

VICTORIA

Auditor-General
of Victoria

**REPORT ON
MINISTERIAL
PORTFOLIOS
JUNE 2000**

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June 2000

The President
The Speaker
Parliament House
Melbourne, Vic. 3002

Sir

Under the authority of section 15 of the *Audit Act* 1994, I transmit my Report on Ministerial Portfolios. The Report also contains a section on the Parliament of Victoria.

This Report completes the cycle of my auditing activities in relation to the 1998-99 financial year.

Yours faithfully

J.W. CAMERON
Auditor-General

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Foreword

This is my first Report on audit issues summarised by *Ministerial Portfolio* since assuming office. The Report covers a diverse range of public interest issues which have been identified through the annual financial audit process of the numerous public sector agencies which come under my responsibility. Some of the major issues covered are:

- infrastructure maintenance and replacement across a range of agencies;
- financial viability of TAFE providers and public hospitals;
- implementation of the GST in the Victorian public sector;
- privatisation of Melbourne IT Ltd; and
- public transport passenger rail privatisation and franchising arrangements.

The Report contains a significant number of observations and recommendations which are aimed at improving financial and resource management, and enhancing accountability within the Victorian public sector.

While the State's overall financial position is sound and the standard of financial reporting continues to improve, this Report shows the need for public agencies to remain ever vigilant in maintaining a responsible hold on sound management practices to ensure that public resources are prudently managed and service obligations are met.

J.W. CAMERON
Auditor-General

Part 1

Executive Summary

Part 1.1

Major findings

1.1.1 Key findings arising from the audit reviews of ministerial portfolios are highlighted at the beginning of each individual section of this Report. **Major findings** are summarised below.

EDUCATION, EMPLOYMENT AND TRAINING

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Privatisation of Melbourne IT Ltd

- Melbourne IT Ltd which was initially established in 1996 with capital of \$350 000, was privatised in 1999 through a share float process, with some \$78.4 million being returned to Melbourne Enterprises International Limited (the subsidiary of The University of Melbourne and the parent entity of Melbourne IT Ltd), from the sale of 85 per cent of the shares in the company. *Paras 3.1.10 to 3.1.19*
- The 85 per cent interest in Melbourne IT Ltd was sold for \$93.5 million, prior to deducting costs of \$7.6 million associated with the sale and \$7.5 million returned to the company as working capital. This interest is now valued by the market, some 5 months later, at around \$350 million. *Paras 3.1.39 to 3.1.40*
- The failure of Melbourne Enterprises International Limited to obtain an independent authoritative valuation of Melbourne IT Ltd was a significant deficiency in the float process, in that a valuation would have provided a benchmark against which proposals from brokers and underwriters could have been better considered. *Paras 3.1.41 to 3.1.56*
- There is no doubt that The University of Melbourne benefited substantially from the public sale of shares in Melbourne IT Ltd. Nevertheless there were lessons for government and public sector entities that can be learnt from the float. These considerations include risk management principles to be adopted, the need to obtain independent valuations from other parties, avoidance of any conflict of interest when persons employed in the public sector benefit from share allocations and consideration of alternative methods of sale to achieve the best outcome from the privatisation of public sector companies. *Paras 3.1.39 to 3.1.122*

Financial viability of TAFE providers

- Overall, there has been a significant improvement in the financial position of public TAFE providers, particularly between 1998 and 1999.

Paras 3.1.128 to 3.1.134

- Six public TAFE providers had negative working capital positions as at 31 December 1999 which may impact on their ability to meet future financial obligations as and when they fall due.

Paras 3.1.137 to 3.1.138

- More recent initiatives taken by the Government to assist public TAFE providers include provision of additional funding totalling \$104 million over the 3 years commencing from 1 July 2000.

Paras 3.1.159 and 3.1.160

Adequacy of asset management practices by TAFE providers

- The combined property portfolios of public TAFE providers in Victoria comprise 927 buildings with a current replacement value of \$1.5 billion and an average age of around 23 years, situated on 139 campuses.

Para. 3.1.171

- The Department of Education, Employment and Training in February 2000 identified an estimated deferred maintenance backlog of \$99 million associated with buildings managed by public TAFE providers. Given the apparent quantum of maintenance backlog across the sector there is a need, as a matter of priority, to focus on this issue to ensure that the TAFE facilities are maintained in a safe condition and are fit for their intended purpose.

Paras 3.1.172 to 3.1.175

- The Department estimated that building maintenance funding requirements for all public TAFE providers were in the order of \$12.6 million per annum but Government recurrent building maintenance funding provided between the 1994-95 and 1998-99 financial years had amounted to around \$2 million per year. The recent State budget has allocated funding of \$6 million towards maintenance for 2000-01.

Paras 3.1.183 to 3.1.187

HUMAN SERVICES

Page 77

Financial viability of hospitals

- There were 8 hospitals which were considered to be operating under financial difficulties as at 30 June 1999. The financial position of a further 3 hospitals was expected to deteriorate in the 1999-2000 financial year.

*Paras 3.2.4 to 3.2.12***Maintenance of public hospital buildings**

- Health care facilities managed by the 89 public hospitals in Victoria are spread over 150 locations, with hospital buildings having an aggregate value of \$2.4 billion.
- The lack of a consistent methodology for the conduct of building condition assessments by hospital managers has resulted in a lack of reliable information being available on the estimated costs required to bring hospital buildings up to the required standards. Nevertheless, those hospitals that we reviewed which had assessed such costs, estimated that the outstanding maintenance on their buildings was around \$100 million.
- Given the level of outstanding maintenance works, there is a need for the Department of Human Services to critically assess the maintenance requirements of all public hospital buildings and the associated funding implications.

*Para. 3.2.13**Paras 3.2.17 to 3.2.20**Paras 3.2.21 to 3.2.22*

INFRASTRUCTURE

Page 99

Public transport passenger rail privatisation and franchising arrangements

- The State has entered into franchise agreements with the private sector for periods of 10 to 15 years under which the franchisees have agreed to provide passenger services, maintain the rail infrastructure and undertake a rolling stock acquisition program, in return for the receipt of subsidies from the State.
- The State received nominal consideration of \$3 for the sale of mainly rolling stock and plant and equipment (which had an estimated aggregate book value of \$663 million) to the 3 franchisees operating the passenger transport businesses. In return, the State obtained a right to receive future services from each franchisee on the basis of reduced subsidy payments from the State.
- The aggregate cost to the State for the delivery of the required services by the franchisees over the next 15 years, in net present value terms, will be around \$2.8 billion.

*Paras 3.3.4 to 3.3.47**Paras 3.3.48 to 3.3.53**Paras 3.3.51 to 3.3.151*

Maintenance of State-owned transport infrastructure

- In September 1998, a consultant engaged by the former Government concluded that the intrastate non-electrified rail infrastructure was basically fit for freight and passenger operating purposes, but a maintenance backlog in the order of \$23 million was identified, affecting all corridors. We have been unable to assess the extent to which this backlog has been cleared.

*Paras 3.3.152 to 3.3.161***Colac-Otway Shire Council – Export meat processing facility development agreement**

- The Council has negotiated a new state-of-the-art meat processing facility that will provide 50 additional job opportunities within the Shire. The facility secured under the development agreement is around half the size of the facility that Council previously negotiated to have constructed.

Paras 3.3.170 to 3.3.173

- The overall cost to ratepayers for the acquisition and operation of the original abattoir until its closure and contributions to the owners of the new facility totalled around \$2.4 million, with a further \$250 000 provided by the State.

*Paras 3.3.179 to 3.3.180***External financial reporting by the local government sector**

- Notwithstanding the additional requirements arising from the introduction in 1998-99 of a new performance reporting regime, local authorities achieved improved levels of timeliness of financial and performance reporting compared with the preceding year.
- A Government study released in January 2000 identified the need for most councils to take action within the next 7 years to fund required infrastructure asset renewals.

*Paras 3.3.186 to 3.3.189**Paras 3.3.220 to 3.3.222***Acquisition of proposed prescribed waste facility site by Wyndham City Council**

- In November 1998, the Wyndham City Council entered into an agreement to purchase a 101 hectare site located in Wests Road, Werribee upon which a company had proposed the establishment of a prescribed waste storage facility. It is estimated that the overall settlement in relation to this property will cost the City Council ratepayers around \$17.7 million.

*Paras 3.3.229 to 3.3.244***The Queen Victoria site**

- The Melbourne City Council acquired the Queen Victoria site during 1997 at a cost of \$38.5 million from a private developer. The private developer had previously acquired the site from the Government during 1992 for \$14.9 million and had entered into an arrangement during 1994 to sell the site to the Republic of Nauru for \$50.3 million.

Paras 3.3.256 to 3.3.262

- The Council recently sold the site to another developer. The total costs incurred by Council on the site to December 1999 of \$46.7 million were greater than the sale price of \$40 million to the developer. Nevertheless, the sale price was consistent with an independent valuation of the site, and the sale will ultimately result in additional rating revenue for Council, open space, public car parking and a crèche.

Paras 3.3.273 to 3.3.297

Outsourcing of traffic camera and fine collection services

- Based on a consultant's report prepared for the Department in 1997, the estimated cost associated with the internal provision of these services was \$35 million per annum. However, consistent with the earlier expectations of the Government, the cost of service provision had increased as a result of the outsourcing arrangements, with the Department incurring total costs of around \$49.4 million per annum.

Paras 3.4.19 to 3.4.21

- Since the commencement of the service agreement in November 1998, the overall performance of the service provider, as indicated by its ability to meet or exceed the standards set in the service agreement, has been good.

Paras 3.4.23 to 3.4.26

- It is unlikely that the long outstanding debt of \$169 million which was not allocated to the service provider for collection will be recovered, given the rationalisation of internal resources.

Paras 3.4.34 to 3.4.39

- Under the service agreement, payments to the service provider in respect of City Link services were to begin in April 1999 in line with the expected opening of the toll roads. Due to a number of delays, the first toll road was not opened until January 2000. The service provider was, however, paid \$2.8 million for the period from April 1999 to December 1999.

Paras 3.4.40 to 3.4.41

Residential Tenancies Bond Authority

- Our review of the Residential Tenancies Bond Authority's tender evaluation processes for outsourcing tenancy bond management functions identified a number of factors which could reasonably have caused the Authority to question the adequacy of the successful service provider's tender, which have resulted in additional costs to the Authority.

Paras 3.4.65 to 3.4.74

Construction of Children's Court

- Despite deficiencies in its tendering process, the Department of Justice has managed to replace an inadequate court facility with a purpose-built world class facility, the construction of which was completed without significant cost overruns, although 15 months later than initially planned.

Paras 3.4.121 to 3.4.123

Catchment management authorities' funding arrangements

- The Government in November 1999 directed catchment management authorities to discontinue charging property owners catchment management tariffs.

Paras 3.5.7 to 3.5.9

- A number of authorities have indicated that it is not economic for them to pursue uncollected catchment management tariffs. However, the decision not to pursue the collection of these tariffs is inequitable given that a significant proportion of property owners have paid their tariffs.

Paras 3.5.14 to 3.5.16

- The 4 power generation companies in the LaTrobe Valley owed \$2.1 million in catchment management tariffs for the 1997-98 and 1998-99 financial years to the West Gippsland Catchment Management Authority.

Paras 3.5.14 to 3.5.16

Water storage management by non-metropolitan urban and rural water authorities

- The estimated cost of remedial works to dams required to be undertaken by authorities over a 5 year period commencing from the 1998-99 financial year is \$122 million, while further works amounting to \$23.5 million are required over a further 5 year period.

Paras 3.5.43 to 3.5.51

- Authorities have a duty of care to convey information to the community on the risks associated with dam failure and flooding.

Paras 3.5.60 to 3.5.64

Electronic procurement within the Department of Natural Resources and Environment

- The Department of Natural Resources and Environment should be commended for its achievement in establishing the first Victorian public sector electronic procurement system. The Department estimates that in the first year of implementation, the electronic procurement system generated savings of more than \$1.3 million by eliminating outdated manual processes.

Paras 3.5.91 to 3.5.94

PREMIER AND CABINET

Page 261

Construction of the Melbourne Museum complex

- The final cost of completing the Museum was estimated as at February 2000 to be \$291.8 million – a \$4.2 million increase over the past 12 months. When compared with the original budget of \$250 million, the overall increase in costs is expected to be \$41.8 million.

*Paras 3.6.4 to 3.6.15***Sale of ticketing joint venture interests – Victorian Arts Centre Trust**

- The result achieved (\$3.4 million) from the sale of Victorian Arts Centre Trust's interest in 2 ticketing joint ventures was at the lower end of independent valuations obtained prior to the sale, and well below the recommended sale price advised to the Trust in August 1998.

*Paras 3.6.51 to 3.6.58***Development of Federation Square**

- The Federation Square Project was launched in March 1996 as a joint venture initiative of the Government and the Melbourne City Council with a provisionally estimated construction cost of \$110 million.

Paras 3.6.59 to 3.6.66

- During October 1997, and prior to the calling of tenders for construction of the Federation Square, the Project Manager's quantity surveyor estimated the cost of constructing the Square at \$249 million based on the winning design resulting from an international design competition. This was significantly above the then stated cost limit of \$128 million for the development of the Square.

Paras 3.6.75 to 3.6.83

- The latest cost estimate of \$262 million, prepared in August 1999, does not seek to capture the total cost of the Federation Square development and is partly unfunded as only \$212.6 million has been committed by the Government and the Council.

Paras 3.6.127 to 3.6.134

STATE AND REGIONAL DEVELOPMENT

Page 301

Construction of the multi-purpose venue at Melbourne Park

- The projected final cost of completing the construction of the multi-purpose venue, excluding the cycling training facility, was \$64.9 million - representing a \$500 000 saving on the original budget. This does not include a claim for damages of \$19.1 million submitted by the contractor.

Paras 3.7.22 to 3.7.24

- The construction of the multi-purpose venue originally planned to be completed by November 1999 is now expected to open in July 2000.

Paras 3.7.27 to 3.7.33

TREASURY AND FINANCE

Page 313

Financial condition of WorkCover

- The WorkCover scheme's continued funding deficiency [the proportion of the schemes' net assets in proportion to its outstanding claims liability – 95.5 per cent] has been mainly due to the growth in the level of outstanding claims liability without a matching or improving increase in available net assets.

*Paras 3.8.4 to 3.8.8***Victorian Channels Authority - Cost of channel operations**

- The balance sheet of the Victorian Channels Authority does not reflect the value of its shipping channels. Accordingly, the true value of all assets available to the Authority are not reported and the true cost of services provided by these channels are not transparent because the channel assets have not been amortised over their useful economic life.

Paras 3.8.29 to 3.8.43

BROAD SCOPE ISSUES

Page 335

Implementation of the GST in the Victorian public sector

- Government agencies are currently preparing for the introduction of the new tax regime and there are substantial operating and financial ramifications for those agencies if they are not prepared in time.

Paras 4.1.1 to 4.1.5

- The arrangements established by the Department of Treasury and Finance for the introduction of the GST throughout the public sector were comprehensive. However, certain problems associated with the monitoring arrangements have adversely impacted on the implementation process. In addition, other factors largely outside the control of the State Government, relating to delays in enacting amendments to the Commonwealth's GST legislation and delays experienced with the Australian Tax Office in providing interpretation and treatment rulings have also adversely impacted on the implementation of the GST throughout the public sector.

Paras 4.1.10 to 4.1.11

- As at 2 May 2000, only 30 per cent of selected public sector agencies were on target to achieve readiness for the implementation of the GST by 30 June 2000.

*Paras 4.1.16 to 4.1.19***Outsourcing in the Victorian public sector**

- Because of a number of factors, including the long-term nature of many of the major outsourcing arrangements currently in place, effective management of outsourced services is likely to remain an important responsibility of government agencies for some time.

Paras 4.2.16 to 4.2.20

- Based on departmental experiences with outsourcing, several key issues will warrant attention in the formulation of policies for the future delivery of government services.

Paras 4.2.27 to 4.2.53

Part 2

Parliament of Victoria

Parliament of Victoria

KEY FINDING

- The audit of the financial statements of the Parliament of Victoria was satisfactorily concluded.

PARLIAMENT OF VICTORIA

The audit of the Parliament of Victoria, including the Victorian Auditor-General's Office, proved satisfactory.

**SCHEDULE A
COMPLETED/INCOMPLETE AUDITS**

<i>Entity</i>	<i>Financial year ended</i>	<i>Reporting to Parliament</i>	<i>Financial statements signed by entity</i>	<i>Auditor- General's report signed</i>
COMPLETED AUDITS				
Parliament of Victoria	30 June 1999	No reporting requirements.	4 Nov. 1999	5 Nov. 1999
Victorian Auditor-General's Office (a)	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.46.</i>	16 Aug. 1999	16 Aug. 1999

(a) The Victorian Auditor-General's Office was audited by a firm of private auditors appointed by the Parliament.

Part 3

Audit of Ministerial Portfolios

Part 3.1

Education, Employment and Training

KEY FINDINGS

Privatisation of Melbourne IT Ltd

- Melbourne IT Ltd which was initially established in 1996 with capital of \$350 000, was privatised in 1999 through a share float process, with some \$78.4 million being returned to Melbourne Enterprises International Limited (the subsidiary of The University of Melbourne and the parent entity of Melbourne IT Ltd), from the sale of 85 per cent of the shares in the company.
Paras 3.1.10 to 3.1.19
- The 85 per cent interest in Melbourne IT Ltd was sold for \$93.5 million, prior to deducting costs of \$7.6 million associated with the sale and \$7.5 million returned to the company as working capital. This interest is now valued by the market, some 5 months later, at around \$350 million.
Paras 3.1.39 to 3.1.40
- The failure of Melbourne Enterprises International Limited to obtain an independent authoritative valuation of Melbourne IT Ltd was a significant deficiency in the float process, in that a valuation would have provided a benchmark against which proposals from brokers and underwriters could have been better considered.
Paras 3.1.41 to 3.1.56
- There is no doubt that The University of Melbourne benefited substantially from the public sale of shares in Melbourne IT Ltd. Nevertheless, there were lessons for government and public sector entities that can be learnt from the float. These considerations include risk management principles to be adopted, the need to obtain independent valuations from other parties, avoidance of any conflict of interest when persons employed in the public sector benefit from share allocations and consideration of alternative methods of sale to achieve the best outcome from the privatisation of public sector companies.
Paras 3.1.39 to 3.1.122

Financial viability of TAFE providers

- Overall, there has been a significant improvement in the financial position of public TAFE providers, particularly between 1998 and 1999.
Paras 3.1.128 to 3.1.134
- Six public TAFE providers had negative working capital positions as at 31 December 1999 which may impact on their ability to meet future financial obligations as and when they fall due.
Paras 3.1.137 to 3.1.138

KEY FINDINGS - *continued***Financial viability of TAFE providers** - *continued*

- In view of the continuing financial difficulties experienced by a number of public TAFE providers, the Office of Post Compulsory Education, Training and Employment needs to continue to ensure that institutes continually re-examine business strategies so that future programs and operations are financially viable. *Paras 3.1.138 to 3.1.158*
- More recent initiatives taken by the Government to assist public TAFE providers include provision of additional funding totalling \$104 million over the 3 years commencing from 1 July 2000. *Paras 3.1.159 and 3.1.160*
- There is a need for all public TAFE providers to review the reporting requirements of all fee-for-service activities in order to ensure that the profitability of commercial activities can be reliably determined, and comprehensive risk management strategies are in place. *Paras 3.1.161 to 3.1.164*

Adequacy of asset management practices by TAFE providers

- The combined property portfolios of public TAFE providers in Victoria comprise 927 buildings with a current replacement value of \$1.5 billion and an average age of around 23 years, situated on 139 campuses. *Para. 3.1.171*
- The Department of Education, Employment and Training in February 2000 identified an estimated deferred maintenance backlog of \$99 million associated with buildings managed by public TAFE providers. *Paras 3.1.172 to 3.1.175*
- Given the apparent quantum of maintenance backlog across the sector there is a need, as a matter of priority, to focus on this issue to ensure that the TAFE facilities are maintained in a safe condition and are fit for their intended purpose. *Paras 3.1.176 to 3.1.182*
- The Department estimated that building maintenance funding requirements for all public TAFE providers were in the order of \$12.6 million per annum but government recurrent building maintenance funding provided between the 1994-95 and 1998-99 financial years had amounted to around \$2 million per year. However, the recent State budget has allocated funding of \$6 million towards maintenance for 2000-01. *Paras 3.1.183 to 3.1.187*
- While substantial funding has been provided by the State and Commonwealth Governments under a modernisation program involving additions, upgrades, refurbishment and replacements of institute buildings, the level of contributions from these sources has progressively declined over the past 5 years. *Paras 3.1.188 to 3.1.189*
- The recently developed departmental compliance and maintenance valuation program when applied to the TAFE sector, will have significant benefits in terms of establishing a current inventory of properties and their relevant characteristics, and should better facilitate the identification and programming of prioritised maintenance and associated costings. *Paras 3.1.194 to 3.1.196*

3.1.1 Three Ministers, namely, the Minister for Education, the Minister for Post Compulsory Education, Training and Employment and the Minister for Youth Affairs have responsibility for operations within the Education sector. These Ministers have collective responsibility for the Department of Education, Employment and Training.

3.1.2 Details of the specific ministerial responsibilities for public bodies within the Education sector are provided in Table 3.1A. These public bodies, together with the Department of Education, Employment and Training were subject to audit by the Auditor-General during 1998-99.

**TABLE 3.1A
MINISTERIAL RESPONSIBILITIES FOR
PUBLIC BODIES WITHIN THE EDUCATION, EMPLOYMENT AND TRAINING SECTOR**

<i>Ministerial portfolio</i>	<i>Entities subject to audit</i>
Education	Board of Studies Telematics Course Development Fund Trust
Post Compulsory Education, Training and Employment	Adult, Community and Further Education Board Council of Adult Education Driver Education Centre of Australia Ltd International Fibre Centre Ltd International Training Australia Pty Ltd Post compulsory education institutions: <ul style="list-style-type: none"> • Universities (8) and associated companies, trusts and foundations (57) • Institutes of technical and further education (14) and associated companies (6) State Training Board Victorian Tertiary Admission Centre
Youth Affairs	-

3.1.3 Comment on matters of significance arising from the audit of agencies within the Education, Employment and Training sector is provided below.

PRIVATISATION OF MELBOURNE IT LTD

3.1.4 During the past 10 years there has been an increasing number of companies established by universities. In particular, as at 31 December 1999, there were 45 companies established as direct subsidiaries of universities with a further 10 companies established by those subsidiaries. In addition, universities also operate a number of other entities such as Trusts and Foundations. Table 3.1B below outlines the number of companies controlled by each university.

**TABLE 3.1B
COMPANIES CONTROLLED BY UNIVERSITIES**

<i>University</i>	<i>Companies established by universities</i>	<i>Subsidiary companies established by university companies</i>	<i>Total</i>
Ballarat	2	-	2
Deakin	2	-	2
La Trobe	6	-	6
Melbourne	9	5	14
Monash	11	2	13
Swinburne (a)	4	3	7
RMIT	9	-	9
Victoria (a)	2	-	2
Total	45	10	55

(a) University of Technology.

3.1.5 The establishment of companies is permitted by each university's enabling legislation provided the Council of each university considers that it is in the interests of the management or conduct of the affairs of the university to form or participate in a limited liability company, the aims of which are to include one or more of the following objects or purposes:

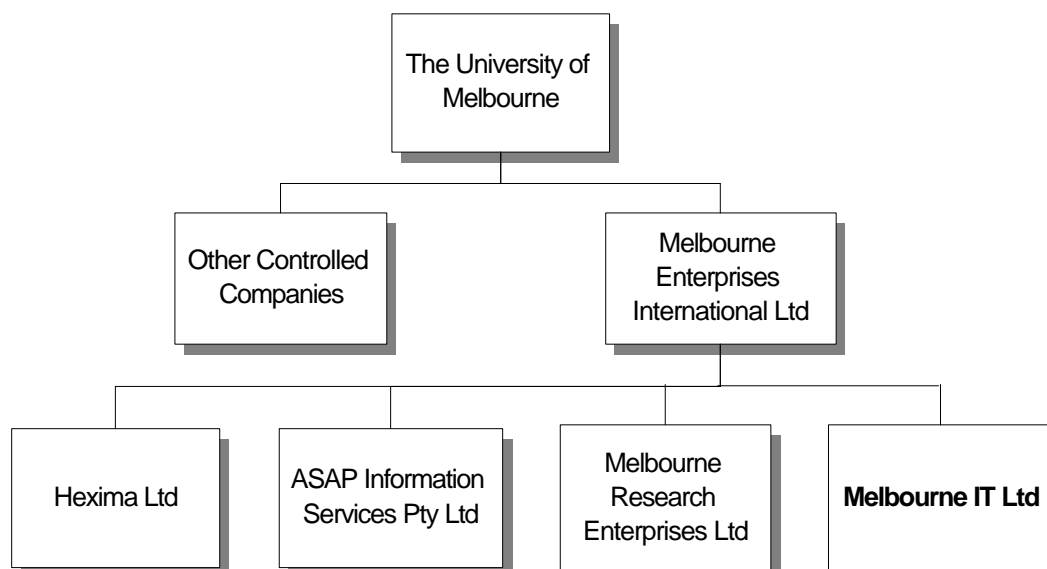
- provide facilities or services for study, research or education;
- undertake research, development, consultancy or other services for commercial organisations, public bodies or individuals;
- aid or engage in the development or promotion of university research or the application or use of the results of such research;
- prepare, publish, distribute or license the use of literary or artistic work, audio or audio-visual material or computer software;
- seek or encourage gifts to the University or for University purposes; and
- promote or assist drama, music, or the visual arts.

3.1.6 Each university's enabling legislation requires a university to notify the Minister of Education within 30 days after the formation of a company of the name of the company and the reasons why the University Council decided that the formation, participation or membership of the company was required.

3.1.7 The legislation nevertheless does not require universities to advise the Minister of the:

- sale or substantial divestment of an interest in a subsidiary established by the university; or
- formation of further companies by university subsidiaries.

3.1.8 Not only has the number of companies established by universities grown over recent years, the company structure within some university frameworks has become very complex. As an example, as at 30 November 1999 the company structure of The University of Melbourne (herein after referred to as Melbourne University) comprised:



3.1.9 Some of these companies, such as Melbourne Enterprises International Ltd are designed to exploit the intellectual property generated by the University to bring ideas and research to the stage where a commercial product can be developed.

Formation and float of Melbourne IT Ltd on the Australian Stock Exchange

3.1.10 Melbourne Information Technologies Australia Pty Ltd was incorporated as a proprietary limited company on 22 April 1996, through the issue of 350 000 ordinary shares at \$1 each to Melbourne Research Enterprises Ltd, a wholly-owned subsidiary of Melbourne Enterprises International Ltd, which in turn is a wholly-owned subsidiary of Melbourne University. As a result of an internal corporate re-organisation, Melbourne Research Enterprises Ltd ceased operating on 1 January 1999 but continued to act as a shell company. All of its assets and liabilities, including the shares in Melbourne Information Technologies Australia Pty Ltd, were transferred to Melbourne Enterprises International Ltd (MEIL), which operates as the University's commercial arm.

3.1.11 Melbourne Information Technologies Australia Pty Ltd was converted to a public company and its name was changed to Melbourne IT Ltd (Melbourne IT) on 20 October 1999 with its share capital increased to 50 million shares. For the sake of simplicity we will refer to Melbourne IT even though some events that we discuss later in this Report occurred while the company operated under the former name, Melbourne Information Technologies Pty Ltd.

3.1.12 Melbourne IT's core business, conducted through its trading division - Internet Names World Wide (INWW), is the supply of domain names or "internet addresses" for individuals and businesses in Australia and overseas. The company is the only issuer of .com.au names in Australia. It also registers .com and other generic domain names worldwide.

3.1.13 The company is also strongly involved in research and the development of new technologies to help businesses throughout Australia that are seeking to improve their operations with the assistance of telecommunications and associated tools such as the Internet.

3.1.14 Melbourne IT's core business originated from obtaining a 5 year licence in October 1996 to register domain names in Australia. This licence was one of only a limited number of licences held worldwide and had been originally obtained in 1989 by a computer systems administrator employed by the University. Up until 1996, this employee was personally responsible for registering all domain names on the Internet in Australia. This task was performed by the employee on a voluntary basis with recoupment only of his direct costs incurred. Eventually, due to increasing demands and a backlog of registrations the employee delegated his licence, on a non-exclusive basis, to Melbourne IT.

3.1.15 Subsequently, the company developed exclusive software of a world class standard whereby registrations could be undertaken within minutes as compared to the previous system whereby registrations could take days or even weeks to process. In April 1999, Melbourne IT won the right to issue global domain names as one of only 5 companies in the world entitled to perform this task under authority from the International Corporation for Assigned Names and Numbers (ICANN).

3.1.16 The large increase since 1996 in public and business demand for the Internet and the company's services eventually led to a situation by mid 1999 whereby the continued ownership of the company by the University was inhibiting the growth of the company. At that time, a minimum of \$5 million was seen as being required for the next stage of the company's commercial development. A number of options were considered for raising additional capital and eventually publicly listing the company on the Australian Stock Exchange was chosen as the best option.

3.1.17 Melbourne University Council approved the public float of the company on 1 November 1999. The University's Finance Committee advised that a due diligence process had been properly conducted by MEIL and that the float had been fully underwritten.

