on electricity tariffs

8.105 The Administrator of the SECV is responsible for the preparation of data and the calculations used to determine the electricity tariffs payable under the electricity supply agreements. In September 1995, the PSS and Alcoa queried the determination of electricity tariffs applied by the SECV for the 1995-96 financial year and subsequently sought a review of the electricity tariff calculations for the period July 1993 to June 1996.

8.106 Consistent with the electricity supply agreements, in October 1995 the Administrator of the SECV requested the Auditor-General to conduct an independent review to ascertain whether the data and calculations used to determine the tariffs for electricity supplied to Alcoa and PSS complied with the requirements of the electricity supply agreements for the financial years 1993-94, 1994-95 and 1995-96.

8.107 Following a review of the data and calculations for the above mentioned 3 financial years, a certificate was issued in June 1997 to the Administrator. The certificate concluded that the data and calculations used to determine the tariff prices during the financial years 1993-94, 1994-95 and 1995-96 did not fully meet the requirements of the electricity supply agreements.

8.108 Following receipt of the Auditor-General's certificate and discussions with the smelter operators, in May 1998 the SECV issued an invoice and received an amount of \$10.7 million from the operators representing a cost adjustment to the period July 1993 to April 1998.

Privatisation of Aluvic

8.109 The successful completion of the supplementary power arrangements removed what was considered by the Government to be a significant impediment to Aluvic's privatisation while, at the same time, had the effect of adding value to the State's 25 per cent interest in the Portland smelter.

8.110 Subsequently, in August 1998, the Government announced the sale of Aluvic to 2 PSS participants, namely China International Trust and Investment Corporation, and the Marubeni Corporation. It is my intention to review and report upon the results of the sale in my May 1999 *Report on Ministerial Portfolios*.

CONTINGENT LIABILITIES OF THE STATE

8.111 Contingent liabilities of the State do not represent actual liabilities but rather potential commitments, the occurrence of which is dependent upon future events or outcomes. Such commitments arise from the provision of guarantees, indemnities, sureties, letters of comfort and other forms of financial support. These instruments are issued for various purposes, but generally to provide assistance to entities in raising funds by reducing the level of risk to private sector institutions.

8.112 Guarantees obligate 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. The provision of indemnities, on the other hand, generally impose a primary obligation on the Government to protect entities in receipt of indemnities against certain financial losses.

8.113 While instruments giving rise to contingent liabilities place no immediate demand on public finances, they are nevertheless significant as the Government may be required to honour its undertakings many years after such undertakings are given.

8.114 **The Government's Annual Financial Statement discloses that the estimated quantifiable contingent liabilities of the State at 30 June 1998 arising from government guarantees and indemnities were around \$1.4 billion.** In addition, various other contingent liabilities existed at 30 June 1998 which could not be reliably quantified. These contingent liabilities are summarised in the Government's Annual Financial Statement.

8.115 My previous Reports to the Parliament identified certain issues relating to the recording, reporting and management of the State's contingent liabilities, which required attention. In particular, in my October 1997 Report, it was highlighted that a policy and procedures manual for the control and monitoring of contingent liabilities still had not been issued to Departments. In addition, the Department of Education had not established its own contingent liability register to assist in the effective management of its exposures.

8.116 An audit follow-up of the above issues during the audit of the Government's Annual Financial Statement revealed that, in June 1998, all departments were issued with a policy and procedures manual relating to the control and monitoring of contingent liabilities. Furthermore, the Department of Education has established appropriate procedures to record and monitor its contingent liabilities.

8.117 In order to form an opinion as to whether the contingent liabilities of the State are fairly presented in the Government's Annual Financial Statement in accordance with the *Financial Management Act 1994*, audit performed the following key verification procedures:

- as part of the financial audits of all major public sector entities, a review was undertaken of procedures in place for the identification, recording and reporting of contingent liabilities;
- examination, on a test basis, of documentation supporting the major contingent liabilities; and
- review of the procedures adopted by the Department of Treasury and Finance for the recording and monitoring of contingent liabilities.

8.118 Based on the results of these procedures, I am satisfied that the contingent liabilities of the State have been presented fairly in the Government's Annual Financial Statement. Comments follow on the more significant contingent liabilities of the State.