3.1.18 Melbourne University, through its subsidiary Melbourne Enterprises International Ltd (MEIL) retained 7 500 000 shares representing 15 per cent of the issued capital of Melbourne IT. The remaining 42 500 000 shares were offered for sale at \$2.20 per share through its broker who acted both as broker and underwriter for the float. In turn the broker assigned 14.53 per cent of the shares to a secondary broker for disposal mainly as retail sales to the public on the Internet. **The offer was fully subscribed, resulting in net proceeds to MEIL of around \$78.4 million, after expenses and the retention of \$7.5 million by Melbourne IT for working capital purposes.**

3.1.19 Table 3.1C details the allocation of proceeds from the sale.

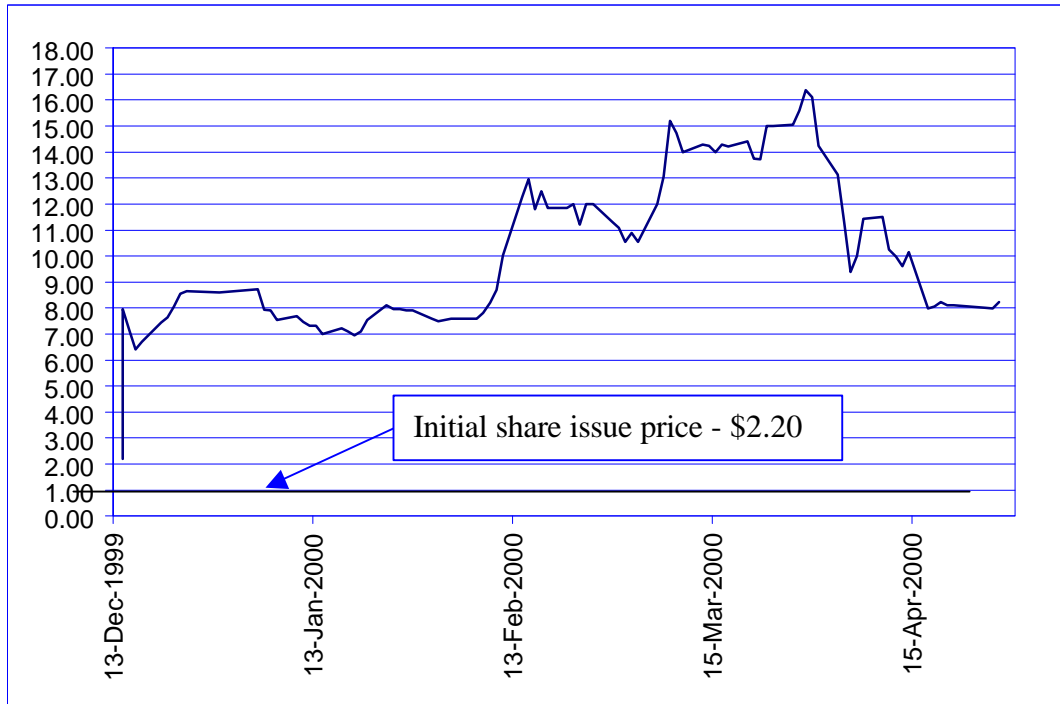
**TABLE 3.1C
PROCEEDS FROM SALE OF 85 PER CENT
OF THE EQUITY IN MELBOURNE IT**

42 500 000 shares @ \$2.20 each		\$93 500 000
Less expenses incurred -		
Underwriting commission	\$2 926 504	
Advisors to the float, including legal & financial advisors	\$2 932 950	
Payments to Melbourne IT executives, including on-costs	\$1 593 750	
Other expenses	\$178 468	\$7 631 672
Net proceeds available to The University of Melbourne and controlled entities		\$85 868 328
Distributed as -		
Grant of additional working capital to Melbourne IT		\$7 500 000
Balance of proceeds retained by MEIL		\$78 368 328

3.1.20 On 14 December 1999, the opening day for the shares on the Australian Stock Exchange, around 28 per cent of the company's share capital was traded, with the shares issued at \$2.20 opening at \$8.20, reaching \$9.10 and finally closing at \$7.95. Since the initial listing, the value of the shares peaked at \$17.00 on 29 March 2000 and, at the date of preparation of this Report, viz April 2000, were trading at around \$8.25.

3.1.21 Chart 31D illustrates the fluctuations in the closing share price that have occurred between the day of the float, viz 14 December 1999 and 28 April 2000.

**CHART 3.1D
FLUCTUATIONS IN CLOSING SHARE PRICE OF MELBOURNE IT
ON AUSTRALIAN STOCK EXCHANGE, BETWEEN
14 DECEMBER 1999 AND 28 APRIL 2000
(\$)**



3.1.22 Melbourne IT was one of the largest companies ever to be developed by an Australian University, and the first company owned by a Victorian University to be floated on the Australian Stock Exchange. The float also had the distinction of recording the second largest first day percentage gain ever recorded on the Stock Exchange.

3.1.23 The floating of State-owned companies within Victoria is uncommon, with virtually all privatisation of government companies that has occurred to date involving trade sales, often to overseas interests. Because of this, there is very little documented guidance to help public sector entities manage these infrequent transactions.

3.1.24 In these circumstances **it is incumbent on those agencies to seek advice not only from those in the private sector familiar with managing floats, but because Melbourne IT was a public sector body, guidance should perhaps have been sought from the Department of Treasury and Finance which has had wide experience with privatisations.** MEIL considered it had no alternative but to seek expert advice from the private sector on the processes to be adopted.

Role of Melbourne University

3.1.25 The composition of the Council of the University is purposely designed to represent various interest groups within the community such as the Government, students, business community, professionals and academics. By comparison with a company Board, the Council has vastly different aims for achieving a wide-ranging set of objectives and would not in its normal experience be familiar with managing projects of this nature.

3.1.26 The University recognised that in general it lacked the necessary high level commercial expertise for the oversight of the float and given these circumstances, after the receipt of legal advice, it assigned responsibility for the float to the Board of MEIL which the Council considered had commercial experience.

3.1.27 The Council also delegated responsibility to its Finance Committee to ensure that the Directors of both MEIL and Melbourne IT carried out a thorough investigation and adopted proper processes in respect of all aspects of the float, in particular, the due diligence process. This was achieved through MEIL providing regular reports along with recommendations to the Finance Committee. In addition, the Vice-Chancellor of the University and the Vice Principal (Corporate Services) were also members of the Board of MEIL.

3.1.28 To avoid the University incurring any liability, the University Council received legal advice that it should not be seen to take part in the float process and in particular, to avoid being regarded as a “*promoter*” in terms of the prospectus. Consequently, the Council, having approved the float and the retention by MEIL of 15 per cent of the shares in Melbourne IT, avoided any further involvement in the float.

3.1.29 To further “*quarantine*” the University from any potential liability arising from the float, Melbourne IT secured a *Directors and Officers Liability* insurance policy that insured against any liability arising from the prospectus in respect of directors and company officers for both MEIL and Melbourne IT, up to a limit of \$85 million. In the event of this policy proving to be inadequate, the Directors of MEIL sought a further indemnity from the University. Subsequent legal advice obtained by the University indicated that the University had no power to grant an indemnity to these Directors, even if it wanted to. To overcome this issue, MEIL was authorised by the University to retain up to \$5 million in a separate fund in order to meet any obligations in respect of any liabilities arising from the float. Further, Melbourne University secured an additional offshore *Directors and Officers* insurance cover of up to \$35 million for the directors of MEIL. In view of the combined insurance arrangements providing a total cover of \$120 million for any liability arising from the prospectus, MEIL granted indemnity to the directors of Melbourne IT in respect of any prospectus liability.

3.1.30 **Although it did not have any direct involvement, the University was the ultimate shareholder of Melbourne IT, its Council did approve the float and it was the ultimate beneficiary of the proceeds from the sale which are to be applied for University purposes.**

3.1.31 We obtained legal advice on whether, in the event of a defect in the prospectus and the insurance arrangements proving to be inadequate, the University would become liable under Corporations Law for any losses incurred by shareholders in Melbourne IT.

3.1.32 The legal advice obtained centred on whether Melbourne University could be described as a promoter of the float. The advice was inconclusive on this point in that, although the University could probably establish that it was not a party to the preparation of the prospectus, its position as ultimate shareholder may make this a point of debate. A precedent was quoted in respect of a 1952-53 High Court decision whereby it was held that persons who left it up to others to set-up a company on the understanding they will also profit, may become promoters. The advice further stated that a dissatisfied shareholder could also issue proceedings under the provisions of the *Trade Practices Act* or the general laws of negligence against Melbourne University. The outcome of such actions would depend on whether Melbourne University could establish it was not a promoter.

3.1.33 **It is critical that the legal position of Universities or other public entities privatising companies they own by means of public floats is clearly established, both in the interests of shareholders and the State, which may be expected to ultimately bear the cost of any losses incurred.**

Role of Melbourne Enterprises International Limited (MEIL)

3.1.34 As previously mentioned, the University Council assigned the responsibility for the float to its subsidiary, Melbourne Enterprises International Ltd which owned all the shares in Melbourne IT. The assignment carried the specific responsibility for MEIL to:

- Maximise the value to the ultimate shareholders, namely the University of Melbourne;
- Provide the University Council with a recommendation as to whether a float was in the best interests of MEIL and Melbourne IT. This recommendation was to be supported by a thorough report detailing all aspects of the investigation, evaluation and due diligence processes leading to the decision; and
- Ensure that the processes adopted by MEIL met all the criteria of probity, validation and corporate good practice.

3.1.35 In undertaking the above task extensive use was made of external advisors. Specifically, the MEIL Board arranged for the appointment of the following:

- Lead Advisor – advice on overall float strategy, including timing and planning, negotiate with the underwriters/brokers on the pricing, terms and marketing of Melbourne IT's shares;
- Business Advisor – advice on structure of Melbourne IT (including which business units to include in the listed company), market outlook, competitive position and material for inclusion in the prospectus and provision of a commentary on a valuation range for the respective business units of Melbourne IT;

- Legal Advisor – advice on all legal matters relating to the float, chair the Due Diligence Committee, co-ordinate the verification of the prospectus and lodge all necessary documentation with the Australian Stock Exchange and the Australian Securities and Investment Commission;
- Investigating Accountant – advice on Melbourne IT’s accounting system, internal controls and the verification of financial information in the prospectus;
- Tax Advisor and Auditor – advice on all matters involving tax issues associated with Melbourne IT; and
- Underwriter and Lead Manager (hereafter referred to as the broker) – advice on market perceptions, recommend pricing and valuation of Melbourne IT and to co-ordinate the selling effort of Melbourne IT. In this later regard a secondary broker was appointed to assist the lead broker.

3.1.36 The duties assigned to the respective advisors as outlined above were detailed in a Due Diligence Report to the Directors of Melbourne IT and MEIL dated 25 October 1999. The broker who was appointed to the role of underwriter advised my Office that it was not part of their underwriting agreement to recommend pricing and valuation of Melbourne IT. Their role was confined to marketing the float and acting as underwriter.

3.1.37 In addition to advice and associated reports received from the various advisors, the MEIL Board also considered numerous other matters including the merits of whether MEIL Directors and staff should receive firm allocations of shares.

3.1.38 As MEIL is a company limited by guarantee, it is prohibited under the *Corporations Law* from paying a dividend to Melbourne University. We were advised by Melbourne University that in order to comply with this requirement, it was necessary for MEIL, from the net float proceeds of around \$78.4 million, to make a donation of \$50 million to the University. MEIL retained the remaining \$28 million to expand its business activities and if required, to defend any legal action associated with the float.

Valuation of Melbourne IT shares

3.1.39 Setting an appropriate share value prior to a float is a very difficult but critical process in that if shares are underpriced, a loss of potential maximum proceeds to the vendor will result. Given that Melbourne IT was underwritten at a value of \$110 million, equating to \$2.20 per share prior to floating on the Australian Stock Exchange in December 1999, and is now valued based on current share prices around \$350 million, the question arises as to whether the issue price of the shares was too low, particularly given that the shares traded at \$8.00 on the first day of trading and have broadly maintained this value since that date.

3.1.40 In broad terms, Melbourne University’s subsidiary, MEIL, received a net return of around \$78.4 million for disposing of 85 per cent of the share capital of Melbourne IT. This 85 per cent is now valued by the market some 5 months later at around \$350 million.

3.1.41 Once the decision was made by MEIL that floating shares in the company offered the potential for the best return to Melbourne University, expressions of interest to act as broker and underwriter were sought from 5 major stockbroking firms. The preference of the MEIL Board was that the firm appointed as broker would also underwrite the issue, given that Melbourne University did not wish to expose itself to any risk associated with the float.

3.1.42 Four firms responded to the above invitation, with the successful broker being chosen mainly on the basis of a background history of undertaking successful floats, lower fees and a willingness to underwrite the float at a figure greater than that proposed by the other brokers. The acceptance of the brokers offer was conditional on another broker, who also tendered, being assigned up to 15 per cent of the stock on the strength of their ability to generate retail sales to the public on the Internet.

3.1.43 It is understood that MEIL considered marketing the float to a larger number of retail investors, including fund managers. However, this process did not proceed due to a perception by MEIL that Melbourne University's reputation could suffer if the float proved to be unsuccessful.

3.1.44 Of the remaining 2 firms that were unsuccessful, one of the firms suggested an indicative valuation of Melbourne IT at between \$58 million and \$78 million based upon very limited financial information. The firm added that the prospects for Melbourne IT were strong and, if it were to be marketed mainly to the retail sector, then a value in excess of the above range might be achievable.

3.1.45 The appointed broker advised MEIL in August 1999 that in the absence of detailed information, it could not provide a firm valuation on the worth of Melbourne IT. However, based upon a number of approaches, including a discounted cash flow methodology, it estimated that the company's worth could be around \$95 million.

3.1.46 MEIL's business advisors, a leading international firm, later in September 1999 provided commentary on the float value of \$95 million proposed by the broker. The firm indicated that use of the discounted cash flow methodology, which was common in many floats to determine share valuations, was not necessarily relevant to internet companies as it may understate their value. The firm acknowledged the extreme difficulties faced in valuing such companies but suggested that its value could be as high as \$190 million were it to be listed on the NASDAQ market. However, the firm emphasised to MEIL that it was not qualified to provide a firm valuation nor did it attempt to independently verify financial information upon which it relied to provide the estimate of value. No action was subsequently taken by MEIL to obtain an independent valuation for Melbourne IT.

3.1.47 **The failure of MEIL to obtain an independent valuation of Melbourne IT was a significant deficiency in the float process, in that a valuation would have provided a benchmark against which proposals from brokers and underwriters could have been better considered.**

3.1.48 At a joint meeting between the Directors of MEIL and Melbourne IT on 3 November 1999, the broker advised that approximately 50 per cent of the stock was to be made available to institutional investors and that marketing efforts were underway. Of the stock available to retail investors, 65 per cent of the remaining 50 per cent of the shares was to be available for the broker's clients and 35 per cent for clients of the secondary broker.

3.1.49 **The broker appointed by MEIL acted in the dual role of being both the broker, involved in marketing the shares, and the underwriter for the float, with the obligation of buying any unsold stock. Although this arrangement is normal practice within the stockbroking industry, we consider there is a risk in this dual role in that the price for the shares could be set at an attractive level to cover the underwriting risk. To offset such a risk, MEIL through its lead advisor should have obtained an independent valuation of Melbourne IT in order to assess the adequacy of the \$110 million float value. Although MEIL, through its business advisor, was provided with a range of potential market values based on various methodologies, this evaluation did not constitute an independent authoritative valuation.**

3.1.50 Prior to the underwriting agreement being entered into, the broker actively marketed the float to institutional clients, but less than half the clients responded to the offer, with a particularly poor response from large institutional investors. Interest from institutional investors was critical to the success of the float given that 50 per cent of the shares were allocated to this sector. In view of the reaction to the float from institutional investors, the broker initially offered to underwrite the float based on a valuation of \$90 million.

3.1.51 MEIL expressed reservations about this offer and eventually on 29 October 1999 the underwriting offer was raised based on a company value of \$110 million, equating to \$2.20 per share. The broker further advised MEIL that they were of the view that if the float offer price was increased further, this would lead to such a significant reduction in institutional demand that the float would be unable to proceed. There were also serious concerns expressed regarding offering shares to retail investors, should the company be valued higher than \$110 million.

3.1.52 Although the broker was firm that they regarded a float value of \$110 million as commercially reasonable, they also added that equity markets were very volatile and it could not be certain that the Melbourne IT shares would not list at a premium or even a very large premium, or that the shares would not fall below the offer price.

3.1.53 The underwriting offer of \$110 million was accepted by the Directors of MEIL and Melbourne IT on 3 November 1999. **It should be noted that the broker did not value Melbourne IT, but rather advised MEIL of the maximum extent to which they were prepared to underwrite the share issue.** We understand that this amount was arrived at on the basis of information contained in the prospectus, equity market pricing parameters, feedback from a range of institutional investors and the broker's assessment of the longer term prospects of Melbourne IT.

3.1.54 We were advised by the broker that although the \$110 million float value was firm, based on commitments given by institutional investors and their market assessment at the end of October 1999, in the event that MEIL decided to update market forecasts in a new prospectus they were prepared to reconsider their float valuation of \$110 million.

3.1.55 In essence, MEIL had the alternative of either accepting the underwriter's offer or postponing the sale. The broker had advised that they would not underwrite a share offer in excess of \$110 million. In addition, if the forecasts in the prospectus were to be updated, this was to include a projection in respect of the year ended December 2001. Given that Melbourne IT was still establishing itself on the world market, a forecast 2 years in advance would have been highly speculative. This factor, in conjunction with the uncertainty about the ongoing authority to register .au domain names as referred to in the prospectus and a chance that internet shares may fall in value by the time a new float could be undertaken, possibly at the earliest in May 2000, led to acceptance by MEIL that the float should proceed as planned in December 1999.

3.1.56 In the light of the above experiences, we consider that in any future floats of public assets such as university companies, consideration should be given by both Government and public sector agencies to the following:

- independent expert valuations should be obtained of the worth of companies to enable benchmarks to be available when determining an appropriate float price;
- establishment of an independent panel of external experts and industry representatives that could advise government and agencies on best practice in this area;
- where it is difficult to determine a valuation for companies, especially Internet companies, a range of sale mechanisms be considered with a view to maximising competitive demand for shares; and
- using the experiences of MEIL in undertaking this float to assist in the formulation of guidelines for any future floats of public sector companies.

Consideration of alternatives to floating of Melbourne IT

3.1.57 As an alternative to floating a company on the Australian Stock Exchange, other sale methods are available:

- management buy-out;
- trade sale; and
- book building.

3.1.58 The extent to which the Directors of MEIL and Melbourne IT considered these alternative methods with a view to maximising proceeds to the University was examined, as outlined below:

- **Management Buy-Out**

In the early stages of the operations of the company in September 1998, MEIL received a management buy-out offer from employees of Melbourne IT of \$500 000. Although this offer was not seriously considered by MEIL, it did provide the catalyst for Melbourne University to seriously consider the future of Melbourne IT.

- **Trade Sale**

Most privatisations that have occurred in the Victorian public sector have involved the direct sale of State-owned businesses to other businesses, usually privately-owned. Trade sales also include joint ventures and part sales.

A trade sale was considered, but the greatest difficulties were: a limited buyer market and the determination of a fair valuation for the company. Ultimately, in conjunction with extensive expert advice, a float was seen as the best method of obtaining optimal value. The Boards of MEIL and Melbourne IT were advised by the Melbourne University Finance Committee to this effect on 6 September 1999.

- **Bookbuilding**

Bookbuilding is an alternative method of floating a company whereby once the volume of shares on offer is determined, expressions of interest are sought from investors as to volume of shares and purchase price they would be prepared to pay within a defined price range. Based upon the response received, a share price can then be determined which would reflect both investor demand and stock market movements.

As referred to earlier in this Report, in recognition of the extreme difficulty in placing a valuation on Melbourne IT, one of the unsuccessful brokers along with MEIL's business advisor to the float, suggested that bookbuilding could be used to determine a share price. The appointed broker also suggested to MEIL that an institutional bookbuild "*would be appropriate if price maximisation was the key objective*". However, the firm outlined some of the disadvantages of bookbuilding and suggested that, depending upon potential institutional demand, a fixed price offer instead of a bookbuild may provide a better overall result. In addition, fixed price offers were seen as lending themselves more readily to underwriting rather than bookbuild offers which are not underwritten. The broker did not influence MEIL in its decision, but restricted their comments to outlining the advantages and disadvantages of bookbuilding.

Although the Directors of MEIL considered the bookbuild alternative, it decided that adoption of this approach would not have guaranteed a successful float of the company.

It is speculative as to whether bookbuilding would have produced a higher share price for Melbourne IT, even after taking into account the high level of demand for internet stocks in late 1999. However, given that demand from institutional investors as identified by the broker was relatively modest around October 1999, the decision to float the company at a fixed price which was underwritten was understandable. This decision also reflected a sense of conservatism on behalf of the boards of both MEIL and Melbourne IT in that if a float failed due to setting a speculative share price that may not have been supported in the longer term, the reputation of the University could suffer.

3.1.59 In any future floats of public sector companies, the use of the bookbuilding method in fixing a share price should be seriously considered, as it may be a better indicator of market demand and therefore price for the share offer, due to the creation of competition between institutional investors and retail investors.

Share price subsequent to issue of prospectus

3.1.60 We attempted to determine some of the reasons for the sharp increase in the price of Melbourne IT shares since the issue of the prospectus on 3 November 1999, offering shares at \$2.20 compared to the peak price of \$9.10 on the Australian Stock Exchange when first listed on 14 December 1999. Although there is usually an expectation that shares will list at a premium on the secondary market, the fact that this first day listing was the second highest percentage gain in the history of the Stock Exchange raised questions as to whether the shares were undervalued. We acknowledge that where shares list at a high premium this does not necessarily mean that a float could have been successfully undertaken at a higher value.

3.1.61 Neither MEIL or Melbourne University could attribute the increase in share value to any specific factors other than a sudden increase in interest by investors in Internet stocks. In addition, Melbourne IT had a major advantage over other Internet stock issues in that it had a strong and expanding cash flow and was trading profitably. In particular, by November 1999, there had been a strong increase in Melbourne IT's sales of top level internet domain names, such as those ending in .com, in the United States and Europe. The company had established itself as one of a very small number of global market leaders in domain name registrations.

3.1.62 Factors identified that might also have contributed to the sudden increase in share value were as follows:

- On the 7 November 1999, after the issue of the prospectus on 3 November 1999, Melbourne IT entered into a one year contract, with options for extension for a further 2 years, with a large United States-based software house, INTUIT, to supply the firm with generic top level domain names (gTLD) in bulk. This was the first gTLD name contract entered into by Melbourne IT. This contract was not announced to the Australian Stock Exchange until 10 December 1999. In this announcement, the company was not named and the announcement was regarded by the Stock Exchange as "*not market sensitive*", in that the shares had not been listed at that stage.

It was not until 9 February 2000, that the Stock Exchange in a "*market sensitive*" announcement, advised that the company had entered into a significant contract with INTUIT, a company that provides financial management software to over 3 million businesses in America. Domain names could be provided to those businesses as a result of the contract with Melbourne IT. The market re-action was that shares in Melbourne IT rose 58 per cent over the following few days of trading.

Although the INTUIT contract was signed on 7 November 1999, the Due Diligence Committee concluded that this event was not material and did not need to be included in a supplementary prospectus. Reasons given for this approach were that the impact of the contract on domain names sales was unclear as was the impact on the costs, profit margins and structure of Melbourne IT.

By the time of MEIL's announcement of the contract to the Stock Exchange on 10 December 1999 all shares had been allocated, therefore leaving the secondary market to judge the value of the shares.

In our opinion, the December announcement of the contract, albeit of a “not market sensitive” nature, would have provided a stimulus in demand for the shares when listed on 14 December 1999.

- On 6 December 1999 Melbourne IT entered into a contract with VERIO INC., the world’s leading website hosting company which manages over 525 000 sites world-wide. Under the contract, Melbourne IT was to provide bulk numbers of gTLD names over a 2 year period. This contract was regarded as significant in that, in addition to the revenue stream it generated, Melbourne IT would establish itself in the United States of America as a significant domain name registration service provider.

Melbourne IT, with the knowledge of MEIL, directed its broker to provide a firm allocation of 2 450 000 shares to the company. Despite entering into this new, very significant contract, the announcement by the Stock Exchange on 12 January 2000 which named the contract with VERIO INC. was also classified by the Stock Exchange as “not market sensitive”.

The broker advised MEIL on 29 October 1999 that they were of the view that successful conclusion of the VERIO contract would not impact on the valuation of Melbourne IT, but merely confirmed the underwriting amount of \$110 million.

3.1.63 The Due Diligence Committee took the view that although the entering into of these 2 contracts did not justify a supplementary prospectus, it was appropriate that the contracts be disclosed to the Stock Exchange on the 10 December 1999 for the purpose of secondary trading, in that the market should be provided with further information that was not able to be included in the prospectus.

3.1.64 We believe it is highly likely that the secondary market viewed these contracts as adding value to Melbourne IT, and investors were prepared to pay a higher premium for the shares as a result.

3.1.65 As previously mentioned, there was increasing interest in technology and internet stocks towards the latter part of 1999. As an example, between late October and mid-December 1999, the share price of Network Solutions, the world’s leading domain name registrar, more than doubled over those 2 to 3 months. The momentum from such factors would also have contributed to the large increase in the share price of Melbourne IT on the secondary market.

3.1.66 The revenue forecasts contained in the prospectus were compiled prior to the finalisation of the above contracts and therefore did not reflect any benefits that might have flowed from the consummation of these 2 significant contracts. Although serious consideration was given by MEIL to deferring the float in order to update market forecasts and potentially raise the issue price for Melbourne IT shares, no action was taken, primarily as the underwriter was not willing to underwrite a higher valuation of the company at that stage based on prospectus forecasts, together with some uncertainty as to whether the rapidly increasing number of domain name registrations could be sustained in the long term. As a consequence, those shareholders who were successful in being allocated shares, stood to make large windfall gains as a result of the secondary market placing a very high premium on the shares and the value of the company.

3.1.67 In essence, the share price of Melbourne IT was determined in October 1999 when it was made very clear that the broker, based on existing commitments from Institutional investors, would not underwrite the float for more than \$110 million. There was also some nervousness in the stock market that internet stocks were inflated and the Directors of MEIL and Melbourne IT were anxious to list the company as soon as possible. As referred to in the prospectus, there were also a range of risk factors to be considered in the future. While domain name registrations can increase in volume, the introduction of competition and discounting of registration fees could lead to profit margins falling.

3.1.68 MEIL further advised my Office that unless the float proceeded in December 1999, there was a strong possibility that key Melbourne IT staff would have left the company given that there had been an assurance that they would be rewarded, by participating in equity, for their efforts in building up the company.

3.1.69 Once the decision was made to float the company and expressions of interest were sought from brokers and underwriters on 6 August 1999, this was seen as a commitment by MEIL to Melbourne IT to float the company prior to Christmas 1999. The value of Melbourne IT was also seen as what Melbourne University could get for it, which translated to the price for which an underwriter was prepared to accept, that was \$110 million. Despite, what we considered were indicators that the market would have valued the company much higher prior to the float if updated market forecasts had been made, MEIL was not prepared to pursue this avenue, having to trade off the potential gain it might have achieved out of the delay of the float against the range of risk factors it could have faced as outlined earlier. **The published results of Melbourne IT for the period ended 31 December 1999 provide evidence of an earnings capacity far beyond the level stated in the prospectus. Revenue was 19 per cent higher than forecasts. The reported revenue of Melbourne IT for the first quarter of 2000 increased against budget by a massive 585 per cent to \$11.3 million. This was only \$3.6 million short of the company's entire revenue for 1999.**

Allocation of shares

3.1.70 On 22 October 1999, the Directors of MEIL authorised the conversion of the 350 000 issued shares that it held in Melbourne IT to 50 000 000 shares. Of this amount, 7 500 000 shares, or 15 per cent of the capital was retained by MEIL. Accordingly 42 500 000 shares were allocated to the broker for sale. Prior to this date, on 6 September 1999 the Directors of MEIL determined that they would make no recommendations to influence any share allocations made by the broker as underwriters to the float, except for an allocation of 50 000 shares to the founding Chairman of the company.

3.1.71 The MEIL Board also determined that the secondary broker should be provided by the broker with a percentage of the allocation for issue to the retail market, especially through Internet based sales. As referred to previously, the broker had advised a joint meeting of MEIL and Melbourne IT Directors that it intended to allocate 50 per cent of the shares on offer to its institutional clients, with the remainder of the shares to be offered on the basis of 65 per cent to the broker's clients and 35 per cent to the secondary broker.

3.1.72 The prospectus stated that a proportion of the offer was to be reserved for clients of the broker and secondary broker. The prospectus did not indicate that only around 8 per cent of the 42 500 000 shares on issue would be available to the general public who were not on a broker's list. Audit understands that, of the secondary broker's allocation, around 2 million shares or 30 per cent of their allocation was offered to existing clients. The remaining 70 per cent of the shares were publicised on the Internet. Interested investors were then given a prospectus and shares were allocated on a first come, first served basis up to a maximum of 50 000 shares.

3.1.73 Share applications were to be sent either direct to the Share Registry for Melbourne IT or to either the broker or secondary broker, depending on which broker issued the prospectus. Applications received direct by the Share Registry were forwarded on to the respective broker. Once the brokers filled their respective quotas with firm applications, the Share Registry returned all subsequent applications.

3.1.74 Based upon the share register, the stock was allocated as outlined in Table 3.1E prior to the float on 14 December 1999:

**TABLE 3.1E
SHARE ALLOCATION PRIOR TO FLOAT
ON 14 DECEMBER 1999**

<i>Share category</i>	<i>Share capital</i>	<i>Percentage of capital</i>
	(\$)	(%)
Institutions	21 603 000	43.2
Broker - Private Investors	11 576 100	23.2
General Public (via secondary broker)	4 176 400	8.4
VERIO Inc	2 450 000	4.9
Secondary broker – Client Investors	2 000 000	4.0
Melbourne IT Directors & Staff	694 500	1.3
	42 500 000	85.0
Shares retained by MEIL	7 500 000	15.0
Total	50 000 000	100

3.1.75 In all, 5 312 shareholders received a share allocation of which 214 shareholders, or 4 per cent, received more than 10 000 shares. Included in this category which mainly comprised large institutions as could be expected, was one Melbourne University Council Member, one Director of MEIL, 3 advisors to the share float and at least 9 Directors and staff of Melbourne IT.

3.1.76 We were aware of some criticism in the media that very few members of the general public, including staff of Melbourne University were able to obtain shares in the float. This factor is reflected in the above table which indicates that **the general public only received around 8 per cent of the total shares allocated.**

3.1.77 Notwithstanding the above views, MEIL received net proceeds of around \$78.4 million from the float. In addition, MEIL retained 15 per cent of the capital primarily as an indication to the investing market that MEIL had confidence in the future of Melbourne IT, and to also act as a hedge against shares listing at a substantial premium, as subsequently occurred.

3.1.78 In any share allocation, and even more particularly with a public sector company, the allocation of shares must be seen as generally fair by investors. To do otherwise could reflect adversely upon any future floats. Apart from the shares allocated to VERIO, as a result of the contract between the firm and Melbourne IT which was signed on 7 November 1999, the allocation of the shares was totally at the discretion of the BROKER.

3.1.79 The Directors of Melbourne IT and MEIL were advised of the intended broad share allocations by the broker. The firm also confirmed to MEIL the desirability of issuing shares to the Directors of Melbourne IT in order to support the share value.

3.1.80 It is considered that the share processes were consistent with the normal process adopted within the stockbroking industry in relation to an underwriter making every effort to cover its risk through the full allocation of shares.

3.1.81 In the absence of any direction to the broker other than to avoid any preferential treatment of persons associated with the float, on how the shares should be allocated, for example government direction on the minimum number of shares that must be issued to the public, the only option available to MEIL was to seek to obtain the maximum return on sale.

Employee share option plan

3.1.82 In any privatisation proposal, the success of the sale is likely to depend upon the extent of goodwill, efforts and expertise of existing staff. In the private sector and particularly in high tech businesses where the element of intellectual capital is significant, it is common practice to offer employees and Directors an incentive in the form of an employee share option plan. Such plans usually provide a guaranteed allocation of shares, often at a discount price or even free, to remain with the firm.

3.1.83 **In offering such plans, public sector entities need to ensure that the share allocations, options for shares and even cash bonuses to enable purchase of shares, are not seen to be over-generous and possibly set a precedent for future floats. Such allocations also need to be balanced against the interests of private investors and in the instance of State-owned companies, be consistent with government policy or guidelines where in existence.**

3.1.84 In June 1999, MEIL was advised by Melbourne IT that it was losing key staff to private sector companies that were offering equity to employees as an inducement. In addition, Melbourne IT staff were seen as being poorly remunerated compared to industry standards and equity participation was regarded as a factor in retaining their employment.

3.1.85 Employee share option plans are permissible under Corporations Law and are relatively common in the IT industry. The prospectus disclosed that a total of 2 928 000 options or around 6 per cent of issued capital was to be made available to staff and directors of Melbourne IT. These options are exercisable over a 3 year period subject to certain performance “*hurdles*” being met after the first year of operation of the privatised company. Essentially, the share option plan enables participants to exercise their individual options to purchase a specified number of non-issued ordinary shares at the issue price of \$2.20. Depending on the extent to which options are taken up, Melbourne IT will need to increase proportionately its issued share capital of 50 000 000 shares to accommodate this plan. Table 3.1F below outlines the allocation of options over the 3 year period.

**TABLE 3.1F
ALLOCATION OF OPTIONS OVER A 3 YEAR PERIOD**

<i>Name/Group</i>	<i>Number of share options</i>
Chief Executive Officer	480 000
Chairman	69 000
Non-Executive Directors	138 000
Other Employees	2 241 000
TOTAL	2 928 000

3.1.86 In addition to the eligibility of Melbourne IT employees to exercise these options, MEIL advised the broker on 25 October 1999 that from their understanding of a likely favourable market reaction, it was left to the discretion of the firm to also allocate shares to the ongoing Directors and staff members of Melbourne IT. The allocation was to be undertaken in a manner appropriate to market expectations but to be kept within reasonable limits in order not to cause any concern that exceptional treatment occurred. **As a result of this communication, the broker allocated 694 500 shares, or around 1.3 per cent of capital, to Directors and staff of Melbourne IT, with 5 Directors receiving collectively 260 000 shares. These allocations were in addition to their entitlement to participate in the employee share option plan.**

3.1.87 One of the Directors of Melbourne IT who received share options and an allocation of 10 000 shares from the broker had originally been appointed to the Board as a representative of Melbourne University.

3.1.88 The Vice Chancellor of Melbourne University strongly expressed an opinion to MEIL on 20 August 1999 that in view of the impending float “*there should be no benefit provided to any current members of staff of the University of Melbourne, including current and/or past members of the executive, nor should there be any benefits to members of University committees, particular University departments, or any other specified entity other than the University itself*”. The Vice Chancellor, however, further stated that any share allocation decision should be made in the best commercial interests of the company to maximise its value.

3.1.89 Despite the Vice Chancellor's views, the Director benefited from the receipt of options and shares on the understanding of MEIL that to do so was in the commercial interests in Melbourne IT. MEIL also understood that the Director concerned was on the Board in his private capacity as a consultant and not as an employee of the University. In essence, the commercial interests of Melbourne IT in becoming successfully floated took precedence over the views of the Vice Chancellor of Melbourne University.

3.1.90 We accept that employee share option plans and the allocation of shares to employees and Directors is a commercial reality designed to improve share values, and that 6 per cent of capital for a share option plan is well within industry standards, however we are concerned that the views of the Vice Chancellor were not heeded at least at the point of restricting the allocation to those persons who were of critical value to the long-term success of the business. The broker confirmed to my Office that they were not made aware of the Vice Chancellor's views.

3.1.91 Melbourne University further advised that it regarded the staff of Melbourne IT as employees of the company and separate from the University, and therefore, the Vice Chancellor's comments did not apply to these staff. We question this view given that, in substance, Melbourne IT was a public asset owned ultimately by the University. Irrespective of legal form, arising from a company structure, Melbourne IT employees were employed in the public sector.

3.1.92 In 1995, a Code of Conduct for the Victorian public sector was issued by the Government. The code states that if public sector employees are involved in the privatisation of government functions, any constraints on share buying imposed by the government are to be observed at the time. On this occasion, no government guidelines had been published to avoid any conflicts of interest or substantial benefits accruing to public sector employees as a direct result of their involvement in privatisation activities.

3.1.93 The extent to which employees and Directors of an entity prior to its privatisation should benefit is a matter which needs to be resolved in the future by the government.

Reward payments

3.1.94 In addition to participation in future share options and share allocations, 4 key executives of Melbourne IT received \$1.5 million between them as reward payments in return for agreeing not to leave and subsequently compete with Melbourne IT. In respect of the Chief Executive Officer, this restriction was to apply for a period of 3 years.

3.1.95 The \$1.5 million in reward payments, which were contingent upon the float proceeding, was allocated as follows:

Chief Executive Officer	-	\$600 000
Employee 1	-	\$350 000
Employee 2	-	\$350 000
Employee 3	-	\$200 000

3.1.96 The payments were made from the proceeds of the float and were based on a recommendation from the Melbourne IT remuneration sub-committee, which was approved at a joint meeting of the Directors of MEIL and Melbourne IT on 3 November 1999.

3.1.97 Originally the payments were seen as a reward for past services by these officers due to their very substantial contributions towards establishing Melbourne IT. The payments revolved around a commitment given by a former Chairman of Melbourne IT to recognise the efforts of the staff for relatively low pay. In this regard, the staff originally sought a 30 per cent equity in the company, but subsequently reduced their demands to 20 per cent. Such a scheme became impossible due to the public float of the company and the reward scheme evolved as a form of compensation for the Chairman's earlier commitment. However, the view of the Vice-Chancellor of Melbourne University, as referred to earlier, was that rewards to staff were extremely sensitive and inappropriate. In redefining the payment in terms of compensation for restricting the individuals from competing with Melbourne IT, the payments were justified on commercial grounds.

3.1.98 **In view of the share options and share allocations also granted to the individuals involved, this was a very generous outcome in a public sector environment which could set a precedent.**

Share allocations to individuals associated with the float

3.1.99 We examined the share register subsequent to the listing of Melbourne IT on the Australian Stock Exchange on 14 December 1999. In view of the clear intention of the Vice Chancellor that persons directly associated with the float should not be seen to be benefiting from the float, the purpose of the examination was to assess the extent to which this view was complied with.

3.1.100 A common feature of floats is the preparation of, a "*Chairman's list*" of individuals or companies which the vendor believes should receive shares. Only one individual was identified for preferential treatment, namely the founding chairman of Melbourne IT, who was deemed as eligible for 50 000 shares.

3.1.101 Following representations from Melbourne IT, MEIL sought advice from the broker as to the desirability of the Directors and staff of both MEIL and Melbourne IT being seen in the market as making a commitment to the future of Melbourne IT by taking up shares. The broker advised MEIL that the allocation of the shares to employees and directors was common commercial practice. MEIL accepted the advice and the allocations were left to the discretion of the stockbrokers after MEIL requested that such individuals should not be seen as receiving favourable treatment in the number of shares allocated as compared to other applicants. There was no compulsion placed on directors to acquire shares, this decision was left to them.

3.1.102 Apart from the allocations to Melbourne IT Directors and staff as referred to previously in this report, audit identified at least 13 individuals or their spouses who received a share allocation, namely University Council Members (4), Directors of MEIL (3), staff of MEIL (2) and Share Float Advisors (4). Of these individuals, 10 persons were either clients of the broker or the secondary broker. At least 2 of the remaining persons received an allocation as a result of responding to the advertisement placed on the Internet by the secondary broker. **It was not possible to determine if shares might have been allocated to trusts and companies associated with persons involved with the float.**

3.1.103 In our opinion, it would be unrealistic to expect persons associated with the float, particularly the float advisors who received 75 000 shares, not to be aware of the market potential of Melbourne IT, which was also strongly emphasised in press articles prior to listing.

3.1.104 Notwithstanding the above view, stockbrokers have an obligation to promote new stocks to all their clients, irrespective of any client association with the vendor. It is then the client's prerogative whether to purchase the shares or not. As client files are confidential to brokers, we were not in a position to establish whether any of the above persons who were broker clients received any preferential treatment. However, any allocation the broker should have been influenced by the clear direction by MEIL that preferential treatment of persons associated with the float was to be avoided.

3.1.105 In order to avoid any potential adverse criticism of the credibility of the share allocation process for any float of a public sector company in the future, protocols need to be established to provide guidance to public sector employees as to what is appropriate in the circumstances.

Licence to register domain names

3.1.106 The licence to register domain names world-wide is the core business of Melbourne IT, with around 60 per cent of its revenue stream coming from this source. As previously mentioned, the licence under which Melbourne IT operated was originally held by a University employee who, between 1989 and 1995, registered domain names on a part time basis. Growth in demand for registrations eventually resulted in the employee delegating the administration of the .com.au internet naming domain to Melbourne IT for a 5 year period commencing 8 October 1996.

3.1.107 The authority for the employee to administer the licence in the first instance relied upon a memorandum forwarded to Melbourne University from an employee of the Internet Assigned Numbers Authority (IANA). This Authority is an American University based authority funded by the American Government which had world-wide responsibility for the Domain Name System. The Authority's functions have been progressively transferred to a new global naming body known as the Internet Corporation for Assigned Names and Numbers (ICANN).

3.1.108 The above mentioned memorandum dated 16 August 1995 from IANA confirmed that the Melbourne University employee had been given delegated authority for administering the top level Internet naming domain for Australia. We were advised by MEIL, however, that this delegation had no statutory or clear basis for legal enforcement and a legal document did not exist. This uncertainty was outlined in the prospectus.

3.1.109 To overcome the above problem, it was intended that the IANA authority held by the University employee be transferred to the au Domain Administration (auDA) in order that the validity of the authority for Melbourne IT to register domain names could be confirmed (auDA is a non profit organization established in April 1999 for the purpose of becoming the Australian Internet self-regulatory body for administering the .au namespace, including licensing the .com.au registration business). This organization will derive its authority from ICANN with the approval of the Australian Government. To date this arrangement had not been formalised but we are advised it can be expected.

3.1.110 Uncertainty over the status of the licence held by the University employee existed at the time of invitations being issued to brokers on 6 August 1999 to manage the float, and at the date of the first prospectus for Melbourne IT Ltd issued on 3 November 1999.

3.1.111 To ensure that the matter was clearly laid out for prospective share investors the Directors of Melbourne IT stated in the prospectus that they believed they had reasonable grounds for assuming that the delegation of the .au administration would be transferred from (the University employee) to either the National Office of the Information Economy (NOIE) or auDA prior to expiration of the current delegated authority in October 2001. As referred to in the prospectus, the employee had indicated that should he retain authority for administration of .au, he may not renew his delegation to Melbourne IT beyond October 2001.

3.1.112 The directors believed that this lack of clarity did not represent a material risk to the Company's operations based on their belief that the authority would be transferred prior to October 2001.

3.1.113 On 11 November 1999, a supplementary prospectus was issued by Melbourne IT informing the public that the University employee had transferred his authority to administer .com.au to auDA, but still retained his authority to administer other .au domain names. It was not clear when or if, the employee's authority to administer these other domain names would be transferred to either auDA or NOIE.

3.1.114 Despite the lack of clarity of the licensing arrangements, with the exception of the .com.au domain name, the Directors believed they adequately fulfilled their responsibilities under the prospectus on the matter. It is worth noting in passing that the major component of Melbourne IT's domain name registration activities now involve the global .com domain name which it administers under the authority of ICANN/IANA in America. Thus, as time goes by, the impact of these initial uncertainties have diminished, with the exception of the .com.au registration rights which were delegated to auDA. This organisation's authority to regulate the internet industry is yet to be confirmed by the Australian Government.

Overall summary

3.1.115 This report deals with the privatisation of Melbourne IT, a subsidiary company of Melbourne University. This company held a valuable asset, namely the delegated authority to register .com.au domain names on the Internet within Australia. In April 1999, it became one of only 5 organisations that were granted the right to register .com domain names worldwide. In essence, the company that was initially established in 1996 with capital of \$350 000, was privatised in December 1999 with some \$78.4 million being returned to MEIL and ultimately the University from the sale of 85 per cent of the shares in the company in 1999. The University's subsidiary MEIL retained 750 000 shares (15 per cent of share capital).

3.1.116 The float was managed by MEIL with the approval of the University Council as part of risk management approach which sought to minimise any risks associated with the float reverting back to itself. Expert advice was obtained by MEIL that floating the company offered the best chance of maximising the return to the University. Although the float involved the disposal of a major public asset, the Department of Treasury and Finance with substantial privatisation expertise was not consulted as part of the privatisation process.

3.1.117 A broker and underwriter was engaged by MEIL, following a competitive process. The selected broker, after extensive negotiations with MEIL, eventually agreed to underwrite the float value of \$110 million. Of the 42 500 000 shares available in the float, the same broker was also responsible for allocation of all but around 15 per cent of the shares, which were assigned to a secondary broker mainly for sale on the internet.

3.1.118 This report highlights the potential for risk of not maximising proceeds in that the broker (who was also the underwriter) effectively set the share issue price based upon the float value that would be underwritten. This is normal practice in the stockbroking industry but raises questions as to whether the share price of \$2.20 properly reflected the value of Melbourne IT and represented the best return to the University. This risk should have been offset through the obtaining by MEIL of an independent valuation of the company to serve as a benchmark for the float value.

3.1.119 An independent valuation was not obtained in respect of Melbourne IT prior to issue price being determined, with estimates rather than valuations from bidding brokers and MEIL advisors ranging from \$50 million up to \$190 million, depending on methodologies applied. Ultimately, the value of the company was fixed at \$110 million which MEIL was advised was the maximum amount for which it could be underwritten at that point in time. Faced with the alternative of either accepting the underwriter's offer based on \$110 million, or deferring the float until at least May 2000, MEIL decided to proceed with the float in mid December 1999.

3.1.120 Factors influencing the decision involved concerns about fluctuations in the value of stocks of Internet companies, a need to prepare market forecasts to 2001, the difficulty in securing an underwriter to accept an upward valuation of the company beyond \$110 million, and a strong possibility that key Melbourne IT staff would leave the company unless the float went ahead in December.

3.1.121 Share allocations, with the exception of an allocation of shares to the founding Chairman and a United States-based company which was a party to a major contract, were left to the discretion of the broker. The University's Vice Chancellor clearly stated to MEIL that persons associated with the float including Directors and staff of MEIL and University employees, were not to receive preferential share allocations. Despite this view, a number of persons in the above category did receive fixed allocations which were justified by MEIL on commercial grounds.

3.1.122 There is no doubt that the University benefited substantially from the floating of Melbourne IT. Nevertheless there are many considerations for government and public sector entities arising from the float which are outlined in this report. These considerations include risk management principles to be adopted, the need to obtain independent valuations from other parties, avoidance of any conflict of interest when persons employed in the public sector benefit from share allocations and consideration of alternative methods to floating companies to achieve the best outcome from the privatisation of public sector companies.

□ **RESPONSE** provided by Director, Higher Education Division, Department of Education, Employment and Training

The Report has raised a number of important issues which need to be considered by universities thinking of entering similar arrangements, and by the Government in framing guidelines and regulations for universities as public authorities. Issues identified by the Report will be reviewed and advice developed for Government on appropriate action.

□ **RESPONSE** provided by the Vice-Principal (Administration) The University of Melbourne

The University of Melbourne would welcome the development of guidelines for the future and notes that none existed at the time. The University understands that the Auditor-General and staff of his office were consulted during the float process concerning their role as auditor and in relation to process. No advice was provided which indicated that the Department of Treasury and Finance should be consulted about the process.

The University has members of Council and senior executives who have the commercial expertise to oversee the float, but consider it was appropriate for the float process to be handled by MEIL. The University ensured that the float process was conducted in such a manner that risks were minimized.

The University was aware that the LEK Partnership had been appointed by MEIL as a business advisor and to provide a commentary on valuation of the business. LEK have been used by both the Victorian and Commonwealth Governments for the valuation for sale of public assets such as National Rail and Australian National. LEK is not a licensed security dealer and as such their commentary on valuation of the business could not be included in the prospectus.

The University considers that the competitive tendering process with broking houses had the effect of producing the highest realistic price, thereby dealing with the conflict of interest otherwise involved in the underwriter setting the price. The only genuine price was what someone was willing to offer, through a competitive tender process, in return for assuming the risk of underwriting.

- **RESPONSE** provided by the Vice-Principal (Administration) The University of Melbourne - continued

The float of Melbourne IT Limited has provided an initial \$78.4 million to be used by the University to develop the teaching, research activities of the University, as well as to improve University programs and infrastructure in both city and regional areas of Victoria. In addition the University through MEIL retains shares in Melbourne IT valued in excess of \$50 million.

- **RESPONSE** provided by the Group Managing Director, Melbourne Enterprises International Limited

Company Structure

The Auditor-General's report characterises the structure of the University of Melbourne's commercial arm as 'very complex'. MEI believes that its corporate structure is in fact very simple and straightforward.

Melbourne Enterprises International is a tax-exempt company of the University of Melbourne. A subsidiary is established where activities are of a commercial nature, or require partners for funding or expertise. Subsidiaries like Melbourne IT are not tax exempt.

The Auditor-General of Victoria is the auditor of MEI; the management letters from the Auditor General's Office have not raised any issues in the past with this structure.

Restrictions on Growth

The Auditor-General states that The University was unable to invest \$5 million in the development of Melbourne IT. A more accurate representation of the decision process was that its commercial arm, MEI, considered it inappropriate to do so given its overall risk profile.

The Department of Treasury and Finance

The Auditor-General states in his report that it was 'incumbent' on MEI to seek advice regarding the float of Melbourne IT from the Department of Treasury and Finance, although later waters this down to a statement that such advice 'perhaps' should have been sought.

During the process of taking Melbourne IT to the market, MEI sought advice from a range of private sector advisors. MEI also consulted with the Auditor-General [and his staff]. The Auditor-General sought a copy of the prospectus prior to the float, after he was asked to give his consent to being named in the options prospectus to Melbourne IT Staff. The Auditor General questioned the number of options being offered to those staff members and reserved his right to raise the matter with the Directors. As a result, representatives of MEI and Melbourne IT met with the Auditor-General prior to the float, to discuss this and other matters raised by him at the meeting. The meeting finished after those matters were explained to his satisfaction. No advisor, including the Auditor-General and his staff, considered at the time that guidance should have been sought from the Department of Treasury and Finance.

- **RESPONSE** provided by the Group Managing Director, Melbourne Enterprises International Limited - continued

Role of the University of Melbourne

The Auditor-General suggests that the float was the initiative of the University, which then assigned responsibility for its management to MEI. In fact the initiative for the float came from the senior staff and board of Melbourne IT to the parent board of MEI, which then sought approval in principle from the Vice Chancellor of the University to proceed with the investigation of sale options, including that of a public float.

Melbourne IT Share Price

All statements in the Auditor-General's report relating to the 'current' share price of Melbourne IT need to be updated in view of the current downward trend in the share price. At its value at time the report was sent, the share price indicates a total value for the company not 'in excess of \$400m', as the Auditor-General's report states, but of \$340m. This highlights the volatility of the market for Melbourne IT shares.

The role of Professional Advisors

The section of the Auditor-General's report describing the roles of advisors to the float omits crucial sections, including:-

- *Lead Advisor- 'Negotiate with the underwriters/brokers on the pricing, terms and marketing of MIT's shares'*
- *Business Advisor- "Commentary on Valuation', which included a valuation range for each of the Melbourne IT Business Units, and a brief to make representations to the Underwriter to get "the right pricing"*

MEI believes these are important omissions, especially in view of the later criticism in the report that an additional valuation should have been sought.

Valuation of Melbourne IT shares

The section of the Auditor-General's report dealing with the question of valuation fails to reflect the discussions held and correspondence passing at the time. The broker, JB Were, had indicated that it was unwilling to underwrite the float to a level higher than \$90m. Given its understanding of the demand and the potential of the float, MEI sought additional advice on this view from the LEK Consultancy, business advisors to the company at the time, in regard to the company's value. LEK constructed a 'Commentary on Valuation' which provided a position which enabled MEI to push the price higher, using examples of other similar companies. In order to strengthen MEI's case in these discussions, the principal example used was NSI Inc - then and still world leader in the domain name registry business - which had been listed on NASDAQ for well over two years. The value of \$190m was the upper end of what Melbourne IT would have been worth if IT was the world leader, on NASDAQ, with a dominant world position. In this respect, the top of the valuation range provided by LEK was helpful as the negotiations ended up with Were's accepting a float price of \$110m.

LEK was represented on the Due Diligence Committee and as a result had access to and had to form an opinion on the financial information (both historical and forecast) that was presented and verified by the Investigating Accountant.

- **RESPONSE** provided by the Group Managing Director, Melbourne Enterprises International Limited - continued

Valuation of Melbourne IT shares -continued

The Auditor-General goes on in this section of his report to say that MEI's decision not to obtain a further opinion on value to the three it already had (Were's, LEK, Deloitte Corporate Finance) a failure of process. MEI is unaware of any public float in recent history in which the value given by the broker, tested and then essentially substantiated by the business advisor, and agreed to by the Lead Advisor to the float, has again been tested by a third opinion on value. This was not a process adopted by the State Government in the float of TAB Corp. Certainly this was not a suggestion made by the Auditor-General and his staff when discussions were held about the process on 9 December 1999. It is unclear from the Auditor-General's report what value an 'independent valuation' would have added to the process in light of the broker's clear unwillingness to raise the offer price under any conditions, and their experience, highlighted in 3.1.50 and 3.1.51, that even at \$90 million, the stock was proving difficult to sell to the institutions.

Any independent expert valuation of the type suggested by the Auditor-General would be relevant in almost all cases to "a prudent investor", - requiring inclusion in the prospectus by the Directors. Due to the liabilities of Directors and experts named in a prospectus, the valuation is going to be conservative in any initial public offering of shares.

Consideration should of course be given to what response the State should prepare itself to make if the independent expert valuation is lower than the price that an underwriter may set in a competitive bid, supported by a bull market. The Auditor-General fails to explore these and other consequences of his recommendation in this regard.

Valuation by J B Were

The Auditor-General draws a distinction between the extent to which the broker was willing to underwrite the share issue and the value of Melbourne IT. MEI is not of the view that this is a distinction with any practical significance to itself the company selling it. The LEK 'Commentary on Value', and Deloitte Corporate Finance's advice as Lead Advisor, was also instrumental in MEI's decision on the value it was prepared to accept.

The Auditor General correctly notes in paragraph 3.1.35 that the MEIL Board appointed the Underwriter and Lead Manager to advise, among other things on '... valuation of Melbourne IT.'

This advice was confirmed, in a letter dated 29 October 1999 from J B Were & Son entitled "Float of Melbourne IT Limited- Value of Melbourne IT". It is useful to consider the following extracts:-

"In our initial valuation discussions with [Melbourne IT] and representatives of LEK. and Deloitte Corporate Finance (DCF) and subsequently with you, we indicated that we would be comfortable with a figure of around \$90 million. It was our view that this would represent a fair valuation that would be accepted by a broad range of investors and analysts and, therefore, allow us to be reasonably sure we could successfully market and underwrite the issue. We also thought this valuation represented a fair balance for investors between risk and potential reward.

- **RESPONSE** provided by the Group Managing Director, Melbourne Enterprises International Limited - continued

...We would on this basis regard a float value for MIT of \$110 million as commercially reasonable today and commercially reasonably reasonable in the event of a Verio contract signing."

MEI is surprised by the Auditor-General's report that it was told by JB Were that they would under any circumstances have reconsidered their float valuation.

This statement is directly at odds with MEI's recollection of discussions between MEI and Were's at the time, and appears to contradict the statement in 3.1.55 that 'MEI had the alternative of either accepting the underwriter's offer or aborting the sale'. It also contradicted by the statement by Were's in their Valuation Letter that:-

"... Our feeling is that MIT would, in these circumstances, decide not to alter the prospectus forecasts but regard the forecasts as having been substantiated by the Verio contract.

We also note that increasing the float price at this stage would probably lead to such a significant reduction in institutional demand that the issue would be unable to proceed. We would also have serious concerns regarding offering shares to retail investors at a higher valuation than \$110 million."

The Future

MEI is of the view that it would be risky for Government to draw conclusions from the float of an internet company in the extremely volatile market of December 1999, and then apply lessons learned more generally to the sale of assets.

Market Volatility

The Auditor-General draws attention throughout his report to the rise in technology stock value during the latter quarter of 1999. He makes no reference to the subsequent fall. MEI believes this is important in the context of its decision not to try to postpone the float to March or April 2000.

INTUIT and VERIO contracts

The Auditor-General draws attention to the high volume involved in the INTUIT and VERIO contracts, but fails to mention the lower margins. It was the combination of the two which made the due diligence committee draw the conclusion that the market would be more discerning than in fact proved to be the case in their assessment of the value of these contracts. Analysts and financial reporters highlighted these issues at the briefing following the AGM of Melbourne IT on 24 May 2000. This is tangentially alluded to in 3.1.67.

Market Assessments

The Auditor-General states that 'Despite what we considered were indicators that the market would have valued the company much higher prior to the float if updated market forecasts had been made, MEIL was not prepared to pursue this avenue, having to trade off the potential gain it might have achieved out of the delay of the float against the range of risk factors it could have faced as outlined earlier. MEI is surprised by this comment, and its implication that the market indicators were clear to the Auditor-General before the float actually took place.

MEI met with its auditor, the Auditor-General of Victoria in December 1999, prior to the float. At no time during those discussions were these views on market expressed to the members of the board of MEI who then met with the Auditor-General.

- **RESPONSE** provided by the Group Managing Director, Melbourne Enterprises International Limited - continued

MEI is also of the view that any opinion as to the accuracy of the prospectus forecasts should be reserved until the end of 2000, as views on this are various and changeable. The Chairman of Melbourne IT himself is quoted in the 25 May Financial Review as having said at the previous day's AGM that: "It is still too early in the year to put a figure on a revised 2000 forecast, particularly in such an emerging market with a number of new players still establishing their positions and credentials". The article goes on to comment that; "Although Melbourne IT still expects to collect some revenue, analysts say free onsellors could reduce the overall price of domain names". Clearly it is too early to make a call on this.