Melbourne City Link

8.119 My previous Reports to Parliament have provided a detailed analysis of the highly complex arrangements established between the Government and Transurban, a private sector consortium, for the financing, construction and operation of the Melbourne City Link.

8.120 The Melbourne City Link project represents one of the largest infrastructure projects ever undertaken in Australia and has an estimated total cost of \$2 billion. The project covers approximately 22 kilometres of road, tunnel and bridge works and involves the linking of 3 of Melbourne's most important freeways, namely, the South Eastern, West Gate and Tullamarine Freeways, together with the upgrading of parts of the South Eastern and the Tullamarine Freeways. The key elements of the development include:

- *Southern Link* - an 8 kilometre freeway connecting the West Gate Freeway east of Kings Way to the South Eastern Freeway, and involving two tunnels under the Kings Domain and the Yarra River; and
- *Western Link* - 13 kilometres of new and upgraded freeway-standard roadway, connecting the Tullamarine Freeway to the West Gate Freeway, via a new elevated roadway and a bridge over the Yarra River.

8.121 The expected opening dates for the Western and Southern Links are April 1999 and December 1999, respectively. The Melbourne City Link Authority has advised that the construction of the project is currently on target.



Construction works for new Yarra Bridge.

8.122 As indicated in my previous Reports, the primary contractual document establishing the basis upon which the project is to proceed is the Concession Deed entered into between the Government and Transurban in October 1995. In addition, the *Melbourne City Link Act 1995*, which was passed by the Parliament in December 1995 and incorporates the Concession Deed, provided the Melbourne City Link Authority with certain powers in relation to land and roads affected by the project and empowered the charging and collection of tolls on the City Link. Once completed, Transurban will operate the roadway as a public tollway for an estimated period of 34 years, with toll revenues collected from motorists to be mainly applied towards the cost of its construction, operation and maintenance, with a return on investment available for the investors in the project. At the end of the specified period, ownership of the City Link will revert to the State at no cost and in a fully maintained condition.

8.123 A detailed analysis of the allocation of key project risks and obligations between the relevant parties reveals that, **while certain project responsibilities and risks have been assumed by the State, substantial risks and exposures have been transferred to Transurban and users of the City Link.** In particular, the State has accepted certain obligations, mainly relating to the maintenance of the current overall operating environment for the project. In addition, the State has undertaken to implement certain traffic management measures involving specific changes to the existing road network in the vicinity of the Link (known as *Agreed Traffic Management Measures*) to enable the most efficient use of the overall road network and provide benefits to the local communities. Furthermore, the Government **may** implement future traffic enhancement measures over the life of the project which could assist Transurban in enhancing the revenues of the project. However, any revenue generated by these additional traffic management measures will be shared between the State and Transurban.

8.124 Under the established arrangements, while the users of the City Link via toll payments will in substance be the financiers of the project, Transurban has ultimately accepted substantial obligations in relation to the delivery and operation of the project.

Exhibition Street extension project

8.125 My October 1997 Report to the Parliament outlined the major considerations and deliberations leading to a Government's in-principle decision in 1996 to proceed with the Exhibition Street Extension project which will involve the development of a direct connection between Exhibition Street and the City Link.

8.126 Consequently, in June 1997, the *Melbourne City Link (Further Amendment) Act 1997* was enacted to facilitate the construction and operation of the project and, at that time, the Melbourne City Link Authority issued a formal notice to Transurban under the terms of the Concession Deed, advising the consortium of the changes required to facilitate the efficient integration of the Exhibition Street Extension with the City Link. In addition, the Minister for Planning and Local Government formally announced that the State Government would proceed with the extension of Exhibition Street south east of the central business district in 2 distinct parts, including:

- *Section 1*, comprising the works on the current project area from Burnley to Batman Avenue, east of Swan Street (known as the 'Punt Road end'). This section is to be developed by Transurban for inclusion in the existing City Link project; and
- *Section 2*, comprising new works outside the current project area from Section 1, along Batman Avenue, the Swan Street/Batman Avenue intersection and along a new alignment and structure over the railyards to Flinders Street (known as the 'City end'). This section would be operated by Transurban, or another private sector operator, on the same basis as that put in place relating to the existing City Link project. However, the State would be responsible for the design and construction of this section, with the operator required to make a financial contribution to the State for the cost of its construction.