Share Allocations

The Auditor-General's report refers to the absence of any direction from MEI on how shares should be allocated. In fact a detailed letter was sent by the Chairman of MEI to the broker on 25 October 1999, outlining allocation policy, requesting an allocation to the founding Chairman of Melbourne IT, and instructing the broker that no member of the staff of the University, or the staff or board of MEI, was to be given preferential access to shares. This letter was the result of considerable deliberation at board level by MEI, and it is therefore grossly misleading to refer to the 'absence of direction' in regard to allocation. This is later acknowledged in 3.1.100, and in fact reference is made in 3.1.104 to the fact that '...any allocation the broker (sic) should have been influenced by the clear direction by MEI that preferential treatment of persons associated with the float was to be avoided'.

Public Sector Employees

No members of the staff of Melbourne IT ever worked for the University of Melbourne, aside from the CEO who held a 10 per cent appointment for other duties up to six months before the float. The Company developed by reinvesting its cashflows, and from the unpaid time provided by its inaugural Chair from the private sector. The staff were not public sector employees. Melbourne IT, unlike the University and MEI was a taxpaying proprietary company. The staff did not benefit from any of the awards or entitlements available to public sector employees, and it is incorrect to refer to them as public sector employees.

Rewards to University staff

The comments of the Vice Chancellor that rewards to staff were sensitive referred to University of Melbourne staff, not staff of Melbourne IT. This section of the Auditor-General's report fails to make the important point that the payments were contingent on the float proceeding. In the context of the float, given the fact that had the four individuals referred to not been willing to stay with the company the float could not have proceeded, these were not overly generous payments. In the context of the IT industry they were in fact well below industry norms.

Shares taken up by MEI Directors and MEI staff

The Auditor-General infers that something is amiss in that four University Council members, three Directors of MEI and two staff of MEI received allocations of shares direct from the brokers. MEI suggests that these figures would probably be no different for any other major float of 1999. It would no doubt also be true of Telstra that approximately four University Council members, three Directors of MEI and two (or more) of MEI's staff were allocated shares. MEI believes that this indicates clearly that allocations were managed in a balanced way.

- **RESPONSE** provided by the Group Managing Director, Melbourne Enterprises International Limited - continued

Implications for advisors to the float

The Auditor-General writes in his report that 'it would be unrealistic to expect persons associated with the float, particularly the float advisors.., not to be aware of the market potential of Melbourne IT.'. This unhelpfully implies that the advisors to the float may have believed the pricing of the stock at listing to be inaccurate, an implication which it is to be expected that those advisors who put their names to the prospectus will refute.

Further audit comment

3.1.123 It should be noted that the Group Managing Director, Melbourne Enterprises International Limited, did not meet with me in respect of the management of the float prior to the issue of the prospectus.

FINANCIAL VIABILITY OF TAFE PROVIDERS

3.1.124 The *Vocational Education and Training Act 1990* established the State Training Board and the Office of Post Compulsory Education, Training and Employment (previously the Office of Training and Further Education) within the former Department of Education. The Office provides administrative support to the Board and is responsible for implementing any policy or decision of the relevant Minister or the Board, made in accordance with prevailing legislation. The Act also provides the framework for the establishment of Technical and Further Education (TAFE) institutes as bodies corporate with significant devolved responsibilities.

3.1.125 In 1999, 14 public TAFE institutes, 4 universities with TAFE divisions and 4 other public TAFE providers offered TAFE programs. In total, over 70 million student contact hours of government-funded and fee-for-service TAFE programs were provided to over 300 000 students.

3.1.126 In addition to the above 22 public TAFE providers, a further 900 private TAFE providers including community, industry and commercial providers, were publicly funded through contestable processes to deliver a range of accredited programs in Victoria in 1999.

3.1.127 In excess of \$500 million in government funding was allocated to public TAFE providers in 1999 to deliver agreed outputs (expressed in student contact hours), and a further \$85 million was allocated towards capital expenditure and \$3 million towards minor works and maintenance. Approximately 8 800 staff were employed by public TAFE providers as at December 1999.

3.1.128 Given the financial difficulties being experienced by a number of TAFE providers identified during audits for the years ended 31 December 1998 and 1999, we conducted a review to assess:

- the financial viability of public TAFE providers;
- initiatives taken by the Government to alleviate the financial difficulties of public TAFE providers;
- initiatives taken by TAFE providers facing financial difficulties; and
- whether the Office of Post Compulsory Education, Training and Employment undertakes adequate monitoring of public TAFE providers.

Financial viability of TAFE providers as at December 1999

3.1.129 A key indicator of an organisation's financial viability is its capacity to meet current liabilities from available current assets as and when they fall due. Accordingly, one of the measurements to determine viability is the working capital position, which compares liabilities falling due for payment in the next 12 months, such as creditors and employee entitlements, against assets that typically provide the funds to extinguish those liabilities.

3.1.130 We analysed the financial viability of all 22 public TAFE providers for the previous 3 years of operations by examining their working capital position at each year-end, together with the following 2 additional key financial indicators:

- operating results for each year, prior to grants received for capital purposes and transactions of an extraordinary nature; and
- net cash flows generated from operating activities during each of the 3 years.

3.1.131 It is acknowledged that public TAFE providers do not receive government funding for depreciation in their annual financial plans, but are still required, in accordance with applicable Ministerial Directions, not to have an operating deficit at the end of any year. We understand that the Office of Post Compulsory Education, Training and Employment, and TAFE providers interpret those Directions to mean the operating result prior to depreciation expense.

3.1.132 Although the Government adopted “accrual-based” appropriations for the year ended 30 June 1999, agreement has not been reached on the flow-on effects of particular aspects, such as the funding of depreciation, to public TAFE providers.

3.1.133 Given that the delivery of TAFE programs involves a non-current asset investment in excess of \$1.3 billion, it is important to recognise that depreciation approximates the investment required in replacements (or upgrades in the case of buildings), in order to maintain the service potential of the non-current asset base. **Only when depreciation is fully funded will there be sufficient financial capacity for the service potential of the assets to be maintained.**

3.1.134 Table 3.1G indicates the overall financial position of all public TAFE providers for the previous 3 years.

TABLE 3.1G
FINANCIAL POSITION OF PUBLIC TAFE PROVIDERS,
AS AT 31 DECEMBER (a)
(\$million)

	1999	1998	1997
Working capital position (b)	66.4	58.1	56.9
Operating result prior to: capital grants, extraordinary items and depreciation	47.6	13.6	14.5
Less depreciation	62.5	62.2	60.0
Operating (Deficit) prior to capital grants and extraordinary items	(14.9)	(48.6)	(45.5)
Net cash inflows from operating activities	32.1	18.2	18.7

(a) Based on audited financial reports.

(b) Excess of current assets over current liabilities.

3.1.135 On the basis of the 3 key indicators shown above, **overall there has been a significant improvement in the financial position of public TAFE providers, particularly between 1998 and 1999.**

3.1.136 Although there was an improvement of 14.3 per cent in aggregate working capital positions between 1998 and 1999, this indicator remains of major concern in a number of TAFE providers. It is essential that attention be given to effective management of working capital to obviate the need for TAFE providers to seek cash flow support from the Office of Post Compulsory Education, Training and Employment to enable suppliers to be paid in accordance with government guidelines.

3.1.137 The aggregate operating deficit prior to capital grants and extraordinary items decreased by 69.3 per cent between 1998 and 1999, also representing a major improvement over this period. Furthermore, there was a major improvement in the net cash inflow from operating activities of 76.4 per cent between 1998 and 1999

3.1.138 In summary, our examination revealed that, for the year ended 31 December 1999:

- 6 public TAFE providers (27 per cent) had a negative working capital position (1998 – 6 providers; 1997 – 7 providers);
- 16 public TAFE providers (73 per cent) incurred a deficit, prior to grants received for capital purposes and transactions of an extraordinary nature (1998 - 20 providers; 1997 – 18 providers); and
- 4 public TAFE providers (18 per cent) had generated negative cash flows from their operating activities (1998 – 6 providers; 1997 – 6 providers).

3.1.139 Table 3.1H identifies the 6 public TAFE providers that, based on the results of our analysis, had negative working capital positions as at 31 December 1999 which may impact on their ability to meet future financial obligations as and when they fall due.

TABLE 3.1H
PUBLIC TAFE PROVIDERS WITH NEGATIVE WORKING CAPITAL POSITIONS,
AS AT 31 DECEMBER 1999 (a)
(\$'000)

<i>TAFE provider</i>	<i>Working capital position (deficit)</i>	<i>Operating surplus (deficit) prior to capital grants and extraordinary items</i>	<i>Net cash inflows from operating activities</i>
Chisholm	(8 514)	(9 495)	1 480
Northern Melbourne	(2 081)	909	720
Central Gippsland	(1 811)	(1 379)	866
Council of Adult Education	(1 023)	685	1 678
William Angliss	(609)	371	923
Driver Education Centre	(427)	(380)	136

(a) Based on audited financial reports.

3.1.140 Further comment in relation to each of the above TAFE providers follows.

Chisholm Institute of TAFE

3.1.141 The working capital position of the Institute declined in 1999, with current liabilities exceeding current assets by \$8.5 million at 31 December 1999, compared with \$6.6 million at 31 December 1998. The magnitude of the deficiency represents a major impediment to the operations of the Institute.

3.1.142 The operating deficit prior to capital grants and extraordinary items of \$9.5 million for 1999 was an improvement on the deficit of \$10.4 million for 1998.

3.1.143 The Institute's budget for the year 2000 and business plans for the years 2001 to 2003 have been established with a strong focus on growth in commercial revenues however, failure to achieve the projected financial outcomes would compound the Institute's existing poor financial position.

3.1.144 Although there was an improvement in the cash flow from operations in 1999, unpaid creditors had increased by \$1.8 million between 1998 and 1999 as a result of the failure of the Institute to pay its accounts in a timely manner in accordance with government guidelines. The Office of Post Compulsory Education, Training and Employment has advised the Institute that it will provide advance funding should the Institute experience liquidity problems during the year 2000.

Northern Melbourne Institute of TAFE

3.1.145 While this Institute had a positive working capital position at 31 December 1996, this position deteriorated over the past 3 years with the Institute having an excess of current liabilities over current assets of \$2.1 million at 31 December 1999.

3.1.146 The major reasons for the deterioration in the working capital position have been identified as the application of Institute resources towards:

- purchase of plant and equipment for the Heidelberg and Greensborough campuses and the refurbishment of other buildings totalling over \$2 million;
- organisational restructure costs of over \$1 million; and
- executive officer performance bonus costs of over \$1.2 million in 1998.

3.1.147 The operating deficit prior to capital grants and extraordinary items improved substantially between 1998 and 1999, however, this was directly influenced by the recognition of book gains associated with the transfer of \$4 million of physical assets to the Institute without consideration during the year. There was also an improvement in the cash flows generated from operating activities in 1999.

Central Gippsland Institute of TAFE

3.1.148 The general financial position of this Institute continued to improve in 1999 with the negative working capital position improving from \$2.4 million at 31 December 1998 to \$1.8 million at 31 December 1999. The extent of external loan commitments and the inability of the Institute to generate adequate cash flows from its activities will result in the working capital position remaining below acceptable levels.

3.1.149 The operating deficit prior to capital grants and extraordinary items improved by more than 10 per cent between 1998 and 1999. The Business Plan for the year 2000 anticipates a minor decline in the operating deficit position of the Institute, notwithstanding the provision of additional funding by the Office of Post Compulsory Education, Training and Employment.

3.1.150 The Institute's cash flow from operating activities further improved in 1999 and as at 31 December 1999 the Institute's cash position had sufficiently improved to enable creditor payments to be made in a timely manner in accordance with government guidelines for the first time in several years. The Office of Post Compulsory Education, Training and Employment has advised the Institute that it will provide advance funding should liquidity problems be experienced during the year 2000.

Council of Adult Education

3.1.151 The general financial position of the Council continued to improve although it had a negative working capital position of \$1 million at 31 December 1999, and had external borrowings of \$3.7 million.

3.1.152 The operating result prior to capital grants and extraordinary items improved from a deficit of \$337 000 in 1998 to a surplus of \$685 000 in 1999. The Business Plan for the year 2000 has not been finalised by the Council at the date of preparation of this Report, however, the Council's budget anticipated a minor decline in the operating position of the Council.

3.1.153 In addition, cash flows from operating activities have substantially improved from \$622 000 in 1998 to \$1.7 million in 1999.

William Angliss Institute of TAFE

3.1.154 The working capital position of this Institute improved in 1999 with current liabilities exceeding current assets by \$609 000 compared with \$1.3 million in 1998.

3.1.155 The operating deficit prior to capital grants and extraordinary items also improved in 1999, with a surplus of \$371 000 for that year compared with a deficit of \$1 million in 1998. The Institute anticipates further improvement in the year 2000, generated particularly from commercial activities.

3.1.156 Notwithstanding the improvements indicated above, the cash flow from operating activities declined from a net inflow of \$1.3 million in 1998 to a net inflow of \$923 000 in 1999.



Entrance to the William Angliss Institute of TAFE.

Driver Education Centre of Australia

3.1.157 The Centre continues to have a negative working capital position with current liabilities exceeding current assets by \$427 000 in 1999 compared with \$765 000 in 1998.

3.1.158 The operating deficit prior to capital grants and extraordinary items improved from a deficit of \$732 000 in 1998 to a deficit of \$380 000 in 1999. Further improvement is anticipated in the year 2000 generated particularly from commercial activities. In addition, the cash flow from operating activities improved from a net outflow of \$643 000 in 1998 to a net inflow of \$136 000 in 1999.

3.1.159 **In view of the continuing financial difficulties experienced by a number of public TAFE providers, the Office of Post Compulsory Education, Training and Employment needs to continue to:**

- **adopt appropriate monitoring strategies for Institutes assessed, based on the above financial indicators, as being of high risk;**
- **ensure that Institutes undertake strategic financial planning to address working capital and financial management issues; and**
- **ensure that Institutes continually re-examine business strategies so that future programs and operations are financially viable.**

Initiatives taken by the Government to alleviate the financial difficulties of public TAFE providers

3.1.160 Over recent years, the Office of Post Compulsory Education, Training and Employment has initiated restructuring of public TAFE providers aimed at ensuring an effective and efficient sector. In addition, a *Ministerial review of the provision of TAFE in the Melbourne Metropolitan Area* (Ramler review) was commissioned by the then Minister in 1997 and, following consideration of the Review Committee's recommendations by the Government, the merger of a number of Institutes was implemented during 1998.

3.1.161 More recent initiatives taken by the Government to assist public TAFE providers include:

- Provision of additional funding totalling \$6.3 million to a number of Institutes and TAFE divisions of universities in 1998 and 1999 to assist in the merger process;
- The allocation of special government grants to public TAFE providers for voluntary redundancy packages (VDPs) totalling \$10 million in 1999. As recently as December 1999, public TAFE providers were advised of further VDP funding availability of up to \$5 million to assist in the management of staffing resources arising from program profile shifts and the need to improve resource flexibility. Previous VDP allocations have included \$8 million in both the 1997 and 1998 years;
- Provision of additional financial assistance in the form of loans, advances or guarantees to several public TAFE providers in order to provide cash flow support, particularly to enable the timely payment of suppliers;
- A \$14.7 million package announced in November 1999 by the Government to assist regional TAFE institutes over 4 years and a \$10 million package to supplement the cost of apprenticeship and traineeship courses and to assist those institutes with large numbers of students eligible for fee exemption; and

- Additional allocations totalling \$104 million over 3 years commencing from 1 July 2000, announced in May 2000 by the Government. These allocations provide further funding for regional TAFE institutes, apprenticeship and traineeship programs, and provide assistance for TAFE providers with large numbers of students eligible for fee exemption, and for maintenance, plant and equipment acquisitions and VDPs.

TAFE initiatives to address financial difficulties

3.1.162 In addition to the Statewide restructuring of public TAFE providers mentioned previously, a number of public TAFE providers have also undertaken further internal restructuring of their operations and management practices without government financial assistance.

3.1.163 Over the past 10 years, public TAFE providers have sought to broaden their revenue base and reduce their reliance on government grants through the development of a wide range of fee-for-service programs and services which are delivered in Victoria, interstate and overseas, and also through other ancillary activities. In 1999, this activity generated \$162 million (22 per cent) of the total revenue of public TAFE providers, compared with \$154 million (21 per cent) in 1998.

3.1.164 However, revenue from this source involves a different set of business and operational risks compared with the delivery of agreed government-funded training programs, which are incorporated in annual performance agreements. Institutes' planning, reporting and accountability processes may not fully recognise these risks and thereby expose institutes to unforeseen costs and loss of income. **Indeed, our review has determined that the majority of public TAFE providers cannot reliably determine the profitability of such business activities.**

3.1.165 We recommend that the Office of Post Compulsory Education, Training and Employment, together with public TAFE providers, review the reporting requirements of all fee-for-service activities in order to ensure that:

- **the profitability of individual commercial activities can be reliably determined;**
- **overheads are correctly allocated to all activities; and**
- **comprehensive risk management strategies are in place which address key risks associated with this significant area of business activity.**

Monitoring by the Office of Post Compulsory Education, Training and Employment

3.1.166 Public TAFE providers enjoy a degree of devolved responsibility and independence under their constitutions and performance agreements with the Government.

3.1.167 To ensure the financial viability of public TAFE providers, the Office of Post Compulsory Education, Training and Employment actively monitors the financial performance of providers through a framework which includes:

- quarterly reporting to the Office by each public TAFE provider comprising a detailed operating statement and balance sheet, including forecasts of the year-end position;

- analysis by the Office of the annual financial statements and reports of providers, including qualitative and quantitative indicators, against performance agreements and the comparative performance of individual TAFE providers; and
- regular discussions between the Office and individual public TAFE providers on budget and performance issues.

3.1.168 A quarterly report on the financial performance of all public TAFE providers is compiled for the executive management of the Office. A report is also provided to the State Training Board, which is responsible for providing advice to the responsible Minister.

3.1.169 Where a public TAFE provider is identified as being at financial risk, the Office initiates action, which culminates in the establishment of an action plan to overcome the problems identified.

3.1.170 We noted that the quarterly performance monitoring reports have not consistently used the same assessment criteria in relation to judging the financial standing of providers. We recommend that consistent and appropriate financial performance criteria be used and that the Office determine whether the focus should be placed on the funded or operating results.

3.1.171 **We recommend that the Office of Post Compulsory Education, Training and Employment continue to maintain a robust and ongoing oversight of the financial performance of all public TAFE providers based on the consistent use of agreed assessment criteria.**

□ **RESPONSE** provided by Director, Office of Post Compulsory Education, Training and Employment

The Office of Post Compulsory Education, Training and Employment (PETE) notes that the Auditor-General has confirmed that for the year ended 31 December 1999, 6 public TAFE providers had a negative working capital position and that 16 providers incurred a deficit prior to grants received for capital purposes and transactions of an extraordinary nature.

The Office also notes the Auditor-General's finding that the Government has undertaken a range of initiatives in order to alleviate the financial difficulties of public TAFE providers, in particular the injection of additional funds as part of the 2000-01 State Budget.

The Report recognises that PETE has monitoring strategies in place and works with Institutes to assist them with strategic financial planning when necessary. The Office notes that as self-governing bodies, institutes continually re-examine business strategies to ensure that future programs and operations are financially viable. For those institutes assessed to be in significant financial difficulty, detailed monitoring strategies have been put in place by PETE which include monthly institute returns and regular discussions with institute management. The Office accepts the Auditor-General's view that these practices need to be continued and refined.

The Report further recommends that the Office of PETE, together with public TAFE providers, review the reporting requirements for all fee-for-service activities. The Office accepts the Auditor-General's view and has in hand action to implement those recommendations.

The Report also recommends that consistent and appropriate financial performance criteria be used in relation to judging the financial standing of providers. The Office accepts this recommendation.

PROPERTY MAINTENANCE AT TAFE INSTITUTES

3.1.172 The combined property portfolios of public technical and further education (TAFE) providers in Victoria comprise 927 buildings situated on 139 campuses located at 14 TAFE institutes and 4 TAFE divisions of universities. The current replacement value of these buildings is \$1.5 billion, while the average age of these buildings is around 23 years. Each institute is responsible for the management of its facilities, while the Department of Education, Employment and Training contributes funding towards the maintenance and modernisation of these facilities.

Maintenance backlog

3.1.173 Maintenance backlog arises from the deferral of maintenance tasks on existing buildings to ensure their continued safety and functionality. In 1996-97, a major *Building Standards and Condition Assessment Survey* was undertaken across all Institutes by various building consultants engaged by institutes or by in-house resources to establish an inventory of buildings and their condition. According to the Department, the data from this survey represented the first comprehensive assessment of the condition of institute buildings.

3.1.174 The survey identified that building works with a value of \$32 million were necessary to bring all buildings up to the standards required by the appropriate building regulations, and occupational health and safety standards.

3.1.175 The most recent estimate of the maintenance backlog and costs associated with annual maintenance on institute buildings is included in a document entitled *Education Asset Management Strategy 2000-2001* which was completed by the Department in February 2000, with the assistance of specialist consultants.

3.1.176 The strategy document was based on data collected by the Department from the institutes as part of the 1996-97 survey and identified an estimated deferred maintenance backlog of \$99 million. However, this estimate is unreliable as it is based on dated information.

Kangan Batman Institute of TAFE

3.1.177 The adverse impact of the failure to undertake adequate maintenance on institute facilities is demonstrated at the Kangan Batman Institute of TAFE, which through amalgamation inherited the automotive campuses at Coburg and Richmond.

3.1.178 The Coburg campus (formerly the John Batman Institute of TAFE), includes the following buildings which are currently used on a daily basis for training and which have major maintenance issues which need to be addressed:

- Building E is currently used for training in motor trimming. This building requires major maintenance works and has an asbestos roof; and

- Building H is currently used for heavy vehicle training. The front part of the building was initially designed to be 2 levels with a suspended concrete slab for the second floor, however, the second level was never built. The slab for the second floor was constructed and was sealed as a roof, however, the interior concrete ceiling has progressively eroded. We were advised that periodically the ceiling has to be tapped to dislodge loose concrete. In the rear part of the building, the roof and outer walls were constructed of corrugated asbestos, with this substance also contained in the floor tiles. We observed that the outer corrugated wall and floor tiles were in disrepair.

3.1.179 In addition, the Coburg campus has several other buildings with obvious signs of deterioration, including Building D, formerly used for automotive electrician training, which is currently only used for storage purposes as it has an asbestos roof.

3.1.180 There are visible signs on all relevant buildings at both campuses warning against working on the asbestos material. An environmental study has been commissioned by the Institute and, at the date of preparation of this Report, was in the final stages of completion. The study is expected to make recommendations which address any risks associated with these materials.



Rear of Building H.



Ceiling of Building H.



Floor of Building H.



Building D.

3.1.181 The Richmond automotive campus (formerly part of the Barton Institute of TAFE) is used daily for training and includes 2 key buildings, namely, the main complex and the automotive parts building, which have similar maintenance and roof material problems as identified in relation to the Coburg campus.

3.1.182 We were advised that, at the date of preparation of this Report, relocation of the Coburg and Richmond automotive training facilities was under consideration.

3.1.183 **Given the apparent quantum of maintenance backlog across the sector, there is a need as a matter of priority to focus on this issue to ensure that the TAFE facilities are maintained in a safe condition and are fit for their intended purpose.**

Annual maintenance

3.1.184 Cyclical and preventative maintenance are vital to ensure that buildings remain functional and safe, as well as provide a working environment that is conducive to high levels of productivity.

3.1.185 As part of our assessment of the cyclical and preventative maintenance program, we found that the management information systems utilised by institutes had varying degrees of capacity to record historical information on maintenance, upgrades and repairs, and the dates that such works were carried out. The majority of the systems also provided minimal information to facilitate the prioritisation and programming of ongoing maintenance projects.

3.1.186 Furthermore, we found that the Department does not maintain up to date information on institute buildings and their condition. For the past 3 years, it has relied on the previously mentioned 1996-97 *Building Standards and Condition Assessment Survey*.

3.1.187 Based on industry standards and the average age of institute buildings, **in February 2000 the Department prepared an Education Asset Management Strategy which estimated that building maintenance funding requirements for all institutes were in the order of \$12.6 million per annum. In contrast, State Government recurrent building maintenance funding provided between 1994-95 and 1998-99 inclusive has amounted to around \$2 million per year.** In respect of this level of maintenance funding, the Department advised that the prime responsibility for meeting ongoing maintenance costs rests with the institutes, with the Department providing an annual grant to the institutes to assist them to meet their requirements.

3.1.188 Notwithstanding the Department's advice, given the substantial assessed shortfall in funding specifically allocated to building maintenance works, there remains a need for action to address this shortfall. In recognition of this need, the recent State budget has allocated funding of \$6 million towards maintenance for 2000-01.

Modernisation program

3.1.189 In conjunction with the provision of maintenance funding, in recent years, the State and Commonwealth Governments have jointly funded a modernisation program involving additions, upgrades, refurbishment and replacements of institute buildings. Table 3.1I shows the annual level of capital funding provided by the State and Commonwealth Governments over the previous 5 years under this program.

TABLE 3.11
FUNDING PROVIDED UNDER STATE AND COMMONWEALTH
GOVERNMENT MODERNISATION PROGRAM, 1994-95 TO 1998-99 (a)
 (\$million)

<i>Financial year</i>	<i>State Government</i>	<i>Commonwealth Government</i>	<i>Total</i>
1994-95	21	72	93
1995-96	19	63	82
1996-97	34	43	77
1997-98	30	34	64
1998-99	21	41	62

(a) All figures expressed in 1999 real terms.

3.1.190 The table discloses that while substantial funding has been provided by Governments under this program, the level of contribution has progressively declined over the past 5 years.



New Arts building in St John Street, Prahran.



New Multimedia building in St John Street, Prahran.

Annual reporting of the condition of buildings

3.1.191 The *Financial Management Act* 1994 requires all public bodies to comply with the *Building Act* 1993 in relation to buildings held, and to include in their annual reports certain information in relation to building works, maintenance and condition.

3.1.192 Our review of the annual reports of the 18 institutes for 1998 identified the following areas of non-compliance with the established disclosure requirements:

- 7 institutes had not reported information on building works and maintenance;
- 10 institutes did not report on the number of buildings conforming with building standards and associated regulations or brought into conformity during the year; and
- 13 institutes did not include information on the year by which conformity with building standards and associated regulations was expected to be achieved.

3.1.193 From an accountability perspective, institutes need to ensure that sufficient information is presented in their annual reports in order to comply with the established requirements.

3.1.194 Advice received from the majority of institutes indicates that in excess of 110 buildings were brought into conformity with the building standards and associated regulations in 1998 and 1999.

Development of a departmental compliance and maintenance evaluation program

3.1.195 In recognition of the information deficiencies associated with the building portfolios of schools and TAFE institutes, the Department has commissioned the development of a comprehensive document entitled *Building Compliance Guidelines, Policies and Procedures* which will establish the framework for ensuring that new buildings conform with current building standards and associated regulations, and existing buildings are safe and fit to occupy.

3.1.196 In addition, the Department has recently let tenders to 4 building surveyor firms to undertake compliance and maintenance evaluations of all Victorian schools. In so doing, the Department will aim to achieve consistency in information gathering, which was a shortcoming of the previously mentioned 1996-97 survey. The Department has advised that it has earmarked \$1 million to undertake a similar program at TAFE institutes within 2000-01.

3.1.197 The development by the Department of the previously mentioned guidelines and the associated evaluation process are positive initiatives which, when applied to the TAFE sector, will have significant outcomes in terms of establishing a current inventory of properties and their relevant characteristics, and should facilitate from a risk management perspective, the identification and programming of prioritised maintenance and associated costings.

□ **RESPONSE** provided by Director, Office of Post Compulsory Education, Training and Employment

The Report highlights a number of maintenance and compliance issues which the Department has commenced to address through a range of strategies including the provision of additional funding for maintenance works to supplement the individual Institute allocations towards overcoming the identified requirements in the Department's Education Asset Management Strategy 2000-2010.

At the same time, the Government provided over \$6 million in the 2000-01 State Budget to help institutes meet their maintenance backlog.

The Office notes with considerable concern the comments about the Coburg campus of the Kangan Batman Institute of TAFE.

The Environmental Study commissioned by the Institute has now been received. In addition, the Institute has already received a number of occupational health and safety reports and has implemented the recommendations of those reports to ensure the safety of the users of the buildings. The Environmental Study is the subject of further urgent discussions between the Institute and the Office of Post Compulsory Education, Training and Employment and those recommendations relating to occupational health and safety issues will be implemented.

Overall, the Report confirms the direction of the strategies which have been developed in relation to maintenance issues and the establishment of consistent information data bases on individual TAFE Institute buildings.

LOSSES, THEFTS AND IRREGULARITIES

3.1.198 Table 3.1J summarises particulars of losses, thefts and irregularities, including property damage, which occurred in 1999 and were reported to my Office by entities within the Education, Employment and Training sector.

TABLE 3.1J
LOSSES, THEFTS AND OTHER IRREGULARITIES
(\$)

<i>Item</i>	<i>Amount</i>
Department of Education, Employment and Training -	
Equipment and property damage caused by fire	2 844 000
Theft, burglary and vandalism	1 447 300
Technical and Further Education Institutes -	
Thefts	19 800
Universities -	
Thefts	13 000

3.1.199 The table identifies that substantial financial losses were incurred, which resulted from numerous instances of theft and burglary, particularly relating to computers and other electronic equipment stolen from a significant number of schools throughout the State.

3.1.200 In addition, a number of fires at schools were reported by the Department of Education, Employment and Training. In the majority of cases, the suspected cause was arson and police were notified. The major instances of fire and the associated damages were:

- Swan Hill Secondary College (\$540 000);
- Northland Secondary College (\$514 000);
- Blackburn Lake Primary School (\$400 000); and
- Chandler Primary School (\$300 000).

**SCHEDULE A
STATUS OF MATTERS RAISED IN PREVIOUS REPORTS**

<i>Report</i>	<i>Subject</i>	<i>Status at date of preparation of this Report</i>
MATTERS RESOLVED OR ACTION COMMENCED		
DEPARTMENT OF EDUCATION, EMPLOYMENT AND TRAINING		
<i>Ministerial Portfolios, May 1998, pp.19-30.</i>	Recent assessments of the level of maintenance backlog in schools across the State indicates the need for expenditure of \$275.4 million over a 5 year period.	The backlog has been reduced to approximately \$137 million. However, this does not take into account any further deterioration since the previous departmental review. The Department indicated that all schools would be re-assessed in 2000.
<i>Ministerial Portfolios, May 1999, p. 19.</i>	While a target of one computer for every 5 students on average has been established for achievement by both primary and secondary schools by June 2000, the current ratio was only one computer to every 9.8 primary students in the regions surveyed by audit.	The Department advised that as at February 2000 the student to computer targeted ratio had been achieved.
<i>Ministerial Portfolios, May 1999, p. 35.</i>	In order to ensure continued training opportunities for teachers, the Department needs to reassess the annual funding rate of \$260 per teacher for professional development activities.	The Department advised that in 1999-2000, all schools will receive a base annual rate of \$263 per teacher. An additional allocation of up to 50 per cent per teacher is made based on rurality and isolation factors. Schools with 3 or fewer teachers automatically receive an extra 50 per cent per teacher. In addition, around \$4.2 million has been allocated for professional development programs to be made available to teachers in 1999-2000.
ROYAL MELBOURNE INSTITUTE OF TECHNOLOGY		
<i>Ministerial Portfolios, May 1997, pp. 33-4.</i>	A review conducted by independent consultants during 1995 identified that \$125 million of expenditure on safety, regulatory and building condition works over a 10 year period was required to bring the University's building stock to an acceptable standard. However, the University's planned maintenance expenditure was substantially less than required.	The University has advised that it has implemented a long-term program to address the issue. Funding has been provided on an annual basis to address regulatory works identified in the consultant's report. Forward budgets to 2004 project continued allocations of \$6 million per annum for these works.

SCHEDULE A
STATUS OF MATTERS RAISED IN PREVIOUS REPORTS - continued

<i>Report</i>	<i>Subject</i>	<i>Status at date of preparation of this Report</i>
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NO ACTION TAKEN

VICTORIAN UNIVERSITIES

*Ministerial
Portfolios,
May 1999,
pp. 44-6.*

Qualified audit opinions were issued on the financial reports of all Victorian universities for the year ended 31 December 1998 due to the inappropriate recognition, in their balance sheets, of an asset representing the funding they expect to receive from the Commonwealth Government by way of future annual grants which in part will be applied towards their unfunded superannuation liabilities.

Position unchanged. The financial reports of all universities were again qualified on this issue for the year ended 31 December 1999.

**SCHEDULE B
COMPLETED/INCOMPLETE AUDITS**

<i>Entity</i>	<i>Financial year ended</i>	<i>Reporting to Parliament</i>	<i>Financial statements signed by entity</i>	<i>Auditor-General's report signed</i>
COMPLETED AUDITS				
EDUCATION				
Board of Studies	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.46.</i>	4 Aug. 1999	9 Aug. 1999
Department of Education	30 June 1999	" "	22 Oct. 1999	28 Oct. 1999
POST COMPULSORY EDUCATION, TRAINING AND EMPLOYMENT				
Adult, Community and Further Education Board	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.46.</i>	28 Sept. 1999	8 Oct. 1999
International Fibre Centre Ltd	31 Dec. 1999	30 April. <i>Financial Management Act 1994, s.53A.</i>	17 Feb. 2000	22 Feb. 2000
International Training Australia Pty Ltd	31 Dec. 1998	" "	31 Mar. 2000	31 Mar. 2000
State Training Board	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.46.</i>	30 Aug. 1999	3 Sept. 1999
Victorian Tertiary Admission Centre	30 June 1999	No reporting requirements.	22 Nov. 1999	15 Dec. 1999
POST COMPULSORY EDUCATION INSTITUTIONS				
Universities and associated companies				
AMPASC Pty Ltd	31 Dec. 1999	30 April. <i>Financial Management Act 1994, s.53A.</i>	29 Feb. 2000	7 Mar. 2000
ASAP Information Services Pty Ltd	31 Dec. 1999	" "	28 Feb. 2000	4 Mar. 2000
Australian Alpine Institute Pty Ltd	31 Dec. 1999	" "	12 Apr. 2000	14 Apr. 2000
Australian International Health Institute Ltd	31 Dec. 1999	" "	18 Apr. 2000	20 Apr. 2000
Australian Music Examination Board (Vic.) Ltd	31 Dec. 1999	" "	10 Feb. 2000	13 Apr. 2000
Australian National Academy of Music Ltd	31 Dec. 1999	" "	31 Mar. 2000	7 Apr. 2000
Betec Ltd (c)	31 Dec. 1999	" "	14 Apr. 2000	18 Apr. 2000
Centre for Innovation and Enterprise Pty Ltd	31 Dec. 1999	" "	16 Mar. 2000	21 Mar. 2000

SCHEDULE B
COMPLETED/INCOMPLETE AUDITS - continued

<i>Entity</i>	<i>Financial year ended</i>	<i>Reporting to Parliament</i>	<i>Financial statements signed by entity</i>	<i>Auditor-General's report signed</i>
COMPLETED AUDITS- continued				
POST COMPULSORY EDUCATION INSTITUTIONS - continued				
Universities and associated companies				
Citytech Pty Ltd	31 Dec. 1999	30 Apr. <i>Financial Management Act 1994, s.53A.</i>	14 Apr. 2000	19 Apr. 2000
Centre for Innovation and Enterprise Trust	31 Dec. 1999	" "	16 Mar. 2000	21 Mar. 2000
Deakin University	31 Dec. 1999	30 Apr. <i>Financial Management Act 1994, s.46.</i>	22 Mar. 2000	30 Mar. 2000 (a)
Deakin Software Services Pty Ltd	31 Dec. 1999	30 Apr. <i>Financial Management Act 1994, s.53A.</i>	24 Mar. 2000	30 Mar. 2000
Hexima Ltd	31 Dec. 2000	" "	23 Mar. 2000	31 Mar. 2000
Inskill Ltd	31 Dec 1999	" "	22 Mar. 2000	3 Apr. 2000
Institute for Innovation and Enterprise Ltd	31 Dec. 1999	" "	27 Mar. 2000	30 Mar. 2000
Land and Food Services Ltd	31 Dec. 1999	" "	20 Mar. 2000	23 Mar. 2000
La Trobe International Pty Ltd	31 Dec. 1999	" "	12 Apr. 2000	20 Apr. 2000
La Trobe Mar.keting Pty Ltd	31 Dec. 1999	" "	6 Apr. 2000	13 Apr. 2000
La Trobe University	31 Dec. 1999	30 Apr. <i>Financial Management Act 1994, s.46.</i>	17 Apr. 2000	20 Apr. 2000 (a)
La Trobe University Housing Ltd	31 Dec. 1999	30 Apr. <i>Financial Management Act 1994, s.53A.</i>	13 Apr. 2000	18 Apr. 2000
Meanjin Company Ltd	31 Dec. 1999	" "	24 Mar. 2000	31 Mar. 2000
Melbourne Enterprises International Ltd	31 Dec. 1999	" "	19 Mar. 2000	11 Apr. 2000
Melbourne IT Ltd (b)	Period 1 Jan. 1999 to 10 Dec. 1999	" "	10 Apr. 2000	11 Apr. 2000
Melbourne Research Enterprises Ltd	31 Dec. 1999	" "	11 Apr. 2000	11 Apr. 2000

SCHEDULE B
COMPLETED/INCOMPLETE AUDITS - continued

<i>Entity</i>	<i>Financial year ended</i>	<i>Reporting to Parliament</i>	<i>Financial statements signed by entity</i>	<i>Auditor- General's report signed</i>
COMPLETED AUDITS - continued				
POST COMPULSORY EDUCATION INSTITUTIONS - continued				
Universities and associated companies - continued				
MUP Services Pty Ltd	31 Dec. 1999	30 Apr. <i>Financial Management Act 1994, s.53A.</i>	3 Mar. 2000	5 Apr. 2000
Melbourne University Private Ltd	31 Dec. 1999	" "	3 Mar. 2000	5 Apr. 2000
Meltech Services Ltd	31 Dec. 1999	" "	14 Apr. 2000	19 Apr. 2000
Monash - Mt Eliza Graduate School of Business and Government Ltd	31 Dec. 1999	" "	23 Feb. 2000	3 Mar. 2000
Monash International Pty Ltd	31 Dec. 1999	" "	14 Feb. 2000	6 Mar. 2000
Monash IVF Pathology Services Trust	31 Dec. 1999	" "	9 Feb. 2000	9 Mar. 2000
Monash IVF Pty Ltd	31 Dec. 1999	" "	9 Feb. 2000	9 Mar. 2000
Monash Language Centre Pty Ltd	31 Dec. 1999	" "	11 Feb. 2000	6 Mar. 2000
Monash Reproductive Pathology and Genetics Pty Ltd	31 Dec. 1999	" "	9 Feb. 2000	15 Mar. 2000
Monash Unicomm Pty Ltd	31 Dec. 1999	" "	16 Feb. 2000	3 Mar. 2000
Monash University	31 Dec. 1999	30 Apr. <i>Financial Management Act 1994, s.46.</i>	6 Mar. 2000	17 Mar. 2000 (a)
Monash Ultrasound Pty Ltd	31 Dec. 1999	30 Apr. <i>Financial Management Act 1994, s.53A.</i>	9 Feb. 2000	3 Mar. 2000
Monash Ultrasound Trust	31 Dec. 1999	" "	9 Feb. 2000	3 Mar. 2000
Monash University Foundation Pty Ltd	31 Dec. 1999	" "	25 Feb. 2000	15 Mar. 2000
Monash University Foundation Year Ltd	31 Dec. 1999	" "	10 Feb. 2000	3 Mar. 2000
Monash University Foundation Trust	31 Dec. 1999	" "	25 Feb. 2000	15 Mar. 2000
Montech Medical Development Pty Ltd	31 Dec. 1999	" "	11 Feb. 2000	3 Mar. 2000

SCHEDULE B
COMPLETED/INCOMPLETE AUDITS - continued

<i>Entity</i>	<i>Financial year ended</i>	<i>Reporting to Parliament</i>	<i>Financial statements signed by entity</i>	<i>Auditor-General's report signed</i>
COMPLETED AUDITS - continued				
POST COMPULSORY EDUCATION INSTITUTIONS - continued				
Universities and associated companies - continued				
Montech Pty Ltd	31 Dec. 1999	30 Apr. <i>Financial Management Act 1994, s.53A.</i>	11 Feb. 2000	3 Mar. 2000
National Institute of Circus Arts Ltd (c)	Period 27 Oct. 1998 to 31 Dec. 1999	" "	15 Feb. 2000	23 Feb. 2000
Neurometric Systems Pty Ltd	31 Dec. 1999	" "	27 Mar. 2000	30 Mar. 2000
Pexmont Pty Ltd (c)	31 Dec. 1999	" "	14 Apr. 2000	18 Apr. 2000
RMIT University	31 Dec. 1999	30 Apr. <i>Financial Management Act 1994, s.46.</i>	31 Mar. 2000	27 Apr. 2000 (a)
RMIT Foundation	31 Dec. 1999	" "	18 Apr. 2000	20 Apr. 2000
RMIT Innovation Ltd	31 Dec. 1999	30 Apr. <i>Financial Management Act 1994, s.53A.</i>	23 Mar. 2000	19 Apr. 2000
RMIT International Pty Ltd	31 Dec. 1999	" "	31 Mar. 2000	19 Apr. 2000
RMIT (Malaysia) SDN BHD	31 Dec. 1999	" "	26 Apr. 2000	27 Apr. 2000
RMIT Resources Limited	31 Dec. 1999	" "	19 Apr. 2000	20 Apr. 2000
RMIT Training Pty Ltd	31 Dec. 1999	" "	4 Apr. 2000	19 Apr. 2000
RMIT Union	31 Dec. 1999	30 Apr. <i>Financial Management Act 1994, s.46.</i>	17 Apr. 2000	19 Apr. 2000
School of Forestry Creswick Ltd	31 Dec. 1999	30 Apr. <i>Financial Management Act 1994, s.53A.</i>	17 Mar. 2000	30 Mar. 2000
School of Mines and Industries Ballarat Ltd	31 Dec. 1999	" "	29 Mar. 2000	3 Apr. 2000

SCHEDULE B
COMPLETED/INCOMPLETE AUDITS - continued

<i>Entity</i>	<i>Financial year ended</i>	<i>Reporting to Parliament</i>	<i>Financial statements signed by entity</i>	<i>Auditor-General's report signed</i>
COMPLETED AUDITS - continued				
POST COMPULSORY EDUCATION INSTITUTIONS - continued				
Universities and associated companies - continued				
Sir John Monash Business Centre Pty Ltd	31 Dec. 1999	30 Apr. <i>Financial Management Act 1994, s.53A.</i>	22 Feb. 2000	16 Mar. 2000
Swinburne Graduate School of Integrative Medicine Pty Ltd (c)	5 Feb. 1999 to 31 Dec. 1999	" "	31 Mar. 2000	31 Mar. 2000
Swinburne Ltd	31 Dec. 1999	" "	27 Mar. 2000	30 Mar. 2000
Swinburne University of Technology	31 Dec. 1999	30 Apr. <i>Financial Management Act 1994, s.46.</i>	27 Mar. 2000	31 Mar. 2000 (a)
Unilink Ltd	31 Dec. 1999	30 Apr. <i>Financial Management Act 1994, s.53A.</i>	24 Mar. 2000	30 Mar. 2000
University of Ballarat	31 Dec. 1999	30 Apr. <i>Financial Management Act 1994, s.46.</i>	27 Mar. 2000	3 Apr. 2000 (a)
University of Melbourne	31 Dec. 1999	" "	18 Apr. 2000	20 Apr. 2000 (a)
Victoria University Enterprises Proprietary Limited	31 Dec. 1999	30 Apr. <i>Financial Management Act 1994, s.53A.</i>	2 Mar. 2000	12 Apr. 1999
Victoria University of Technology	31 Dec. 1999	30 Apr. <i>Financial Management Act 1994, s.46.</i>	29 Mar. 2000	12 Apr. 2000 (a)
Victoria University of Technology Foundation Ltd	31 Dec. 1998	30 Apr. <i>Financial Management Act 1994, s.53A.</i>	18 Feb. 2000	12 Apr. 2000
Victorian College of the Arts	31 Dec. 1999	30 Apr. <i>Financial Management Act 1994, s.46.</i>	18 Jan. 2000	31 Mar. 2000 (a)
Institutes of technical and further education and associated companies, and other providers				
Angliss Consulting Pty Ltd	31 Dec. 1999	30 Apr. <i>Financial Management Act 1994 s.53A.</i>	28 Feb. 2000	29 Mar. 2000
Angliss Solutions Pty Ltd (c)	Period 15 Jul. 1999 to 31 Dec. 1999	" "	28 Feb. 2000	29 Mar. 2000
Bendigo Regional	31 Dec. 1999	30 Apr. <i>Financial Management Act 1994, s.46.</i>	25 Feb. 2000	15 Mar. 2000
Box Hill	31 Dec. 1999	" "	23 Mar. 2000	24 Mar. 2000

SCHEDULE B
COMPLETED/INCOMPLETE AUDITS - continued

<i>Entity</i>	<i>Financial year ended</i>	<i>Reporting to Parliament</i>	<i>Financial statements signed by entity</i>	<i>Auditor-General's report signed</i>
COMPLETED AUDITS - continued				
POST COMPULSORY EDUCATION INSTITUTIONS - continued				
Institutes of technical and further education and associated companies, and other providers				
<i>- continued</i>				
Box Hill Enterprises Ltd	31 Dec. 1999	30 Apr. <i>Financial Management Act 1994, s.53A.</i>	23 Mar. 2000	24 Mar. 2000
Central Gippsland	31 Dec. 1999	30 Apr. <i>Financial Management Act 1994, s.46</i>	28 Mar. 2000	3 Apr. 2000
Chisholm	31 Dec. 1999	" "	31 Mar. 2000	3 Apr. 2000
Council of Adult Education	31 Dec. 1999	" "	7 Mar. 2000	9 Mar. 2000
Driver Education Centre of Australia Ltd	31 Dec. 1999	30 Apr. <i>Financial Management Act 1994, s.53A.</i>	9 Mar. 2000	29 Mar. 2000
East Gippsland	31 Dec. 1999	30 Apr. <i>Financial Management Act 1994, s.46</i>	23 Mar. 2000	24 Mar. 2000
Gordon	31 Dec. 1999	" "	16 Mar. 2000	23 Mar. 2000
Goulburn Ovens	31 Dec. 1999	" "	20 Mar. 2000	24 Mar. 2000
Holmesglen	31 Dec. 1999	" "	15 Mar. 2000	29 Mar. 2000
Holmesglen International Training Services Pty Ltd (c)	31 Dec. 1999	30 Apr. <i>Financial Management Act 1994, s.53A.</i>	29 Mar. 2000	29 Mar. 2000
John Batman Training and Consulting Pty Ltd (c)	31 Dec. 1999	" "	22 Mar. 2000	28 Mar. 2000
Kangan Batman	31 Dec. 1999	30 Apr. <i>Financial Management Act 1994, s.46.</i>	22 Mar. 2000	28 Mar. 2000

SCHEDULE B
COMPLETED/INCOMPLETE AUDITS - continued

<i>Entity</i>	<i>Financial year ended</i>	<i>Reporting to Parliament</i>	<i>Financial statements signed by entity</i>	<i>Auditor-General's report signed</i>
COMPLETED AUDITS - continued				
POST COMPULSORY EDUCATION INSTITUTIONS - continued				
Institutes of technical and further education and associated companies, and other providers				
<i>- continued</i>				
Northern Melbourne	31 Dec. 1999	30 Apr. <i>Financial Management Act 1994, s.46.</i>	1 Mar. 2000	7 Mar. 2000
South West	31 Dec. 1999	" "	16 Mar. 2000	24 Mar. 2000
Sunraysia	31 Dec. 1999	" "	30 Mar. 2000	31 Mar. 2000
WAI Online Pty Ltd (c)	Period 15 Jul. 1999 to 31 Dec. 1999	30 Apr. <i>Financial Management Act 1994, s.53A.</i>	28 Feb. 2000	29 Mar. 2000
William Angliss	31 Dec. 1999	30 Apr. <i>Financial Management Act 1994, s.46.</i>	27 Mar. 2000	29 Mar. 2000
Wodonga	31 Dec. 1999 ^a	" "	3 Mar. 2000	20 Mar. 2000

INCOMPLETE AUDITS

EDUCATION

Telematics Course Development Fund Trust	31 Dec. 1999	31 Oct. <i>Financial Management Act 1994, s.46.</i>	Audit substantially completed
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(a) Audit report qualified.

(b) Formerly known as Melbourne Information Technologies Australia Pty Ltd. The entity was privatised on 10 December 1999.

(c) New audit responsibility.

Part 3.2

Human Services

KEY FINDINGS

Financial viability of hospitals

- There were 8 hospitals which were considered to be operating under financial difficulties as at 30 June 1999. The financial position of a further 3 hospitals was expected to deteriorate in the 1999-2000 financial year.

Paras 3.2.4 to 3.2.12

Maintenance of public hospital buildings

- Health care facilities managed by the 89 public hospitals in Victoria are spread over 150 locations, with hospital buildings having an aggregate value of \$2.4 billion.
- Para. 3.2.13*
- The lack of a consistent methodology for the conduct of building condition assessments by hospital managers has resulted in a lack of reliable information being available on the estimated costs required to bring hospital buildings up to the required standards. Nevertheless, those hospitals that we reviewed which had assessed such costs, estimated that the outstanding maintenance on their buildings was around \$100 million.
- Paras 3.2.17 to 3.2.20*
- Given the level of outstanding maintenance works, there is a need for the Department of Human Services to critically assess the maintenance requirements of all public hospital buildings and the associated funding implications.
- Paras 3.2.21 to 3.2.22*
- The significant number of public hospital buildings over 30 years of age (around 40 per cent) has major funding implications for the Department and reinforces the need to ensure that hospitals complete property assessments to facilitate the development of effective asset maintenance strategies.

Paras 3.2.23 to 3.2.26

KEY FINDINGS – *continued*

Maintenance of public hospital buildings - *continued*

- The Department considers that a funding benchmark equivalent to approximately 3 per cent of the book value of buildings is required annually to maintain hospital buildings to required standards. However, only 4 of the 17 hospitals examined by my Office had expended funds equivalent to or greater than this maintenance benchmark over the 3 years to 30 June 1999.

Paras 3.2.27 to 3.2.29

- Given the significant upgrades required by public hospitals to meet fire safety standards and duty of care obligations, the Department needs to ensure that the required works (assessed at \$92 million) are completed within required timelines.

Paras 3.2.30 to 3.2.34

3.2.1 The Minister for Health, the Minister for Community Services, the Minister for Aged Care, the Minister for Housing and the Minister for Aboriginal Affairs, have responsibility for operations within the Human Services sector. These Ministers have collective responsibility for the Department of Human Services.

3.2.2 Details of the specific ministerial responsibilities for public bodies within the Human Services sector are listed in Table 3.2A. In addition to the Department of Human Services, the entities listed below were subject to audit by the Auditor-General during the 1998-99 financial year.

**TABLE 3.2A
MINISTERIAL RESPONSIBILITIES FOR PUBLIC BODIES
WITHIN THE HUMAN SERVICES SECTOR**

<i>Ministerial portfolio</i>	<i>Entities subject to audit</i>
Aboriginal Affairs	-
Aged Care	-
Community Services	-
Health	Advanced Dental Technicians Qualifications Board Ambulance Officers' Training Centre Alexandra and District Ambulance Service Ambulance Service Victoria - Metropolitan Region Anti-Cancer Council of Victoria Chiropractors Registration Board of Victoria Dental Board of Victoria Dental Technicians Licensing Committee Infertility Treatment Authority Medical Practitioners Board of Victoria Mental Health Review Board Nurses Board of Victoria Optometrists Registration Board of Victoria Osteopaths Registration Board of Victoria Pharmacy Board of Victoria Podiatrists Registration Board of Victoria Physiotherapists Registration Board of Victoria Prince Henry's Institute of Medical Research Psychologists Registration Board of Victoria Psychosurgery Review Board Public cemeteries (14) Public hospitals (89) Rural Ambulance Victoria Victorian Health Promotion Foundation Victorian Institute of Forensic Mental Health
Housing	-

3.2.3 Comment on matters of significance arising from the audit of entities within the Human Services sector is provided below.

FINANCIAL VIABILITY OF HOSPITALS

3.2.4 It is generally accepted that a key indicator of an organisation's financial viability is its capacity to meet current liabilities from available current assets as and when they fall due. Accordingly, one of the measurements to determine viability is the working capital position which compares liabilities falling due for payment in the next 12 months, such as creditors and employee entitlements, against assets that typically provide the funds to extinguish those liabilities.

3.2.5 The May 1999 *Report on Ministerial Portfolios* commented on the financial condition of public hospitals at 30 June 1998. That analysis identified 18 hospitals that were considered to be operating under financial difficulty. In its response to our analysis, the Department of Human Services indicated that additional funding of \$168 million was to be provided to hospitals during the 1998-99 financial year and, together with the implementation of improved management strategies, the sector would see a financial turnaround in 1999-2000, with data at that time projecting year-end surpluses in excess of \$20 million in the sector.

3.2.6 As the capacity of hospitals to deliver high quality health services is influenced by their ability to maintain a sound financial position, we reviewed the financial position of hospitals for the year ended 30 June 1999. Indicators used focused on:

- the working capital position of public hospitals at that date;
- operating result for the year, prior to grants received for capital purposes and transactions of an extraordinary nature; and
- net cash flows generated from operating activities during the year.

3.2.7 Our examination shows that the overall financial performance of hospitals had improved in the 1998-99 financial year. We found that the sector recorded:

- a deficit (prior to grants received for capital purposes) of \$2.7 million for the 1998-99 financial year compared with a deficit of \$174.9 million for the 1997-98 financial year;
- net cash inflows from operating activities of \$116.9 million for the 1998-99 financial year compared with net cash outflows of \$2.1 million for the 1997-98 financial year; and
- a positive working capital position of \$170.6 million as at 30 June 1999 compared with a negative working capital position of \$16.0 million as at 30 June 1998.

3.2.8 In addition, only 4 of the 18 hospitals identified in the previous review as showing signs of financial difficulty were considered to be in financial difficulty as at 30 June 1999, namely, Alpine Health, Maffra District Hospital, Maldon Hospital, and Mildura Base Hospital.

3.2.9 Overall, there are 8 hospitals which, based on the results of our analysis, are considered to be operating under financial difficulties as at 30 June 1999. These hospitals are identified in Table 3.2B.

TABLE 3.2B
PUBLIC HOSPITALS DISPLAYING SIGNS OF FINANCIAL DIFFICULTY,
AS AT 30 JUNE 1999 (a)
 (\$'000)

<i>Hospital</i>	<i>Operating deficit prior to capital grants and extraordinary items</i>		<i>Net cash inflows (outflows) from operating activities</i>		<i>Positive (negative) working capital position</i>	
	<i>1997-98</i>	<i>1998-99</i>	<i>1997-98</i>	<i>1998-99</i>	<i>1997-98</i>	<i>1998-99</i>
Alpine Health	1 473	87	(511)	(80)	(1 235)	(118)
Central Wellington Health Service (b)	1 886	1 072	304	(296)	(2 610)	(2 949)
Corangamite Regional Hospital Services (c)	215	633	117	(24)	(266)	(125)
Kooweerup Regional Health Service (d)	334	1 093	294	(776)	82	(1 785)
Maffra District Hospital (b)	289	174	(38)	(50)	(106)	(134)
Maldon Hospital	90	46	(26)	(90)	(107)	(132)
Mildura Base Hospital (e)	3 874	2 373	(3 233)	(889)	(5 743)	(3 270)
Upper Murray Health and Community Services	57	360	334	(5)	(142)	(28)

(a) Based on audited financial statements (except for Kooweerup Regional Health Service - see (d) below).

(b) Amalgamated to form new entity on 1 July 1999 known as Central Gippsland Health Service.

(c) Amalgamated to form new entity on 1 July 1999 known as South West Health Care.

(d) Based on draft financial statements.

(e) Activities of hospital to be transferred to private sector.

3.2.10 A further 6 hospitals had suffered an operating deficit prior to capital grants and extraordinary items for the 1998-99 financial year and had an excess of current liabilities over current assets as at 30 June 1999, but had generated net cash inflows from operating activities for the 1998-99 financial year. While 3 of these hospitals forecast improved financial performance in the 1999-2000 financial year, **the Austin and Repatriation Medical Centre, O'Connell Family Centre (Grey Sisters) Inc., and Wodonga Regional Health Service expected their financial position to deteriorate.**

3.2.11 In November 1999, the Minister for Health established a review panel to provide advice on new governance and management structures for metropolitan hospitals. On establishing the review panel, the Minister indicated that the Government favoured a health services delivery model which would see smaller groups of hospitals and other agencies working in partnership across sectors such as hospitals, aged care and mental health.

3.2.12 In an interim report released in February 2000, the review panel has suggested that the metropolitan health care networks be disaggregated into 12 metropolitan health services. The panel has recognised that financial viability will be an important consideration in the re-aggregation of agencies and has indicated that further assessment of the viability of the proposed aggregations is currently underway.

❑ **RESPONSE** provided by Secretary, Department of Human Services

This Report relies on information published by public hospitals in their audited financial statements for the year ended 30 June 1999. Although the Auditor-General reports an improvement in the financial result, the reported result (prior to grants received for capital purposes) was none the less inadequate.

Management accounts of hospitals show that the financial results of hospitals have deteriorated over the 1999-2000 financial year.

One of the factors is that some of the additional funding provided in 1998-99 was on a once-off basis and has not been continued during 1999-2000. Private patient revenue, revenue from veterans and some donations have fallen below anticipated levels while at the same time there has been continued unavoidable growth pressures for both elective and emergency services in hospitals.

While audited financial statements provide a useful guide to performance, up-to-date management accounts are also a pre-requisite for policy deliberations. The Government's budget for 2000-2001 will provide an additional \$176 million to enable hospitals to meet growth in demand for services as well as providing an increase in service prices paid to hospitals to ensure that they remain viable.

MAINTENANCE OF PUBLIC HOSPITAL BUILDINGS

3.2.13 The Department of Human Services is responsible for the overall funding and co-ordination of health care services provided by the 89 public hospitals in Victoria. The effective delivery of health care is influenced, among other things, by the condition of the buildings within the public hospital system which are spread over 150 locations. At 30 June 1999, the book value of public hospital buildings totalled \$2.4 billion.

3.2.14 The Board of Management of each public hospital is required to establish and manage processes which facilitate the effective monitoring of the condition of buildings under their control to ensure that the buildings are maintained to appropriate standards and meet service needs. In particular, government policy provides that hospitals undertake:

- standards assessments which are aimed at ensuring that buildings comply with the building regulations and meet health and safety standards; and
- condition and maintenance assessments which are aimed at ensuring that buildings are of an acceptable physical condition to allow effective service delivery.