8.127 The expected completion dates for Section 1 and Section 2 of the Exhibition Street Extension project are December 1999 and September 1999, respectively.



Exhibition Street extension bridge supports.

8.128 It is my intention to include an analysis in my May 1999 *Ministerial Portfolios Report* to the Parliament of the arrangements entered into between the State and the contractor in relation to the development and financing of both sections of the Extension project, including comment on any disputes between the parties in relation to the City Link project.

State's commitments

8.129 Expenditure incurred by the Melbourne City Link Authority in relation to the total City Link project during the period ended 30 June 1995 to 30 June 1998 amounted to \$249 million, of which \$34 million related to the Exhibition Street Extension Project. The expenditure incurred to 30 June 1998 comprised \$84 million expended towards the acquisition of land, \$96 million expended towards specified State works and \$34 million for other costs, including salaries and administrative expenditure.

8.130 The State's capital commitments in relation to the City Link project amounted to \$120 million as at 30 June 1998 and have been included as part of the State's capital commitments in the notes to the Government's Annual Financial Statement. These capital commitments mainly relate to specified State works associated with the City Link project, including the Exhibition Street extension.

OTHER FINANCIAL COMMITMENTS OF THE STATE

8.131 In addition to the financial obligations commented upon earlier in this Part of the Report, public sector bodies have entered into a number of arrangements which will impact on the future financial operations of the State. At 30 June 1998, the public sector had financial commitments relating to operating leases and works not performed under existing contracts, valued at \$2.9 billion (1996-97, \$2.6 billion).

8.132 However, as highlighted earlier in this Report and in my October 1997 Report to the Parliament, the above amounts do not include the State's commitments under outsourcing contracts entered into to provide services to Victorian taxpayers.

Statewide computer network

8.133 The development of a wide-area computer network (WAN) has been under consideration by the Government since 1995, with the Department of State Development proposing to establish a core telecommunications network which provides government agencies across the State with a high speed data communications network to support advanced network computer applications.

8.134 In December 1996, it was agreed by Cabinet that this project should proceed and that budget sector agencies should be encouraged to use these services. Consequently, the Department sought registrations of interest for the delivery of wide area network services to budget sector agencies, which resulted in the receipt of 10 bids from interested parties, of which 3 were subsequently shortlisted.

8.135 While the Department's analysis of the submitted bids indicated that the proposals were marginally more expensive than the estimated costs associated with the direct provision of the wide area network by budget sector agencies, it was anticipated that, following further negotiations with the bidders, a positive financial outcome would be realised. At the same time, the Department considered that capital funding of around \$30 million would need to be made available to agencies to upgrade their computerised systems in order to reduce the costs of acquiring the advanced WAN services.

8.136 The evaluation criteria applied by the Department in the assessment of the bids included the financial impact on the State, the service providers' capability and the network coverage. It was proposed that the network would be developed and operated by the private sector and would be used by agencies on a fee-for-service basis, to be funded by individual agencies from within their current appropriations. It was also anticipated that budget savings would be derived from the re-engineering of business processes of service delivery to the public.

8.137 A Steering Committee established to conduct an investment evaluation associated with the establishment of the network determined that the preferred option would be to proceed with a whole of government approach to the development of a wide area network, by issuing a project brief to the 3 shortlisted bidders, and that this approach should be supported by a capital funding allocation to agencies to facilitate the upgrade of existing computerised systems which would be required for the efficient delivery of the WAN services.

8.138 In January 1997, Multimedia Victoria, a unit within the Department of State Development, sought a capital funding allocation of \$30 million over a 5 year period, comprising \$10 million in the 1997-98 financial year and \$5 million for each of the following 4 years to June 2002. However, the funding actually approved for application by agencies to assist in the establishment of computing capabilities which facilitate the utilisation of the WAN services was reduced to \$5 million during the 1997-98 financial year and \$2.5 million for each of the subsequent 4 years to June 2002.

8.139 Following an analysis of the bids received, in August 1997, the Minister for Multimedia was advised by the lead project team comprising representatives from the Department of State Development and the Department of Treasury and Finance that AAPT Ltd should be selected as the preferred bidder to commence final negotiations, given that the pricing mechanism proposed by the preferred bidder provided for prices to fall significantly throughout the life of the contract, as new technology and competition forces the market prices down, which will in turn deliver value for money to public sector agencies.