3.2.15 In 1997, the Department of Human Services published the *Building Standards and Condition Assessments Guideline* to assist hospitals in the management of their assets. The Guideline provides detailed advice on the conduct of both types of assessment and suggests a strategy which requires hospitals to develop a prioritised program of works which forms a basis for planning, forward budgeting and reporting. Hospitals were required to ensure that buildings conform with the established building standards by the year 2000 or are consistent with guidelines as set out in the *Minister for Finance Guideline-Building Act 1993-Standards for Publicly Owned Buildings*.

3.2.16 We conducted a review of actions taken by a number of hospitals in monitoring the condition of buildings under their control in order to assess the adequacy of existing maintenance levels through cyclical, preventative and urgent maintenance programs, and to determine the extent of any backlog maintenance. The hospitals included in our review comprised 5 metropolitan healthcare networks and 12 regional and rural hospitals. Our review covered 75 per cent of the value of all public hospital buildings.

Property condition assessments

3.2.17 In order to identify existing maintenance requirements and reliably assess future requirements to maintain the proper functioning of the buildings to support service delivery, it is essential that the Department of Human Services and individual hospitals are informed of the condition of these assets.

3.2.18 We found that, while most hospitals had commenced a buildings condition assessment, they did not follow a standardised approach with the result that the basis of the assessments ranged from a casual walk-through to a thorough examination of buildings and associated services. In addition, information collected during the assessments was not recorded in a consistent manner.

3.2.19 In the light of the results of our review, the Department needs to ensure that condition assessments are undertaken on a systematic and timely basis, and that information is recorded in a consistent manner. Such an approach would allow the Department and individual hospitals to ensure that scarce resources are applied effectively, following the identification of the:

- nature and extent of works required to bring facilities and services up to the required standard;
- frequency of works and related costs required to maintain that standard; and
- urgency and priority of the required works.

Level of outstanding works

3.2.20 As indicated previously, the lack of a consistent methodology for the conduct of condition assessments by hospitals resulted in not all hospitals covered in our review having reliable information of the estimated costs required to bring hospital buildings up to the required standard. However, **those hospitals that had assessed such costs, estimated that the outstanding maintenance on their buildings was around \$100 million.** These hospitals acknowledged that had regular maintenance been undertaken on these buildings, the cost of the works now required would have been reduced, and the useful life of these structures extended.

3.2.21 Inadequate maintenance puts at risk a hospital's capacity to ensure the continuation of effective service delivery and, in the long-term, may increase the cost of service provision.

3.2.22 Given the level of outstanding works, there is a need for the Department of Human Services to critically assess the maintenance requirements of all public hospital buildings and the associated funding implications.

Age profile of public hospital buildings

3.2.23 The profile of hospital buildings in Victoria is diverse with facilities ranging from single storey specialist buildings to major high-rise acute hospital complexes. Existing buildings also vary in age from recent constructions to buildings constructed in the early 1900s.

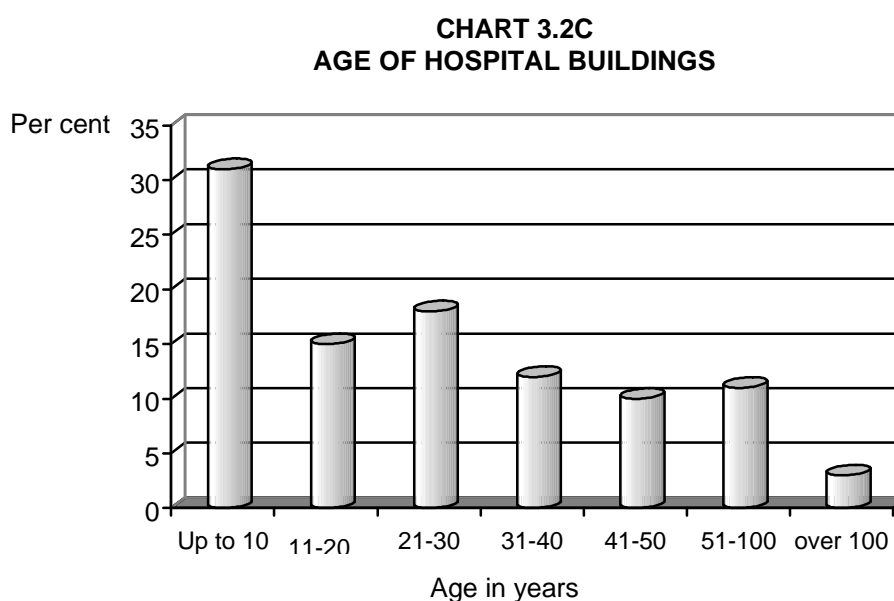


New hospital – Northern Hospital.



Old buildings – Royal Melbourne Hospital.

3.2.24 Chart 3.2C outlines the age profile of hospital buildings covered by the audit review.



3.2.25 The chart illustrates that around 40 per cent of hospital buildings are over 30 years of age. In broad terms, the older a hospital building the higher the level of maintenance required. A study conducted in 1994 by a consultant for the former Department of Health and Community Services and titled *Capital Investment in Victorian Public Hospitals*, concluded that it was likely that buildings aged between 25 and 45 years would require major refurbishment at a cost of around 35 per cent of the replacement value of the buildings. For buildings over 45 years of age, the study concluded that it was likely that about half would need to be replaced while the other half would need major refurbishment at a cost of around 35 per cent of their replacement value.

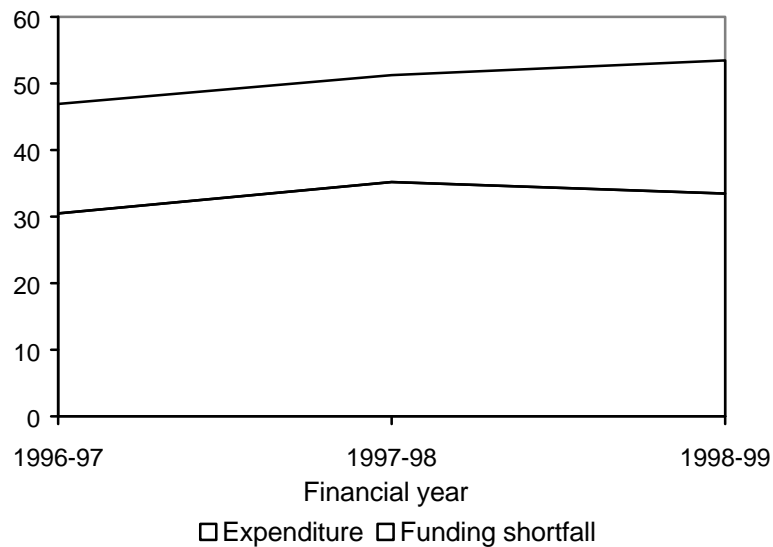
3.2.26 The significant number of public hospital buildings over 30 years of age has major funding implications for the Department of Human Services and reinforces the need to ensure that hospitals complete property assessments to facilitate the development of effective asset maintenance strategies.

Maintenance expenditure

3.2.27 The Department of Human Services considers that a funding benchmark equivalent to approximately 3 per cent of the book value of buildings should be allocated each year in order to maintain hospital buildings to existing standards.

3.2.28 Chart 3.2D shows that expenditure actually incurred on the maintenance of buildings over the past 3 years by those hospitals examined by audit was significantly below the 3 per cent threshold.

CHART 3.2D
MAINTENANCE EXPENDITURE
 (\$million)



3.2.29 We found that only 4 of the 17 agencies examined had expended funds equivalent to, or greater than, 3 per cent of the written-down value of buildings on maintenance over the 3 years to 30 June 1999. Several hospitals expressed concern that continuing financial restraints resulted in insufficient work being undertaken to maintain hospital buildings in the longer-term.

Fire risk management

3.2.30 There are numerous statutory requirements relating to fire safety in hospital buildings and the Department of Human Services has issued an *Interim Fire Risk Management Guideline* to enable hospitals to develop a consistent approach to fire risk management.

3.2.31 Consultants were engaged by the Department during 1998 to undertake fire safety audits at public hospitals. The aim of these audits was to provide information on the extent of work required to comply with the fire safety requirements and allocate a rating according to the following scale:

- Interim - requires immediate attention;
- Priority 1 - requires attention within 2 years;
- Priority 2 - requires attention within 2 to 5 years; and
- Priority 3 - requires attention after 5 years.

3.2.32 The fire safety audits identified that a substantial amount of work was required to upgrade buildings to the standard required by the interim guideline issued by the Department. In particular, the consultants estimated that over \$142 million was required to be allocated over the next 2 years to meet the fire safety requirements for all public hospitals in Victoria.

3.2.33 The Department spent \$50 million in 1998 and 1999 on interim and some priority 1 works, leaving a further \$92 million in works rated as priority 1 to be completed within the next 2 years. The Department has determined that hospitals need to establish a program to fund and undertake works rated as priority 2 and 3.

3.2.34 Given the significant upgrades required by public hospitals to meet the fire safety standards and to meet duty of care obligations, the Department needs to ensure that the required works rated as priority 1 are completed within the next 2 years.

□ *RESPONSE* provided by Director, Acute Health Division, Department of Human Services

The amount of funding that hospitals have available for maintenance of buildings and equipment relates to the overall financial viability of the hospital sector which has been under considerable pressure in recent years. The maintenance of hospital buildings is a component of the overall capital funding for hospitals and this Report has separated maintenance from other funding streams that include upgrade and redevelopment of buildings to meet increasing service demand, capability for new technologies and equipment.

The audit estimate for outstanding maintenance on buildings of around \$100 million is noted and should this figure include major engineering infrastructure services and plant then the estimate is considered to be low. The Department has established systems, procedures and documentation to assist hospital management to evaluate the maintenance requirements and costs of buildings and services. The Department acknowledges the benefit of a critical assessment of maintenance requirements of all public hospital buildings and the collation of the funding implications and priorities for the hospital sector.

The Department's work program includes benchmarking the maintenance and upgrading of hospital and healthcare buildings against national standards and will extend the work to cater for the Auditor-General's comments.

The Department's assessment will also consider refinement of the funding benchmark of 3 per cent for maintenance which is a broad estimate for annual expenditure and requires review to take into account existing building age, conditions, risk assessment and deferred maintenance within each hospital.

The Fire Risk Management Program is continuing with an additional \$20 million being allocated in the 1999-00 Assets Investment Program for the Department and the remaining funds will be sought in future budget submissions.

SCHEDULE A
STATUS OF MATTERS RAISED IN PREVIOUS REPORTS

<i>Report</i>	<i>Subject</i>	<i>Status at date of preparation of this Report</i>
MATTERS RESOLVED OR ACTION COMMENCED		
DEPARTMENT OF HUMAN SERVICES		
Accountability of community health centres		
<i>Ministerial Portfolios, May 1999, p.63.</i>	Service Agreements between the Department and community health centres specify the level and range of services to be provided by centres for an agreed amount of funding. Audit found delays in the signing of Service Agreements which could result in inadequate accountability, less than optimal performance or financial loss.	In order to improve the timeliness in signing Service Agreements, the Department has improved the quality and timeliness of data available on the Service Agreement Management System (SAMS), streamlined sign-off process between the central office and regions, and implemented procedures to monitor the progress of service agreement negotiations with centres.
<i>Ministerial Portfolios, May 1999, pp. 63-4.</i>	As community health centres become larger and responsible for an increasing level of public resources, consideration needs to be given to their level of accountability to the Parliament and ultimately to Victorian taxpayers. As the Parliament's auditor, it will be important that the Auditor-General is involved in this accountability process.	Information links are being developed that will enhance the capacity for electronic exchange of information between providers and the Department. In addition, interim measures to improve the centres' reporting processes have been implemented which will improve accountability to the Department. Consideration is still required to developing a direct accountability framework to the Parliament.
<i>Ministerial Portfolios, May 1999, pp. 64-5.</i>	The Department needs to develop qualitative performance indicators so that it can evaluate the effectiveness of services delivered by community health centres.	The Department's Aged Care and Mental Health Division is redeveloping its funding framework. This work will include the development and trialing of qualitative performance measures that will be applied to the Community Health Program.
Financial viability of public hospitals		
<i>Ministerial Portfolios, May 1999, p. 69-73.</i>	As at 30 June 1999, there were 18 public hospitals showing signs of financial difficulty.	Further comment on the viability of hospitals is provided earlier in this Part of the Report.
Maintenance of public housing		
<i>Ministerial Portfolios, May 1999, p. 78.</i>	There was a clear need for the Department to establish appropriate information systems which record reliable information on the condition and future maintenance of its property portfolio.	The Department has enhanced the property condition recording system and the database is updated as maintenance works are completed.

SCHEDULE A
STATUS OF MATTERS RAISED IN PREVIOUS REPORTS - continued

<i>Report</i>	<i>Subject</i>	<i>Status at date of preparation of this Report</i>
MATTERS RESOLVED OR ACTION COMMENCED - continued		
DEPARTMENT OF HUMAN SERVICES – continued		
Condition of residential care facilities		
<i>Ministerial Portfolios, May 1999, pp. 81-2.</i>	As at February 1999, 23 State-owned residential care facilities had not met Commonwealth Government certification standards. Unless these facilities achieved accreditation by January 2000, they would not qualify for Commonwealth Government funding or be able to charge fees, thus putting their financial viability at risk .	As at May 2000, 14 State-owned residential aged care facilities had not met Commonwealth Government certification standards. The Department expects that 8 of these facilities will meet the required standards by 1 January 2001 and a further 6 facilities will meet the required standards by 30 June 2001. The Government is engaged in formal discussions with Commonwealth Government representatives to inform them of the work being undertaken to meet certification standards.
<i>Ministerial Portfolios, May 1999, pp. 82.</i>	A further 23 State-owned residential care facilities merely achieved the minimum standard required for Commonwealth accreditation. The Department will need to develop strategies to ensure these facilities continue to meet the required standards.	In the 2000-2001 State Budget, the Government has allocated \$47.5 million over 3 years to its Residential Aged Care Strategy to upgrade State-owned facilities to meet Commonwealth certification standards and to provide appropriate standards of comfort and care for residents.
Management of residents' amenities funds		
<i>Ministerial Portfolios, May 1998, p. 61.</i>	Deficiencies were identified in the content, approval and monitoring of expenditure plans relating to Residents' Amenities Funds.	Revised guidelines have been implemented by the Department. The guidelines require the monitoring of expenditure during a year to ensure that it accords with the approved plan.
<i>Ministerial Portfolios, May 1998, p. 62.</i>	Vehicle operating expenses are the major item of expenditure from Residents' Amenities Funds. As vehicle costs are rapidly depleting amounts available in the Funds, the Department needs to urgently review the ongoing viability of the Funds.	In those Training Centres where the Funds are depleted, the Department is progressively funding government vehicles. The proceeds of sale of the existing vehicles or other assets purchased by the Fund are returned to the Fund for use in approved expenditure plans or remain available for distribution to eligible persons if the centre is closed.
<i>Ministerial Portfolios, May 1998, p. 62.</i>	The Department does not have a systematic process to identify and record asset purchases funded from Residents' Amenities Funds. Accordingly, the Department was unable to assure the safeguarding of the assets or ensure that proceeds on disposal of the assets were returned to eligible persons as required by the <i>Intellectually Disabled Persons' Services Act</i> 1986.	The revised guidelines adopted by the Department addressed items of concern raised by my Office and included implementation of compulsory asset registration to be used to identify and record assets purchased from the Residents' Amenities Fund. The registration of assets enables identification for proceeds of assets sold to be returned to the Fund for use in approved expenditure plans or remain available for distribution to eligible persons if the centre is closed.

SCHEDULE A
STATUS OF MATTERS RAISED IN PREVIOUS REPORTS - *continued*

<i>Report</i>	<i>Subject</i>	<i>Status at date of preparation of this Report</i>
MATTERS RESOLVED OR ACTION COMMENCED - <i>continued</i>		
DEPARTMENT OF HUMAN SERVICES – <i>continued</i>		
<i>Management of residents' amenities funds - continued</i>		
<i>Ministerial Portfolios, May 1998, p. 62.</i>	In relation to 2 institutions that were being closed, the Department had not formulated a method for the distribution of moneys standing to the credit of the respective Residents' Amenities Funds	Following receipt of legal advice, the Department has formulated a method for the distribution of moneys in accordance with the relevant clauses of the <i>Intellectually Disabled Persons' Services Act 1986</i> .

**SCHEDULE B
COMPLETED/INCOMPLETE AUDITS**

<i>Entity</i>	<i>Financial year/ period ended</i>	<i>Reporting to Parliament</i>	<i>Financial statements signed by entity</i>	<i>Auditor- General's report signed</i>
COMPLETED AUDITS				
Department of Human Services	30 June 1999	31 Oct. <i>Financial Management Act</i> 1994, s.46.	6 Sept. 1999	8 Nov. 1999
HEALTH				
Advanced Dental Technicians Qualifications Board	30 June 1999	" "	29 Sept. 1999	6 Oct. 1999
Ambulance Officers' Training Centre	30 June 1999	" "	15 Sept. 1999	24 Sept. 1999
Alexandra and District Ambulance Service	30 June 1999	" "	4 Oct. 1999	14 Oct. 1999
Ambulance Service Victoria - Metropolitan Region	30 June 1999	" "	30 Aug. 1999	6 Sept. 1999
Anti-Cancer Council of Victoria	31 Dec. 1999	" "	20 Mar. 2000	28 Mar. 2000 (a)
Chiropractors Registration Board of Victoria	30 June 1999	" "	1 Dec. 1999	2 Dec. 1999
Dental Board of Victoria	30 Sep. 1999	" "	7 Dec. 1999	24 Dec. 1999
Dental Technicians Licensing Committee	30 June 1999	" "	29 Sep. 1999	6 Oct. 1999
Infertility Treatment Authority	30 June 1999	" "	1 Sep. 1999	7 Sept. 1999
Medical Practitioners Board of Victoria	30 Sept. 1999	" "	31 Jan. 2000	8 Feb. 2000
Mental Health Review Board	30 June 1999	" "	24 Sept. 1999	30 Sept. 1999
Nurses Board of Victoria	30 June 1999	" "	26 Aug. 1999	15 Sept. 1999
Optometrists Registration Board of Victoria	30 June 1999	" "	29 Sept. 1999	8 Oct. 1999
Osteopaths Registration Board of Victoria	30 June 1999	" "	6 Sept. 1999	15 Sept. 1999
Pharmacy Board of Victoria	30 June 1999	" "	2 Aug. 1999	12 Aug. 1999
Physiotherapists Registration Board of Victoria	30 June 1999	" "	2 Sept. 1999	24 Sept. 1999
Podiatrists Registration Board of Victoria (b)	30 June 1999	" "	14 Dec. 1999	22 Dec. 1999
Prince Henry's Institute of Medical Research	31 Dec. 1999	" "	29 Mar. 2000	24 May 2000

SCHEDULE B
COMPLETED/INCOMPLETE AUDITS - continued

<i>Entity</i>	<i>Financial year/ period ended</i>	<i>Reporting to Parliament</i>	<i>Financial statements signed by entity</i>	<i>Auditor- General's report signed</i>
COMPLETED AUDITS - continued				
HEALTH - continued				
Psychologists Registration Board of Victoria	31 Dec. 1999	31 Oct. <i>Financial Management Act 1994, s.46.</i>	12 April 2000	18 April 2000
Psychosurgery Review Board	30 June 1999	" "	24 Sept. 1999	30 Sept. 1999
Public Cemeteries -				
Anderson's Creek Cemetery Trust	31 Dec. 1999	" "	29 Mar. 2000	4 April 2000
Ballaarat General Cemeteries Trust	31 Dec. 1999	" "	25 Feb. 2000	22 Mar. 2000
Bendigo Cemeteries Trust	31 Dec. 1999	" "	27 Mar. 2000	3 April 2000
Cheltenham and Regional Cemeteries Trust	31 Dec. 1999	" "	29 Mar. 2000	30 Mar. 2000
Geelong Cemeteries Trust	31 Dec. 1999	" "	14 Mar. 2000	20 Mar. 2000
Keilor Cemetery Trust	31 Dec. 1999	" "	7 Mar. 2000	29 Mar. 2000
Mildura Cemetery Trust	31 Dec. 1998	" "	24 Aug. 1999	14 Sept. 1999
Mildura Cemetery Trust	31 Dec. 1999	" "	16 Mar. 2000	30 Mar. 2000
Preston Cemetery Trust	31 Dec. 1998	" "	24 Nov. 1999	30 Nov. 1999
Trustees of the Fawkner Crematorium and Memorial Park	31 Dec. 1999	" "	2 Mar. 2000	17 Mar. 2000
Trustees of the Memorial Park	31 Dec. 1999	" "	23 Mar. 2000	30 Mar. 2000
Trustees of the Necropolis Springvale	31 Dec. 1999	" "	17 Mar. 2000	29 Mar. 2000
Wyndham Cemeteries Trust	31 Dec. 1998	" "	19 July 1999	16 Aug. 1999
Wyndham Cemeteries Trust	31 Dec. 1999	" "	2 Mar. 2000	17 April 2000
Rural Ambulance Victoria (c)	30 June 1999	" "	16 Sept. 1999	17 Sept. 1999
Victorian Health Promotion Foundation	30 June 1999	" "	8 Sept. 1999	5 Oct. 1999 (a)

SCHEDULE B
COMPLETED/INCOMPLETE AUDITS - continued

<i>Entity</i>	<i>Financial year/ period ended</i>	<i>Reporting to Parliament</i>	<i>Financial statements signed by entity</i>	<i>Auditor- General's report signed</i>
COMPLETED AUDITS - continued				
HEALTH - continued				
Victorian Institute of Forensic Mental Health (d)	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.46.</i>	28 Sept. 1999	25 Oct. 1999
PUBLIC HOSPITALS				
Alexandra District Hospital	30 June 1999	" "	17 Aug. 1999	3 Sept. 1999
Alpine Health	30 June 1999	" "	17 Aug. 1999	17 Sept. 1999
Austin and Repatriation Medical Centre	30 June 1999	" "	27 Sept. 1999	17 Nov. 1999 (a)
Bairnsdale Regional Health Service	30 June 1999	" "	25 Aug. 1999	8 Sept. 1999
Ballarat Health Services	30 June 1999	" "	16 Aug. 1999	7 Oct. 1999 (a)
Barwon Health	30 June 1999	" "	4 Oct. 1999	15 Nov. 1999 (a)
Beaufort and Skipton Health Service	30 June 1999	" "	20 Aug. 1999	24 Sept. 1999
Beechworth Hospital	30 June 1999	" "	23 Aug. 1999	3 Sept. 1999
Benalla and District Memorial Hospital	30 June 1999	" "	17 Aug. 1999	15 Sept. 1999 (a)
Bendigo Health Care Group	30 June 1999	" "	8 Sept. 1999	21 Sept. 1999 (a)
Bethlehem Hospital Incorporated	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.53A.</i>	6 Sept. 1999	10 Sept. 1999
Boort District Hospital	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.46.</i>	6 Sept. 1999	13 Sept. 1999
Caritas Christi Hospice Limited	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.53A.</i>	30 Sept. 1999	7 Oct. 1999
Casterton Memorial Hospital	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.46.</i>	13 Aug. 1999	24 Aug. 1999
Central Wellington Health Service (e)	30 June 1999	" "	29 Sept. 1999	1 Oct. 1999

SCHEDULE B
COMPLETED/INCOMPLETE AUDITS - continued

<i>Entity</i>	<i>Financial year/ period ended</i>	<i>Reporting to Parliament</i>	<i>Financial statements signed by entity</i>	<i>Auditor- General's report signed</i>
COMPLETED AUDITS - continued				
PUBLIC HOSPITALS - continued				
Cobram District Hospital	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.46.</i>	18 Aug. 1999	6 Sept. 1999 (a)
Cohuna District Hospital	30 June 1999	" "	16 Sept. 1999	17 Nov. 1999 (a)
Colac Community Health Services	30 June 1999	" "	19 Aug. 1999	31 Aug. 1999
Coleraine and District Hospital	30 June 1999	" "	24 Aug. 1999	7 Sept. 1999
Corangamite Regional Hospital Services (e)	30 June 1999	" "	26 Aug. 1999	31 Aug. 1999
Dental Health Services Victoria	30 June 1999	" "	19 Aug. 1999	8 Sept. 1999
Djerriwarrh Health Services	30 June 1999	" "	10 Sept. 1999	12 Oct. 1999
Dunmunkle Health Services	30 June 1999	" "	28 Sept. 1999	15 Oct. 1999
East Grampians Health Service	30 June 1999	" "	2 Sept. 1999	29 Sept. 1999
East Wimmera Health Service	30 June 1999	" "	5 Nov. 1999	12 Nov. 1999
Echuca Regional Health	30 June 1999	" "	6 Oct. 1999	7 Oct. 1999
Edenhope and District Memorial Hospital	30 June 1999	" "	7 Oct. 1999	19 Oct. 1999
Far East Gippsland Health and Support Service	30 June 1999	" "	6 Sept. 1999	1 Oct. 1999
Gippsland Southern Health Service	30 June 1999	" "	23 Aug 1999	1 Sept. 1999
Goulburn Valley Health (f)	30 June 1999	" "	27 Sept. 1999	27 Sept. 1999
Hepburn Health Service	30 June 1999	" "	7 Sept. 1999	1 Oct. 1999
Hesse Rural Health Service	30 June 1999	" "	23 Aug. 1999	17 Sept. 1999
Heywood and District Memorial Hospital	30 June 1999	" "	6 Sept. 1999	24 Sept. 1999

SCHEDULE B
COMPLETED/INCOMPLETE AUDITS - continued

<i>Entity</i>	<i>Financial year/ period ended</i>	<i>Reporting to Parliament</i>	<i>Financial statements signed by entity</i>	<i>Auditor- General's report signed</i>
COMPLETED AUDITS - continued				
PUBLIC HOSPITALS - continued				
Inglewood and Districts Health Service	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.46.</i>	6 Sept. 1999	17 Sept. 1999
Inner and Eastern Health Care Network	30 June 1999	" "	23 Aug. 1999	27 Oct. 1999 (a)
Kerang and District Hospital	30 June 1999	" "	13 Sept. 1999	21 Sept. 1999
Kilmore and District Hospital	30 June 1999	" "	8 Nov. 1999	9 Nov. 1999
Kyabram and District Memorial Community Hospital	30 June 1999	" "	5 Aug. 1999	19 Aug. 1999
Kyneton District Health Service	30 June 1999	" "	10 Sept. 1999	17 Sept. 1999
Latrobe Regional Hospital	30 June 1999	" "	11 Oct. 1999	21 Oct. 1999
Lorne Community Hospital	30 June 1999	" "	27 Aug. 1999	4 Oct. 1999
Maffra District Hospital (e)	30 June 1999	" "	29 Sept. 1999	29 Sept. 1999
Maldon Hospital	30 June 1999	" "	9 Sept. 1999	29 Sept. 1999
Mallee Track Health and Community Service	30 June 1999	" "	21 Sept. 1999	22 Sept. 1999
Manangatang and District Hospital	30 June 1999	" "	2 Sept. 1999	17 Sept. 1999
Mansfield District Hospital	30 June 1999	" "	1 Sept. 1999	5 Oct. 1999 (a)
Maryborough District Health Service	30 June 1999	" "	20 Sept. 1999	5 Oct. 1999
Mclvor Health and Community Services	30 June 1999	" "	23 Aug. 1999	20 Sept. 1999
Mercy Public Hospitals Inc.	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.53A.</i>	20 Dec. 1999	4 Jan. 2000 (a)
Mildura Base Hospital	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.46.</i>	19 Aug. 1999	8 Sept. 1999 (a)
Mt Alexander Hospital	30 June 1999	" "	30 Sept. 1999	7 Oct. 1999

SCHEDULE B
COMPLETED/INCOMPLETE AUDITS - continued

<i>Entity</i>	<i>Financial year/ period ended</i>	<i>Reporting to Parliament</i>	<i>Financial statements signed by entity</i>	<i>Auditor- General's report signed</i>
COMPLETED AUDITS - continued				
PUBLIC HOSPITALS - continued				
Nathalia District Hospital	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.46.</i>	26 Aug. 1999	7 Sept. 1999
North Western Health Care Network	30 June 1999	" "	30 Sept. 1999	11 Oct. 1999 (a)
Numurkah District Health Service	30 June 1999	" "	18 Aug. 1999	3 Sept. 1999
O'Connell Family Centre (Grey Sisters) Inc.	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.53A.</i>	29 Oct. 1999	29 Nov. 1999
Omeo District Hospital	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.46.</i>	24 Aug. 1999	20 Sept. 1999
Otway Health and Community Services	30 June 1999	" "	30 Sept. 1999	30 Sept. 1999
Peninsula Health Care Network	30 June 1999	" "	23 Aug. 1999	27 Sept. 1999 (a)
Port Fairy Hospital	30 June 1999	" "	16 Aug. 1999	13 Sept. 1999
Portland and District Hospital	30 June 1999	" "	31 July 1999	6 Sept. 1999
Queen Elizabeth Centre	30 June 1999	" "	23 Aug. 1999	14 Sept. 1999 (a)
Robinvale District Health Services (g)	30 June 1999	" "	20 Sept. 1999	24 Sept. 1999
Rochester and Elmore District Health Service	30 June 1999	" "	23 Aug. 1999	17 Sept. 1999
Rural North West Health (h)	30 June 1999	" "	19 Oct. 1999	28 Oct. 1999
Seymour District Memorial Hospital	30 June 1999	" "	6 Sept. 1999	27 Sept. 1999
South Gippsland Hospital	30 June 1999	" "	27 Sept. 1999	28 Sept. 1999
Southern Health Care Network	30 June 1999	" "	19 Aug. 1999	17 Sept. 1999 (a)
St Vincent's Hospital (Melbourne) Limited	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.53A.</i>	30 Sept. 1999	7 Oct. 1999 (a)
Stawell District Hospital	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.46.</i>	5 Oct. 1999	7 Oct. 1999

SCHEDULE B
COMPLETED/INCOMPLETE AUDITS - continued

<i>Entity</i>	<i>Financial year/ period ended</i>	<i>Reporting to Parliament</i>	<i>Financial statements signed by entity</i>	<i>Auditor- General's report signed</i>
COMPLETED AUDITS - continued				
PUBLIC HOSPITALS - continued				
Swan Hill District Hospital	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.46.</i>	8 Sept. 1999	13 Sept. 1999
Tallangatta Hospital	30 June 1999	" "	19 Aug. 1999	10 Sept. 1999
Terang and Mortlake Health Service	30 June 1999	" "	27 Aug. 1999	2 Sept. 1999
Timboon and District Healthcare Service	30 June 1999	" "	18 Aug. 1999	31 Aug. 1999
Tweddle Child and Family Health Service	30 June 1999	" "	25 Aug. 1999	8 Sept. 1999
Upper Murray Health and Community Services	30 June 1999	" "	31 Aug. 1999	28 Sept. 1999
Wangaratta District Base Hospital	30 June 1999	" "	6 Sept. 1999	30 Sept. 1999 (a)
Warrnambool and District Base Hospital (e)	30 June 1999	" "	31 Aug. 1999	10 Sept. 1999
Western District Health Service (i)	30 June 1999	" "	26 Aug. 1999	20 Sept. 1999
West Gippsland Healthcare Group	30 June 1999	" "	17 Sept. 1999	17 Sept. 1999
West Wimmera Health Service	30 June 1998	" "	20 Aug. 1999	23 Aug. 1999
West Wimmera Health Service	30 June 1999	" "	1 Feb. 2000	9 Feb. 2000
Wimmera Health Care Group	30 June 1999	" "	6 Oct. 1999	15 Oct. 1999 (a)
Wodonga Regional Health Service	30 June 1999	" "	19 Aug. 1999	9 Sept. 1999
Women's and Children's Health Care Network	30 June 1999	" "	22 July. 1999	22 July. 1999
Wonthaggi and District Hospital	30 June 1999	" "	8 Sept. 1999	21 Sept. 1999 (a)
Wycheproof and District Health Service (e)	30 June 1999	" "	3 Sept. 1999	9 Sept. 1999
Yarram and District Health Service	30 June 1999	" "	25 Aug. 1999	8 Sept. 1999

SCHEDULE B
COMPLETED/INCOMPLETE AUDITS - continued

<i>Entity</i>	<i>Financial year/ period ended</i>	<i>Reporting to Parliament</i>	<i>Financial statements signed by entity</i>	<i>Auditor- General's report signed</i>
COMPLETED AUDITS - continued				
PUBLIC HOSPITALS - continued				
Yarrawonga District Hospital	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.46.</i>	1 Sept. 1999	22 Sept. 1999
Yea and District Memorial Hospital	30 June 1999	" "	1 Sept. 1999	7 Sept. 1999
INCOMPLETE AUDITS				
Ambulance Officers Training Centre (e)	30 Nov. 1999	31 Oct. <i>Financial Management Act 1994, s.46.</i>	Awaiting signed financial statements.	
Kooweerup Regional Health Service	30 June 1999	" "	" "	" "
Preston Cemetery Trust	31 Dec. 1999	" "	" "	" "
Templestowe Cemetery Trust	31 Dec. 1999	" "	" "	" "
Trustees of the Lilydale Memorial Park and Cemetery	31 Dec. 1999	" "	" "	" "
Wyndham Cemetery Trust	31 Dec. 1999	" "	" "	" "

(a) Qualified audit report issued.

(b) Podiatrists Registration Board of Victoria formerly known as Chiropractors Registration Board of Victoria.

(c) Rural Ambulance Victoria was created following the merger of 5 rural regional of ambulance service.

(d) Victorian Institute of Forensic Mental Health commenced operations on 1 July 1998.

(e) Entity abolished as at reporting date.

(f) Goulburn Valley Health formerly known as Goulburn Valley Base Hospital.

(g) Robinvale District Health Services formerly known as Robinvale District Hospital and Health Services.

(h) Rural North West Health was created following the merger of Warracknabeal District Hospital and 2 bush nursing hospitals.

(i) Western District Health Service was created following the merger of Hamilton Base Hospital and Penshurst and District Memorial Hospital.

Part 3.3

Infrastructure

KEY FINDINGS

Public transport passenger rail privatisation and franchising arrangements

- The State has entered into franchise agreements with the private sector for periods of 10 to 15 years under which the franchisees have agreed to provide passenger services, maintain the rail infrastructure and undertake a rolling stock acquisition program, in return for the receipt of subsidies from the State.

Paras 3.3.4 to 3.3.47

- The State received nominal consideration of \$3 for the sale of mainly rolling stock and plant and equipment (which had an estimated aggregate book value of \$663 million) to the 3 franchisees operating the passenger transport businesses. In return, the State obtained a right to receive future services from each franchisee on the basis of reduced subsidy payments from the State.

Paras 3.3.48 to 3.3.53

- The aggregate cost to the State for the delivery of the required services by the franchisees over the next 15 years, in net present value terms, will be around \$2.8 billion.

Paras 3.3.51 to 3.3.151

- The franchisees have accepted the risks associated with not meeting the revenue projections and the consequences of passengers evading the payment of fares. However, this risk is to some extent mitigated by the Government's intention to fund, through increased subsidy payments of around \$10.2 million per annum, an additional 100 tram conductors and a further 100 staff to man metropolitan train stations.

Paras 3.3.55 to 3.3.76

- Based on the terms and conditions in the agreements, the franchisees are responsible for the maintenance of rolling stock and infrastructure to a minimum standard. Provision for these costs is included in the subsidy payments made by the State.

Paras 3.3.77 to 3.3.114

KEY FINDINGS - *continued*

Maintenance of State-owned transport infrastructure

- In September 1998, a consultant engaged by the former Government concluded that the intrastate non-electrified rail infrastructure was basically fit for freight and passenger operating purposes, but a maintenance backlog in the order of \$23 million was identified, affecting all corridors. We have been unable to assess the extent to which this backlog has been cleared.

Paras 3.3.152 to 3.3.161

- The target conditions for the interstate rail infrastructure assets, against which the actual condition of the infrastructure will be assessed on an ongoing basis, have been determined. However, the quantification of any future maintenance requirements has not been specifically identified.

Para. 3.3.161

Colac-Otway Shire Council – Export meat processing facility development agreement

- The Council has negotiated a new state-of-the-art meat processing facility that will provide 50 additional job opportunities within the Shire. The facility secured under the development agreement is around half the size of the facility that Council previously negotiated to have constructed.

Paras 3.3.170 to 3.3.173

- The Council's contributions under the development agreement, combined with the additional financial assistance provided by the State, will exceed \$1.8 million - equivalent to 24 per cent of the construction cost of the facility.

Paras 3.3.174 to 3.3.175

- The overall cost to ratepayers for the acquisition and operation of the original abattoir until its closure and contributions to the owners of the new facility totalled around \$2.4 million, with a further \$250 000 provided by the State.

Paras 3.3.179 to 3.3.180

External financial reporting by the local government sector

- Notwithstanding the additional requirements arising from the introduction in 1998-99 of a new performance reporting regime, local authorities achieved improved levels of timeliness of financial and performance reporting compared with the preceding year.

Paras 3.3.186 to 3.3.189

- The audit of performance statements for the 1998-99 financial year disclosed that all statements were supported by appropriate records of results achieved for the year except in 3 cases where qualified audit reports were issued. In addition, 36 councils received qualified audit reports for not complying fully with the legislative requirements of the Act.

Paras 3.3.196 to 3.3.199

KEY FINDINGS – *continued*

External financial reporting by the local government sector – *continued*

- A government study released in January 2000 identified the need for most councils to take action within the next 7 years to fund required infrastructure asset renewals.

Paras 3.3.220 to 3.3.222

- Recent litigation under the *Workplace Relations Act 1996* indicates councils could be exposed to significant risks arising from outsourcing former functions. Local authorities need to monitor developments regarding the transmission of business provisions under the *Workplace Relations Act 1996*.

Paras 3.3.224 to 3.3.228

Acquisition of proposed prescribed waste facility site by Wyndham City Council

- In November 1998, the Wyndham City Council entered into an agreement to purchase a 101 hectare site located in Wests Road, Werribee upon which a company had proposed the establishment of a prescribed waste storage facility. It is estimated that the overall settlement in relation to this property will cost the City Council ratepayers around \$17.7 million.

Paras 3.3.229 to 3.3.244

- The settlement effectively met the Council's primary objective of halting a proposal by the company to establish a prescribed waste facility on the site, while securing sufficient capacity to meet the Council's long-term waste management requirements.

Paras 3.3.244 to 3.3.253

The Queen Victoria site

- The Melbourne City Council acquired the Queen Victoria site during 1997 at a cost of \$38.5 million from a private developer. The private developer had previously acquired the site from the Government during 1992 for \$14.9 million and had entered into an arrangement during 1994 to sell the site to the Republic of Nauru for \$50.3 million.

Paras 3.3.256 to 3.3.262

- The Council had entered into an arrangement with the Republic of Nauru to sell part of the site back to the Republic for \$38.5 million, however, the Republic failed in certain of its obligations under those arrangements and the Council terminated the arrangement by paying the Republic \$1.9 million and releasing securities it had over certain assets of the Republic.

Paras 3.3.259 to 3.3.273

- The Council recently sold the site to another developer. The total costs incurred by Council on the site to December 1999 of \$46.7 million were greater than the sale price of \$40 million to the developer. Nevertheless, the sale price was consistent with an independent valuation of the site, and the sale will ultimately result in additional rating revenue for Council, open space, public car parking and a crèche.

Paras 3.3.273 to 3.3.297

3.3.1 The Minister for Local Government, the Minister for Planning, the Minister for Ports and the Minister for Transport have responsibility for operations within the Infrastructure sector. These Ministers have collective responsibility for the Department of Infrastructure.

3.3.2 Details of the specific ministerial responsibilities for public bodies within the Infrastructure sector are listed in Table 3.3A. These public bodies, together with the Department of Infrastructure, were subject to audit by the Auditor-General during the 1998-99 financial year.

**TABLE 3.3A
MINISTERIAL RESPONSIBILITIES FOR PUBLIC BODIES
WITHIN THE INFRASTRUCTURE SECTOR**

<i>Ministerial portfolio</i>	<i>Entities subject to audit</i>
Local Government	CityWide Service Solutions Pty Ltd Municipal councils (78) Prahran Market Pty Ltd Regent Management Company Pty Ltd Regional library corporations (16) Queen Victoria Market Pty Ltd Melbourne Wholesale Fish Market Pty Ltd
Planning	Architects Registration Board of Victoria Building Control Commission Heritage Council Melbourne City Link Authority Plumbing Industry Commission ULC Real Estate Services Pty Ltd Urban Land Corporation
Ports	Marine Board of Victoria
Transport	Roads Corporation Public Transport Corporation

3.3.3 Comment on matters of significance arising from the audit of entities within the Infrastructure sector is provided below.

PUBLIC TRANSPORT PASSENGER RAIL PRIVATISATION AND FRANCHISING ARRANGEMENTS

3.3.4 Our previous Reports to the Parliament have commented on the former Government's public transport reform program. As part of this program, in July 1998 the former business units of the Public Transport Corporation were corporatised to form the following passenger transport businesses:

- *Met Train 1 (trading as Bayside Trains)*, providing all metropolitan train services to and from Melbourne's northern, western and south-eastern suburbs through a network of 9 rail lines. In addition, this business managed the Stony Point line, which is a non-electrified line;
- *Met Train 2 (trading as Hillside Trains)*, providing all metropolitan train services to and from Melbourne's eastern and north-eastern suburbs through a network of 6 rail lines. All of the train lines within this area are electrified and the business generally does not share its lines with other freight or passenger trains;
- *Met Tram 1 (trading as Swanston Trams)*, providing tram services on 18 routes operating from 4 depots to the north-western and south-eastern suburbs, and the Melbourne central business district;
- *Met Tram 2 (trading as Yarra Trams)*, providing tram services on 10 routes operating from 4 depots, encompassing both the north-eastern and southern suburbs as well as the central business district; and
- *V/Line Passenger Corporation*, providing a network of integrated train and coach services to towns and cities across regional Victoria. The rail network consists of 1 640 kilometres of track over 5 rail corridors.



Swanston trams.

3.3.5 As part of the reform program, the Government also established the Victorian Rail Track Corporation (VicTrack) in April 1997, which assumed responsibility for the non-electrified track and related infrastructure in Victoria. In July 1999, VicTrack also assumed ownership of the electrified metropolitan track and related train control and signalling assets.

3.3.6 In August 1997, the Government announced plans to proceed with the privatisation of public transport in Victoria, with the following key objectives:

- secure a progressive improvement in the quality of services to public transport users in Victoria;
- continue to provide users with a high level of safety;
- minimise the long-term costs of public transport to taxpayers;
- transfer the risk to the private sector; and
- secure a substantial and sustained increase in the number of passengers using the public transport system.

3.3.7 The Government established the Transport Reform Unit, part of the Department of Treasury and Finance, to oversee the rail passenger and freight reform program. The Unit comprised of staff seconded from the Departments of Treasury and Finance, and Infrastructure, and staff recruited from outside Government. The Unit was supported by a range of technical and commercial consultants including various legal, corporate, financial and engineering consultants. The Unit initially reported to a Strategic Review Group, which comprised the former Treasurer of Victoria and the former Minister for Transport. In March 1998, the Strategic Review Group was replaced by the Public Transport Cabinet Committee, which included the Treasurer, the Minister for Transport and the Minister for Youth and Community Services.

3.3.8 In October 1998, the Government released the Public Transport Passenger Charter which outlined 12 assurances to protect passengers' rights and to foster improved service quality under a future privatised transport system. The charter formed the basis of the key principles upon which contractual arrangements between the State and the selected private service operators would be developed. The assurances provided are outlined below:

- **Services** - the existing passenger network of operational train and tram lines throughout Victoria will remain in operation for the duration of the franchise and any changes to timetables will require the approval of the Director of Public Transport who will be required to consult with the Passengers' Charter Committee, whose membership will include members of the public;
- **Fares** - the value of fares will increase in accordance with movements in the Consumer Price Index (CPI) only;
- **Concessions** - all current concessions, including those offered to pensioners, senior citizens, students and other groups in need, will continue to be provided;
- **Ticketing** - operators will continue to provide multi-modal tickets on Melbourne's trains, trams and buses, and travel on Melbourne's City Circle tram route will continue to be free of charge;
- **Performance** - train and tram operators will be required to maintain and enhance the current levels of punctuality and reliability and will face penalty payments if these requirements are not met;

- **Customer Service** - private operators will be obliged to take action if station cleanliness, staff conduct and other key measures do not meet the performance standards set by the State and the Government will establish clear arrangements to ensure that passengers who wish to complain about the performance of private operators will be able to do so easily;
- **Information** – private operators will be required to set up a new timetable inquiry and bookings service;
- **Compensation** - private operators will be required to compensate passengers for poor service through free extensions to long term periodical tickets;
- **Overcrowding** - operators will be required to run extra trains and trams if their services become overcrowded;
- **Safety** - private operators will be required to ensure that current safety standards are maintained, and such operators will be required to work closely with the police to reduce crime on the public transport system;
- **Accessibility** - private operators will be required to demonstrate that they are catering properly for people with special needs and disabilities; and
- **Heritage** - 53 W Class Trams will be retained in service.

3.3.9 In January 1999, the Government created the position of Director of Public Transport (the Director) within the Department of Infrastructure to oversee the operation of the public transport businesses and enable the ongoing monitoring and administration of the contractual arrangements associated with the delivery of public transport services by private sector operators.

3.3.10 Following the completion of its sale preparation process, in February 1999 the Government announced the sale of the V/Line Freight Corporation to a consortium now known as Freight Australia (formerly Freight Victoria). A detailed assessment of this sale was presented in my Report to the Parliament on the Victorian Government's Finances 1998-99. **In June 1999 and July 1999, the Government announced the finalisation of the sale and associated franchise arrangements for the remaining transport businesses, with the respective franchise terms varying from 10 to 15 years.** In this Report, I have provided a comprehensive analysis of these arrangements.

Models for privatisation

3.3.11 As the provision of public transport was considered to be a loss making business that would require continued financial support and Government oversight, 3 possible models of privatisation were considered by the Cabinet including:

- **Outright sale** - involving the sale of the businesses on the basis of an indefinite or periodically negotiated Government commitment to provide a level of subsidy to support a defined level of service;
- **Contracting out** - involving the operation of public transport by private sector management on a contract basis over a fixed period, with the State retaining revenue and other commercial risks; and
- **Franchising** – involving the introduction of private sector management through fixed term contracts, in conjunction with the transfer of commercial risks to these private operators.

3.3.12 In relation to these models the Transport Reform Unit advised that an outright sale had the disadvantage of locking in a single supplier in perpetuity requiring substantial regulation to protect the State’s long-term interests and no reliable benchmark would be available against which to gauge the performance of the operator. Contracting out was considered beneficial as it captured the benefits of competition between potential contractors, but franchising provided the added benefit of transferring risk to the private sector and would create incentives for private operators to improve efficiency and grow patronage, thereby improving the long term viability and performance of the passenger transport businesses. In November 1997, Cabinet approved the recommendation of the Unit to pursue franchising as the preferred privatisation model.

3.3.13 Shortly after Cabinet also decided to offer the future train and tram franchisees management control over the rail infrastructure so as to improve efficiency and accountability as the operators, with ownership of the infrastructure retained by the State. However, in the case of the intra-state rail network used by V/Line Passenger, Freight Australia retained responsibility for the infrastructure.

Costs associated with the passenger rail privatisation program

3.3.14 The State has incurred substantial expenditure as part of the passenger rail privatisation program for the ultimate purpose of establishing more efficient freight and passenger transport businesses. The Auditor-General’s *Special Report No. 57 Public Transport Reform – Moving from a System to a Service* identified the costs associated with the implementation of the public transport reform program to 30 June 1996 which included staff termination payments totalling around \$267 million.

3.3.15 Our review identified that further costs totalling around \$116 million were incurred by the Government in relation to the establishment of the public transport franchising arrangements, including \$70 million of expenditure incurred by the Transport Reform Unit. Table 3.3B provides a breakdown of these costs.

TABLE 3.3B
COSTS INCURRED BY THE STATE ON THE PASSENGER
RAIL PRIVATISATION PROGRAM (a)
 (\$million)

<i>Details</i>	<i>Amount</i>
Operation of the Transport Reform Unit	5
Payments to legal advisers	13
Payments to financial advisers	18
Payments to sale advisers	12
Other payments to external parties	22
	70
Industry restructuring costs	15
Employee redundancy costs	24
Early termination fee of lease arrangements associated with the existing rolling stock	7
Total costs	116

(a) Source: Department of Treasury and Finance. The table above excludes costs associated with the privatisation of V/Line Freight of approximately \$6 million.

Bid selection and evaluation process

3.3.16 In October 1998, the Transport Reform Unit publicly sought expressions of interest from the private sector for the franchise of 5 passenger rail businesses, and subsequently received around 30 expressions of interest. These expressions of interest were reviewed by the Unit. The Unit then issued an invitation to tender to qualified bidders in November 1998, supported by information memoranda and other tender documentation.

Key proposed arrangements advised to potential bidders

3.3.17 The key arrangements proposed to be established by the State as part of the privatisation program, as outlined in the information memoranda and other tender documentation issued to potential bidders are outlined below.

Proposed contractual arrangements for passenger businesses

3.3.18 The core agreement between the Director of Public Transport on behalf of the State and the successful bidder (the franchisee) for the operation of each business would be the franchise agreement, which will specify minimum service requirements and performance standards, regulate maximum fares, provide for the payment of subsidies and concession fare supplements, and contain incentive and penalty regimes for operational performance, passenger growth and customer satisfaction.

3.3.19 The State intends to sell the assets of the businesses such as rolling stock on an outright basis, and to lease the other infrastructure and network assets to the franchisees for periods of between 10 to 15 years. The infrastructure lease will specify the infrastructure assets that will be leased to the franchisees in order for them to operate their passenger services. In addition, the lease agreement will specify the franchisees' maintenance, renewal and improvement obligations with respect to the infrastructure.

3.3.20 The Unit advised that it was seeking bids on the basis of the acquisition of new rolling stock for each of the passenger rail franchises. The new rolling stock would be subject to a 15 year lease arrangement under which, at the end of the first franchise period, the State will decide whether to replace the rolling stock at the end of the initial 15 year lease period or continue to lease the rolling stock for a further term after the 15 year lease period. In addition, the prospective franchisees for Bayside Trains and Hillside Trains would be expected to include in their bids the financial impact of the refurbishment of certain existing rolling stock units, known as the Comeng rolling stock.

3.3.21 Furthermore, inter-operator agreements would be entered into between the franchisees covering such issues as revenue allocation, management of the contract associated with the automated ticketing system, track access, station access, operating and electrical control systems, and maintenance.

3.3.22 The State also advised prospective franchisees that under the above agreements they would have the opportunity to earn revenue from the following sources:

- *Base subsidy* - a subsidy payable by the State, determined during the bidding process and set out in the franchise agreement;
- *Operational Performance Regime incentives* - financial incentives payable by the State to franchisees where pre-defined levels of operational performance are exceeded;
- *Patronage incentives* - financial incentives payable by the State to franchisees where pre-defined levels of patronage growth are exceeded;
- *Farebox revenue* - revenue from ticket sales;
- *Concession top-up* - reimbursements payable to the franchisees by the State in respect of tickets sold at concession prices;
- *Other revenue* - revenue earned from ancillary commercial activities such as retailing and advertising; and
- *Access and inter-operator revenue* - revenue earned by franchisees from regulated or contractual access charges payable by third party operators for the use of their assets and facilities or services provided.

Employee considerations

3.3.23 Given that employee-related expenses accounted for 47 per cent of the Public Transport Corporation's operating expenses in the 1997-98 financial year, these costs and labour productivity would represent a significant determinant of the franchisees' financial and operating performance. In view of this fact, the State advised bidders that they would have the opportunity to choose from a defined pool of existing public transport employees and the State would accept liability for the payment of accrued benefits and redundancy payments associated with employees not offered positions. The Transport Reform Unit also indicated that as the Government had an obligation under the relevant enterprise bargaining agreements to maximise employment, the bid evaluation process would consider the cost of any expected redundancy costs to be met by the State.

Ownership restrictions

3.3.24 The Transport Reform Unit advised bidders that since the proposed franchises were founded on geographically based service groups, direct competition between franchisees would not be a major driver of business performance. However, in the interests of maintaining comparative competition, there would be limits on cross-ownership of the franchises. In particular, successful bidders for one of the metropolitan tram and train franchises (or anyone who is entitled to more than a 20 per cent interest in, or controls, a metropolitan tram and train franchise) would be prohibited from being entitled to an interest in, or controlling, any part of the other same-mode metropolitan franchise. However, exemptions for passive investors may be made with the prior written approval of the Treasurer. The Government imposed no restriction on the ownership by any one party of both a tram and metropolitan train franchise, and the V/Line Passenger franchise.

3.3.25 The Unit advised bidders that arrangements would be established to ensure that the ownership restrictions are retained through the life of the franchises and that there was potential for additional competition from third party operators who successfully negotiate access to the train and tram networks in the future.

3.3.26 The Government determined that any entity which is wholly or partially-owned or controlled by any Australian Government, and the existing management of the public transport businesses, would be precluded from having an equity stake in any purchasing consortium.

Regulatory environment

3.3.27 As previously mentioned, the franchisees would enter into franchise and infrastructure lease agreements with the Director of Public Transport, who would be responsible for managing and monitoring the Government's contracts with the franchisees and ensuring that they comply with the established service standards.

3.3.28 In addition, it is envisaged that the Regulator-General will have responsibility for the regulation of third party access to rail infrastructure in accordance with the *Rail Corporations Act* 1996. The Regulator-General's principal role is to arbitrate access disputes where a third party operator is unable to agree on the terms and conditions of access to rail infrastructure.

Bidding process

3.3.29 Following the issue of the invitation to tender and related tender documentation to qualified bidders, 40 indicative bids were received in January 1999 for the 5 passenger rail franchises. The bids received were evaluated against the following key criteria:

- the net present value of State cash flows during the franchise period, taking into account the annual base subsidy profile in real terms, lease payments, the acquisition price for the existing rolling stock and other assets of the businesses, the residual lease payments for the rolling stock and other assets at the end of the franchise period and any expected employee redundancy costs to be met by State;
- the merit of any enhancements proposed to the operation and management of the passenger transport businesses and how they meet the State's objectives;
- the quality and thoroughness of the business plan (including the preliminary asset management plan) demonstrating the bidder's ability to operate and manage the business including the bidder's understanding of the franchising proposition, obligations to maintain infrastructure assets and the reasonableness of the assumptions underlying the bidders projected cash flows with the State;
- the extent to which any amendments are proposed by the bidder to the proforma contractual arrangements;
- the extent of any risk transfer to the State proposed by the bidder, having regard to the State's ongoing exposure to residual risk and the State's general policy of not providing warranties, guarantees or indemnities; and
- any other conditions attaching to the indicative bid.

3.3.30 In addition, the bidders were notified that the State would be able to apply other criteria for the evaluation of bids and would also assess the relevant experience of the bidder (including operational, maintenance and other expertise) and the perceived ability to deliver a quality service over the franchise period.

3.3.31 The Transport Reform Unit also established 5 Sales Teams to evaluate the bids received. These Sales Teams included staff from the Unit and its external advisory team. The Sales Teams reported to a Sales Control Group. This Group was staffed by the Director of Public Transport, senior personnel of the Departments of Treasury and Finance, and Premier and Cabinet, members of the Unit's executive, the leaders of the Sales Teams, and the Unit's external advisory team. The sales evaluation processes were overseen by a probity auditor.

3.3.32 The Sales Teams recommended to the Sales Control Group a short-list of 5 bidders for each of the businesses in February 1999 following a comprehensive evaluation of the indicative bids using the evaluation criteria set out above. These recommendations were approved by the Sales Control Group and the Public Transport Cabinet Committee. Bidders were then requested to submit their final bids. Those indicative bids that were rejected were considered to have, among other things, inadequate asset management proposals, low passenger growth targets and an excessive level of requested subsidy payable by the State in net present value terms.

3.3.33 The criteria established to evaluate the final bids were consistent with that established for the indicative bids, however they were supplemented with additional criteria relating to the reliability, safety and service of the proposed replacement rolling stock (known as committed rolling stock) and the refurbishment of the Comeng rolling stock as part of the assessment of the business plan.

3.3.34 As part of the tendering arrangements, the Unit advised us that the Government decided not to impose a minimum level of locally manufactured content for the committed rolling stock as part of the proposed contractual arrangements, based on a view that the community would receive greater value if bidders were provided with the flexibility to purchase rolling stock from local and overseas-based manufacturers. However, bidders were required to specify the proportion of local manufactured content for the committed rolling stock.

3.3.35 In March 1999, the Transport Reform Unit issued supplementary information to the short-listed bidders, which provided additional details about the final bid parameters for each franchise, a revised approach for the procurement of the committed rolling stock and specifications for the refurbishment of Comeng rolling stock. In relation to the procurement of rolling stock, the bidders were advised that:

- The State had decided to mandate a requirement for the provision by the successful franchisee of a certain number of new rolling stock units with a useful life of 30 years and for the option to direct the franchisee of each business to acquire a specified number of additional units for unplanned passenger growth;
- Bidders may choose to put in place a special purpose entity to acquire the new and option rolling stock and to lease it to the franchisee, or bidders may decide to contract with third parties outside the bidder group to acquire the new and option rolling stock and lease it to the franchisee. These parties will be required to enter into a lease with an initial term of 15 years for each unit;

- The purchaser of the new rolling stock (lessor) will be required to enter into a direct agreement with the State which will require the lessor to lease the new rolling stock on the same terms to any subsequent franchisee or to the State upon termination or expiry of the franchise arrangement, at least until the end of the original period of the lease;
- The State will take a charge over the new rolling stock and any option rolling stock which will rank ahead of any other security;
- The residual value of the rolling stock at the expiry of the lease must be at least 30 per cent of the prevailing price of modern equivalent replacement stock for delivery at the time of expiry of the rolling stock lease;
- The State will be given the option to require the lessor to transfer the new rolling stock to a successor franchisee or successor lessor at the end of the rolling stock lease upon payment of a termination value. If the State elects not to take up this option, the new franchisee will continue to lease the new rolling stock from the lessor until the expiry of the rolling stock lease and after expiry the stock will be returned to the lessor;
- In the event of a default by the franchisee, the State will continue to meet the payment obligations under the rolling stock lease until a replacement franchisee has been installed;
- The existing rolling stock will be transferred from the franchisee to its successor or to the State at the end of the franchise period. The transfer will occur under the franchise arrangements where the existing rolling stock is owned by the franchisee or under the direct agreement where another party has acquired ownership of the existing rolling stock;
- The franchisee will be free to sell the existing rolling stock to a lessor, or a lessor can acquire the existing rolling stock direct from the State with the franchisee entering into a leaseback of the equipment. When the existing rolling stock is transferred to the successor franchisee or the State, the State will not meet any further lease payments to the lessor; and
- The franchisee will be entitled to dispose of the existing rolling stock that is replaced by new rolling stock.