8.140 In September 1997, the Minister for Multimedia announced that the contract to develop an advanced computer network within the State was awarded to AAPT Ltd. The company will build and own the network at a cost of between \$100 million and \$150 million over 5 years, with full commissioning of the network to occur by mid-1999.

8.141 A probity auditor, engaged by the Department, reported that the bidders were evaluated and ranked fairly against the selection criteria.

Contractual arrangements

8.142 In September 1997, a Heads of Agreement was entered into between the State, AAPT Ltd and QNET Communications (Australia) Pty Ltd, a subsidiary of AAPT Ltd (the contractor), for the provision of wide area network services over a period of 5 years, from October 1997 to September 2002. Under this agreement, the State has the option to extend the term of the contract for a maximum of 2 additional terms of 1 year duration.

8.143 The key terms of the Heads of Agreement are as follows:

- The State will make reasonable endeavours to ensure that the nominated budget sector agencies, including the Departments of Education (covering primary and secondary schools and TAFE institutions), Natural Resources and Environment, Human Services (including public hospitals), Justice (including Victoria Police), Treasury and Finance, State Development, Infrastructure, and Premier and Cabinet, utilise the WAN services of the preferred supplier. Agencies with existing network services are required to utilise the contractor for the provision of WAN services within 2 years of the commencement date of the agreement;
- Individual agencies are required to pay monthly service charges which are linked to pre-determined standards of service delivery and operation, in accordance with individual Service Agreements executed between the agencies and the contractor. In the event that the contractor does not meet certain performance measures, adjustments will be made to the monthly service charges payable by the agencies;

- During the term of the agreement, neither the State or any nominated budget sector agency shall seek the supply of WAN services from an alternative supplier;
- The contractor shall assume the technical and commercial risk associated with the selection of relevant equipment for the provision of services to each agency;
- The contractor will use reasonable endeavours to market the services to other Victorian government agencies, on terms similar to those available to the nominated agencies in the budget sector, agencies within the Commonwealth government and the private sector;
- The State accepts no responsibility for the costs incurred by the contractor in developing or maintaining the network;
- The contractor shall ensure that, in addition to any obligation arising under individual Service Agreements, the network shall be consistently upgraded and operated in a manner consistent with world's best practice;
- A mid term review of the States' requirements for WAN services and delivery of services by the contractor will be undertaken by an independent expert appointed by the Minister in April 2000;
- The State may at any time during the term of the agreement terminate or suspend the agreement in whole or in part, by way of written notification to the contractor. The State may also terminate the agreement immediately, where the contractor is in material default of the agreement. On termination or suspension of the agreement, the State will pay the contractor a specified sum for each year remaining to the expiration of the contract. However, this payment will not be made where the termination of the agreement is a result of a default by the contractor which is not capable of being remedied. In addition, at expiry or early termination, the State may request the contractor to arrange for the transfer of the WAN to alternate service provider(s) or to the State at a fair market valuation;
- If the State determines that the contractor has materially breached its obligations under the agreement, it may appoint an independent manager to assist the contractor in discharging its obligations. For the duration of the appointment of the manager, the contractor will be liable for all reasonable costs incurred by the State in order to mitigate its losses resulting from the contractor's breach; and
- The contractor and the State have agreed to indemnify each other for any loss or liability arising from a negligent act or omission.

Overall assessment of arrangements

8.144 Under the established arrangements, the contractor will develop, own and operate a computerised wide area network for nominated Victorian Government agencies over an initial period of 5 years, with an option to extend the term by an additional 2 years. The contractor is also expected to market these services to other State Government agencies, Commonwealth Government agencies and the private sector.

8.145 The network will be utilised by the respective Government agencies on a fee-for-service basis. Where the contractor does not provide the required level of service, agencies will be entitled to adjust the service fees payable to the contractor or to terminate the service agreement. In the event of the expiry or the early termination of the agreement, the State has the option to purchase the network equipment at its fair market value. However, if the State elects to terminate the agreement without cause, it will be required to pay the contractor a sum of \$4 million for each year remaining until the expiration of the agreement. Accordingly, these arrangements will form part of the State's commitments under outsourcing contracts for services to be provided.

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