3.3.36 During the final bid stage, a number of short-listed bidders withdrew from the process. In May 1999 the Transport Reform Unit received final bids and combined bids for more than one franchise. All together, bids were received from 8 parties.

Selection of successful franchisees

3.3.37 In June 1999, the Sales Teams recommended to the Sales Control Group the preferred bidders for the passenger rail businesses with the exception of Hillside Trains. These recommendations were accepted by the Public Transport Cabinet Committee. The bidders for Hillside Trains were requested to re-submit their final bids in early July 1999 to address particular areas of concern and having regard to the more favourable results achieved by the State for the other rail passenger businesses. Shortly after, the Sales Team recommended to the Sales Control Group the preferred bid for the franchise of Hillside Trains, which was confirmed by the Committee.

3.3.38 The preferred bidders were selected on the basis of the previously mentioned criteria which took into account both the financial and operational aspects of the bids together with the investment proposals of each bidder.

3.3.39 Table 3.3C outlines the net cost to the State in net present value terms of the successful bidders.

TABLE 3.3C
NET COST TO THE STATE IN NET PRESENT VALUE TERMS OF
SUCCESSFUL BIDDERS
((\$million))

<i>Successful bidder</i>	<i>Bayside Trains</i>	<i>Hillside Trains</i>	<i>Swansto n Trams</i>	<i>Yarra Trams</i>	<i>V/Line Passenger</i>
Melbourne Transport Enterprises		(a) 837			
MetroLink				231	
National Express Group	577		405		621

(a) Subsequent to the final bid for the franchise of Hillside Trains receiving approval from Cabinet, and prior to signing the transaction documents, a further reduction in the net cost to the State of \$12.3 million, in net present value terms, was negotiated with the successful bidder.

3.3.40 The bid for the franchise of Hillside Trains was approved despite the higher cost to the State, compared to another bid received for that franchise, on the basis that it outweighed other bids by an improved risk transfer to the franchise and a greater commitment to service quality.

3.3.41 The membership of the successful consortiums which were awarded franchises is provided below:

MetroLink with a franchise period of 12 years relating to Yarra Trams

- *Projects Victoria Pty Ltd (Groupe Egis)*, a French-based organization specialising in the provision of engineering and infrastructure projects whose largest shareholder is Caisse des Depots et Consignations, a State-owned financial institution;
- *Transdev Victoria Pty Ltd*, controlled by Transdev, an urban transport operator based in France which is ultimately controlled by Caisse des Depots et Consignations. The company also operates transport services in the United Kingdom; and
- *Transfield Metrolink Victoria Pty Ltd*, an Australian civil works and maintenance company whose parent is in partnership with Groupe Egis in the provision of electronic tolling and the operation of the Melbourne City Link.

Melbourne Transport Enterprises Pty Ltd with a franchise period of 15 years relating to Hillside Trains

- *CGEA Transport Pacific Holdings Pty Ltd*, a French-based organization with transport interests in Europe, Australia and the Philippines which is controlled by Vivendi - a major utility also based in France.

- *Alstom Ltd*, a supplier of components, systems and services in the energy, transport and marine industries based in France. The company owns power plants and transmission networks, and is the supplier of rolling stock to the Eurostar cross channel rail service and TGV rail services in Western Europe. The company also acquired a maintenance depot from the Public Transport Corporation in November 1999.

National Express Group Australia Pty Ltd with a franchise period for 15 years relating to Bayside Trains; with a franchise period of 12 years relating to Swanston Trams; and with a franchise period of 10 years relating to V/Line Passenger

- *National Express Group PLC*, a major passenger transport service provider based in the United Kingdom, with responsibility for 5 passenger rail franchises and a leading member of the joint venture company appointed for the management of the Eurostar rail service in Western Europe, along with certain Belgian and French companies. This organization acquired the National Bus Company Pty Ltd in May 1999, the largest privately owned bus company in Australia which operates urban bus services in Melbourne, Brisbane, Sydney and Perth.

3.3.42 The probity auditor appointed in August 1998 to review the bid selection and evaluation process concluded that all probity issues arising during the process were satisfactory resolved, the bids at both the indicative and final bid stages were evaluated and ranked equitably against the agreed selection criteria and all bidders were accorded fair and equitable treatment throughout the sale process.

Public sector benchmark

3.3.43 As part of the bid selection and evaluation process, the Transport Reform Unit established a public sector benchmark (PSB) of \$718 million, representing the likely future annual cost to the State of operating the passenger rail businesses if they remained under public sector ownership and continue to provide the existing level of services at current efficiency levels. This amount included an operating deficit of \$169 million, a depreciation charge of \$190 million and a capital asset charge on the existing rolling stock and infrastructure of \$359 million.

3.3.44 The capital asset charge referred to above was included in the financial statements for the financial year ended 30 June 1999 for the Public Transport Corporation and each of the passenger rail businesses. The capital asset charge equated to around 15 per cent of the written-down replacement cost of the businesses' non-current physical assets. However, the 1998-99 Budget Papers tabled in Parliament, stated that capital asset charges are generally imposed on the written-down value of non-current physical assets, with the charges generally set at 8 per cent.

3.3.45 The Transport Reform Unit concluded that the franchising of the 5 passenger rail businesses was expected to deliver real average savings against the PSB of \$161 million per annum, over the next 15 years, representing savings in real terms of \$1.76 billion over a 15 year period using a discount rate of 4.5 per cent. This calculation was based on the adjusted annual cost to the franchisees of \$557 million, which included the following:

- \$226 million - cost of payments to franchisees;

- \$51 million - amortisation of the cost of the existing rolling stock;
- \$31 million - one-off reform costs (amortised) and ongoing maintenance costs; and
- \$249 million - infrastructure capital charge.

3.3.46 The Unit noted that the payments to the franchisees would implicitly include a cost of capital and capital recovery during the term of the franchise for their investments in new and refurbished rolling stock and infrastructure. Expected concession fare payments were excluded from both the PSB and payments to the franchisees. In addition, the PSB was based on an annual patronage growth of between 2.1 per cent and 2.7 per cent (which compares to a historical growth rate of 1.0 per cent per annum for the last decade). However, the franchisees had projected growth rates of 3.6 per cent from 1999 to 2014.

Contractual framework

3.3.47 The franchising of the Victorian passenger rail system involved the establishment of a complex contractual framework. The principal contracts are outlined below:

Core transaction documents

- *Sale of assets agreements* - dealing with the sale of the transport business net assets, including the existing rolling stock to the newly appointed franchisees;
- *Franchise agreements* - establishing the arrangements for the continued provision of passenger rail services by the franchisees and the States obligations to make payments to the franchisees in return for the services provided;
- *Direct agreements* - which provide the Director of Public Transport with certain rights over the arrangements associated with the supply, lease and maintenance of new rolling stock which are required to be brought into service by the franchisees;
- *Deed of charge* - which assigns the Director a charge over the core assets of the franchisees;
- *Core infrastructure lease agreements* - relating to the lease of core rail infrastructure (including stations and in the case of the metropolitan-based franchisees the rail track) to the franchisees; and
- *State indemnity agreement* - under which the Treasurer of Victoria will provide a guarantee to the OneLink Consortium for payment of any amounts owed to the Consortium by a new company known as Revenue Clearing House Pty Ltd for the intended assignment of the contract associated with the Automatic Ticketing System from the Public Transport Corporation. At the date of the preparation of this Report, this agreement remains unsigned;

Inter-operator agreements

- *Access agreement* - enabling access to certain sections of track and stations by more than one franchisee;
- *Rolling stock hire agreement* - under which the franchisee of Swanston Trains has entered into a rolling stock agreement with the franchisee of Yarra Trams for the hire of 31 “Z3” trams;

- *Infrastructure maintenance agreements* - enabling the franchisees of Bayside Trains, Hillside Trains, Swanston Trams and Yarra Trams to provide maintenance services to each other;
- *Electrical systems operation agreements* – the electrical control system for the metropolitan trains is leased to the franchisee of Hillside Trains, who provides services to the Bayside Trains franchisee. Similarly, the electrical control system for the tram network is leased to the Yarra Trams franchisee who manages the system and provides electrical services to the franchisee of Swanston Trams; and
- *Rolling stock unit control and monitoring agreements* – the train control system for the metropolitan train network is leased to the Bayside Train franchisee, who provides access to the franchisee of Hillside Trains. In relation to the tram network, the franchisee of Swanston Trams is responsible for the monitoring of tram movements and provides access to the system to the Yarra Trams franchisee;

Third party contracts

- *Telecommunications service agreement* - under which VicTrack has agreed to continue to provide telecommunications services to each franchisee to enable them to operate passenger services; and
- *Maintenance agreements* – dealing with the provision of maintenance services between the franchisees in relation to the former major maintenance depots of the Public Transport Corporation which have been sold to private operators.

Sale arrangements

3.3.48 Under the sale arrangements for the 5 passenger transport businesses to the 3 separate franchisees, the State received a nominal consideration of \$3 for the transfer of the businesses' net assets, which mainly comprised of rolling stock and plant and equipment, to the franchisees. As a result, the State incurred an estimated aggregate book loss of \$663 million on the sale of the net assets of the businesses. The sale arrangements excluded the software and equipment associated with the automated ticketing system which is operated by OneLink. **Although the State only received a nominal consideration for the transfer of these net assets, the State nevertheless received a right to receive future services from each franchisee requiring a reduced subsidy payment from the State.**

3.3.49 A key term of the sale arrangements was that, within 12 months of sale completion, the purchaser may lodge up to 2 notices seeking restitution from the State where it is determined that assets with a market value in excess of \$1 million were not transferred as required, or where the assets transferred were found to be damaged or destroyed prior to completion and the cost of restoration was estimated to be greater than \$1 million. The total amount the State may be liable for under these provisions has been capped at \$5 million.

3.3.50 The State also agreed to nominate the purchaser as an employing authority for the purpose of the State Superannuation Fund. This effectively permitted those existing employees that were offered employment with the purchaser the option to continue their membership of the Fund. However, the cost of the employer contributions from the date that the franchise commenced is the responsibility of the franchisees.

Franchise arrangements

3.3.51 The Director of Public Transport has entered into agreements with each franchisee for the purchase of passenger service delivery in accordance with a master timetable, over a franchise period of between 10 to 15 years. Under these agreements, the franchisees are required to meet minimum operational requirements such as the minimisation of overcrowding, safety standards and adequate levels of maintenance of the rolling stock units and infrastructure. In addition, the franchisees will be required to maintain the number of train and tram annual kilometres travelled at a level of at least that existing at the commencement of the franchise period, and introduce additional services during the franchise period.

3.3.52 The franchisees have agreed to maintain specified minimum levels of equity in each franchise and to ensure that the actual level of equity does not fall below 50 per cent of these amounts, which will be subject to CPI movements. The lowest level of permissible equity per franchise, subject to CPI movements, is as follows:

- Bayside Trains - \$10 million;
- Hillside Trains - \$7.5 million;
- Swanston Trams - \$5 million;
- Yarra Trams - \$5 million; and
- V/Line Passenger - \$7.5 million

3.3.53 In addition, the franchisees have provided performance bonds which may be called upon by the State in the event of termination of the franchise arrangements, to compensate the Director for any costs that may be incurred as a consequence of the termination. The total value of these bonds is \$105 million, comprising \$30 million for Bayside Trains, \$25 million for Hillside Trains, \$15 million for Swanston Trams, \$15 million for Yarra Trams and \$20 million in relation to V/Line Passenger.

3.3.54 The key terms of the franchise agreements and other related agreements are outlined below.

Fare revenue

3.3.55 The Director has authorised the franchisees to collect and retain the proceeds received from the sale of regulated fares to the public. In the 1998-99 financial year, the public transport businesses collected a total of \$245 million in passenger fare revenue and received additional State funded contributions of \$48 million for fare concessions such as student and pensioner concessions.

3.3.56 To a large extent, the profitability of the franchisees will be significantly influenced by their ability to achieve projected increases in patronage growth over the franchise period. These projections, based on the level of fare revenue generated in the 1997-98 financial year, are as follows:

- Bayside Trains - 84 per cent;
- Hillside Trains – 64 per cent;
- Swanston Trams - 42 per cent;
- Yarra Trams – 57 per cent; and

- V/Line Passenger – 64 per cent.

3.3.57 Therefore, the franchisees have accepted the risks associated with not meeting these revenue projections and the consequences of passengers evading the payment of fares. However, this risk is to some extent mitigated by the Government's intention to fund, through increased subsidy payments of around \$10.2 million per annum an additional 100 tram conductors to assist customers and improve public safety, and a further 100 staff to man metropolitan train stations. This arrangement is expected by the State to increase passenger revenues which, in turn, should reduce future levels of subsidies payable by the State to the franchisees.

3.3.58 Under the franchise arrangements, the franchisee of Bayside Trains and Swanston Trams is required to negotiate with the National Bus Company, together with V/Line Passenger and SkyBus, for a new joint fare, and each franchisee shall record the rates of fare evasion and report to the Director action taken to minimise such rates. Furthermore, the franchisees must consult with the Director in respect of any new proposals in respect of any new ticketing technology or enhancements.

3.3.59 As outlined in our May 1999 *Report on Ministerial Portfolios*, all fare revenue earned on multi-modal MetCard tickets, based upon the established arrangements associated with public transport ticketing, is pooled and allocated across the metropolitan passenger rail businesses and the public bus system, on the basis of estimated usage as determined by customer surveys. The reliance on these surveys for the basis of the allocation of fare revenue has been due to a lack of appropriate information produced by the Automated Ticketing System, as passengers do not diligently re-validate their tickets between modes of transport and the system is unable to measure the distance travelled on trams and buses.

3.3.60 On 1 July 1999 a revenue clearing house, previously established by the Transport Reform Unit, assumed responsibility for the management of the surveys and the allocation of fare revenue to the train and tram businesses, and the Secretary of the Department of Infrastructure on the behalf of metropolitan buses. As part of the franchising arrangements, ownership of the revenue clearing house was transferred to the Revenue Clearing House Pty Ltd, a private company that is now jointly owned by the franchisees and the Secretary of the Department.

3.3.61 The responsibilities of the above shareholders is regulated under the Revenue Clearing House Shareholders Agreement, under which these parties have agreed not to make any material change to the nature and scope of the company's business, nor provide any financial accommodation or approve the termination or extension of any material amendment to the contractual documentation associated with the automated ticketing system. As previously mentioned in this Report, it is intended that the OneLink Consortium will consent to the assignment of the contractual arrangements associated with the automated ticketing system from the Public Transport Corporation to the Revenue Clearing House Pty Ltd, on the basis that the Treasurer of Victoria continues to provide a guarantee for payment of any amounts owing under the relevant arrangements. In turn, each franchisee has entered into an indemnity agreement in favour of the Treasurer of Victoria against any amounts incurred by the Treasurer as a result of his guarantee to the Consortium.

3.3.62 The related MetCard Management Agreement, sets out the rights and obligations of the respective parties in relation to the operation of MetCards and the collection and allocation of MetCard revenue. The key principle embodied in this agreement is the allocation of revenue based on the relative usage of each MetCard operator's services, in terms of passenger boardings and distance travelled. The conduct of surveys, rather than reliance on information produced by the automated ticketing system will continue as the core basis for the distribution of proceeds from fares. Other key provisions of this agreement include:

- any amount payable by the company to the consortium under the automated ticketing system contractual arrangements at the end of the term of those arrangements will be met jointly by the State and the franchisees;
- the company is required to make bonus payments to the consortium, where necessary under the contractual arrangements, and is entitled to receive compensation payments from that consortium, where entitled under the contractual arrangements. Where the payments due to consortium from the company are reduced due to late commissioning, the company must pay to the Public Transport Corporation the amount by which the ordinary payment was so reduced;
- the company is liable to make payments to the consortium in relation to any vandalism on the consortium's equipment;
- prior to the expiry of the automated ticketing system contract, the company must prepare and submit to the Director a new MetCard ticketing plan that provides for an alternative MetCard ticketing system, and ensure that existing obligations by operators will be met, and arrangements for the sale and use of MetCards by bus operators continue; and
- each shareholder of the company, including the Secretary of the Department of Infrastructure who has a 17.7 per cent interest in the company, must make contributions in their specified proportions at the time of any loss by the company.

3.3.63 The Public Transport Corporation remains solely responsible for any payment obligations under the contractual arrangements associated with the consortium and any related claims, up to the franchise commencement date. Furthermore, the Corporation may continue to exercise any rights it has under these contractual arrangements if the exercise of such right does not materially affect the interests of the company, a franchisee or the bus operators. In addition, the Corporation may exercise its rights where the consortium is in breach of its contractual obligations to the Corporation.

3.3.64 In May 2000, the Minister for Transport announced that public transport fares will increase by around 2 per cent for country tickets and 5 per cent for metropolitan tickets, to be applied on 1 July 2000, due to the introduction of the Goods and Services Tax (GST). The Minister also stated that this increase precedes the annual Consumer Price Index (CPI) fare adjustment that will take place on January 2001 which is expected to result in an additional increase in fares of around 7.5 per cent due to cumulative movements in the CPI since 1 January 1999 and the likely effects of the GST on the CPI.

Subsidy payments to franchisees

3.3.65 As the projected revenues from the sale of fares will be insufficient, particularly in the initial stages of the franchise periods, to operate the public transport businesses, the State has agreed to provide a number of subsidies to the franchisees.

3.3.66 It is anticipated that over the franchise periods the State will provide subsidies to the franchisees with an aggregate value of \$2.8 billion in net present value terms, comprising fixed subsidies of \$1.9 billion and variable subsidy payments of \$934 million, with the latter including concession fare top-up payments of \$501 million. Table 3.3D outlines the major components of the fixed subsidy amounts payable by the State to the franchisees over the franchise periods.

3.3.67 Specific provisions are included in the franchise arrangements to cater for the one-off pricing impact of the GST. These provisions recognised the potential impact on the CPI by the introduction of the GST and the simultaneous removal of other indirect taxes in July 2000. Analysis undertaken by the Transport Reform Unit's external advisers determined that over the medium term, the net effect of the introduction of the GST would be a 5 per cent increase in costs and therefore bidders were required to take this into account for the determination of the subsidy payments.

TABLE 3.3D
TOTAL FIXED SUBSIDY PAYMENTS UNDER THE
FRANCHISE ARRANGEMENTS (a)
 (\$million)

<i>Component</i>	<i>Amount</i>
Real annual franchise payments (b)	923.6
Rolling stock adjustment payments (c)	801.9
Capital grants - infrastructure lease	136.2
Capital grants – franchise agreement (d)	70.8
Core infrastructure lease rental (e)	(2.4)
Non-core infrastructure lease rentals (e)	(58.0)
Net cost to the State	1 872.1
Net cost to the State per franchisee:	
Bayside Trains	354.4
Hillside Trains	620.9
Swanston Trams	286.0
Yarra Trams	134.4
V/Line Passenger	476.4
Total	1 872.1

(a) *Source:* Department of Treasury and Finance. All amounts expressed in net present value terms as at 30 June 1999, using a discount rate of 4.5 per cent which was the rate used by the Department of Treasury and Finance for the assessment of bids and are payable when franchisees meet certain contractual obligations.

(b) The real annual franchise sum will be subject to movements in the CPI and has been based on the assumption that fares will increase by 5 per cent, in real terms, to take into account the introduction of the GST.

(c) The rolling stock adjustment payment to the franchisee of Hillside Trains will be subject to the impact of the GST (capped at 5 per cent) and movements in the CPI.

(d) Capital grants under the franchise agreements payable to the franchisees of Bayside Trains, Swanston Trams and Yarra Trams will be subject to the impact of the GST (capped at 5 per cent) and the payments to the latter will also be subject to movements in the CPI. These payments include works valued up to \$38 million and will be undertaken in the event that feasibility studies prove that the proposed works will generate a commercial rate of return.

(e) Represents rental payments for the use of the core infrastructure such as the track and signalling equipment and non-core infrastructure such as certain depots and buildings.

3.3.68 The **real annual franchise sum** represents the core subsidy paid by the State to the franchisees and may be subject to adjustments where:

- Fares are not increased by 5 per cent, in real terms, to take account of the impact of the introduction of the GST;
- The Director approves a change in the passenger service requirements;
- A change in the master timetable of a franchisee which has a flow on impact on the timetable or access arrangements of another franchisee;
- The cost of providing passenger information in accordance with the Director’s requirements, in relation to call centre technology, exceeds the generally accepted levels of technology for an equivalent type of information service;

- There are changes by the Director to the regulated fares or related terms and conditions which adversely impact on franchisee operations;
- Changes are made to the eligibility criteria for those able to travel free of charge;
- Any net loss incurred by a franchisee resulting from a change in Victorian law or a new Victorian law which specifically relates to the franchisee or the Victorian public transport and has a direct material increase in costs to the franchisee. The Director also has the option of funding such losses through a change in fares, reduced payments to the Director or a combination of these payment streams;

3.3.69 In addition, the arrangements provide that:

- Franchisees are to fund passenger counts twice each year, however the Director may undertake additional counts which will be funded by the franchisee where the Director has determined that the load standards have been exceeded. Where load standards are altered by the Director and the franchisee has completed any works as required, the Director must adjust the real annual franchise sum;
- The Director at his cost, may upgrade, replace or add to any of the infrastructure or construct new infrastructure, and is required to provide a reasonable opportunity to the franchisee to tender for these works, however the Director is under no obligations to make that opportunity exclusively to the franchisee. The franchisees will be consulted over the costs likely to be incurred by the franchisee and the revenue (if any) likely to be foregone or received by the franchisees as a direct result of the State works, which will culminate in an adjustment to the real annual franchise sum to compensate for the financial impact;
- Where the Director is not prepared to indemnify the franchisee for the cost of any works required to rectify a latent defect and the franchisee advises that use of that part of the infrastructure would be unsafe, the franchisee must immediately stop using that part of the infrastructure and surrender it to the Director. The real annual franchise sum will be adjusted for the financial impact on the franchisee resulting from the surrender;
- In the event that rolling stock is destroyed or damaged beyond economic repair and the proceeds of insurance are applied to discharge or partially discharge any debt relating to the affected units, or to terminate the lease relating to those units, the real annual franchise sum will be adjusted by the amount of the reduction in expenditure relating to the debt or the annual lease payments;
- Franchisees will be entitled to adjustments in subsidy payments where termination of a mandatory inter-operator agreement occurs;
- The occurrence of a force majeure event may in certain circumstances trigger a reduction in the real annual franchise sum as a result of cost savings to the franchisee for the cessation of operations; and
- The franchisees of Bayside Trains and Hillside Trains are to be compensated for any financial loss or damage suffered as a direct result of a commercial development project to be undertaken at Spencer Street Station or the construction and operation of a rail link to the Melbourne Airport.

3.3.70 As part of the subsidy arrangements, the State has also agreed to make:

- **rolling stock adjustment payments** to the franchisees in order to fund the lease costs incurred by each franchisee for the procurement of new rolling stock;
- **refurbishment rolling stock payments** which are equivalent to more than 90 per cent of the cost to be incurred by the franchisees based in the metropolitan area for the refurbishment of the existing (Comeng trains) rolling stock; and
- other **mandated work payments**, representing specified amounts to be paid for other required works on the franchisees' existing rolling stock and the State-owned infrastructure.

3.3.71 In return for these fixed subsidy payments from the State, the franchisees have broadly accepted the financial risks associated with the day to day operations of the franchise businesses, including expenditure in excess of the projected costs of operating each franchise. However, this risk is to an extent mitigated by the fact that the Director has retained the financial risk associated with movements in the CPI and his obligation to fund any change to the scope of operations.

3.3.72 Table 3.3E outlines the major components of the variable subsidy amounts payable by the State to the franchisee under the arrangements.

TABLE 3.3E
VARIABLE SUBSIDY PAYMENTS UNDER THE
FRANCHISE ARRANGEMENTS (a)
(\$million)

<i>Component</i>	<i>Total</i>
Passenger growth incentive payments (b)	351.5
Concession fare payments (c)	500.7
OPR incentive payments	45.5
Other expected service payments	36.4
Net cost to the State	934.1
Net cost to the State per franchisee:	
Bayside Trains	352.5
Hillside Trains	259.1
Swanston Trams	108.5
Yarra Trams	116.1
V/Line Passenger	97.9
Total	934.1

(a) Source: Department of Treasury and Finance. All amounts expressed in net present value terms as at 30 June 1999, using a discount rate of 4.5 per cent, which is equivalent to the rate used by the Department of Treasury and Finance for the assessment of bids.

(b) The passenger growth incentive payments are payable to the metropolitan based franchises only and take into account the impact of the GST as bidders were required to assume an increase in fares of 5 per cent, in real terms, due to the introduction of the GST.

(c) The concession fare payments will be subject movements in the CPI and take into account the impact of the GST as bidders were required to assume an increase in fares of 5 per cent, in real terms, due to the introduction of the GST.

3.3.73 Under the arrangements, **passenger growth incentive payments** are to be made by the Director to each franchisee, equal to 50 cents for each additional dollar of revenue collected in excess of a specified threshold based on the franchisee's base fare revenue generated in the 1998-99 financial year. However, the value of this payment in any one year cannot exceed 50 per cent of this specified threshold.

3.3.74 The **concession fare payments** to the franchisees will top up fare revenue from concession fare passengers to 75 per cent of the value of an equivalent full fare each year over the franchise period.

3.3.75 The **OPR incentive payment** relates to an incentive regime which aims to influence franchise management behaviour and was established to encourage adherence to the master timetable and the daily timetable, with its calculation based on performance against specified targets. In addition, this payment is aiming to foster a significant improvement in service reliability and punctuality. The calculation of this payment is not affected by any adverse impact of force majeure events and certain State works.

3.3.76 Other circumstances which may impact on the level of net variable payments by the State are as follows:

- The Director will be required to make payments to the franchisees to fund any "free travel reimbursement" to eligible passengers, "senior citizens week payments" and "special event balancing payments" for additional services required to be provided for designated special events;
- The franchisees, other than the franchisees of Hillside Trains and Yarra Trams, will be required to share with the Director 50 per cent of the value of any taxation benefits resulting from any tax-based funding arrangement for the committed rolling stock;
- In the event that there are changes to Commonwealth tax legislation relating to the calculation of depreciation for the initial rolling stock, the franchisees (excluding the franchisees of Hillside Trains and Yarra Trams) must pay to the Director an amount calculated in accordance with the proposed law, however if the franchisee is denied the application then the Director must refund the amount received; and
- In relation to the franchisees of Bayside Trains, Swanston Trams and V/Line Passenger the Director is entitled to a share of any profits generated by the franchisee in excess of a level determined on the basis of a pre-established formula, based on the amount by which the "audited book profit" exceeds the projected bid profit for a financial year for each franchisee. The Director must apply any such profit share towards investment or other expenditure approved by the franchisee.

Minimum asset maintenance

3.3.77 Under the arrangement each franchisee is required to ensure that all rolling stock designated by the Director as “primary franchise assets”, together with the infrastructure assets are maintained in an adequate condition, based on pre-determined target condition indices. In relation to the infrastructure, the franchisees are required to repair and maintain the infrastructure in a condition which enables the franchisees to comply with their obligations under the arrangements, to enable the infrastructure to be used safely and to preserve the infrastructure in a functional state and in a condition which does not compromise the operation of the Victorian train transport network. Minimum service standards are also to be met in relation to cleanliness, the repair of vandalised damage, railway station conditions, security and the provision of information.

3.3.78 Where, at the franchise commencement date, the condition index for an asset type is less than the minimum target condition, franchisees are given up to 3 years to upgrade the asset to the required level.

3.3.79 If a franchisee fails to ensure that maintenance work on the rolling stock is undertaken in accordance with the franchisee’s rolling stock management plan, and the Director believes that such failure represents an unreasonable deferral of maintenance, the Director may, at the expiry or termination of the franchise agreement direct the franchisee to undertake any maintenance work which has not been performed, or request the franchisee to pay the Director on demand an amount reasonably determined by the Director to be the estimated costs to undertake the maintenance works.

3.3.80 If at any time the “primary franchise assets” are destroyed or damaged beyond economic repair, the franchisees at their cost are required to replace these assets, unless the franchisees can prove that the asset is unnecessary for them to meet their obligations under the arrangements.

3.3.81 The arrangements provide that a specified portion of the fixed subsidy payment known as the “real annual franchise sum”, which is payable to the franchisees, is to be paid into an escrow account for the purpose of funding maintenance expenditure on infrastructure. In turn, the Director is to issue funds from the escrow account to the maintenance accounts that are established by each franchisee, with the funds ultimately drawn down by the franchisee to fund maintenance costs incurred in relation to the infrastructure.

3.3.82 Following the receipt of a condition survey after at least 3 years from the commencement of the franchise period, each franchisee may request that all or part of the balance remaining in the escrow account to be used by the franchisees at their discretion.

3.3.83 **Based on the terms and conditions incorporated in the respective agreements, the franchisees are responsible for the maintenance of the rolling stock and the infrastructure at a minimum standard set by the Director at the commencement of the franchise, that is, an appropriate operating level. However, provision for these costs is included in the subsidy payments made by the State.**

Rolling stock units

3.3.84 Under the franchise arrangements, the train franchisees have agreed to refurbish a specified number of rolling stock units by December 2003, which they acquired under the above-mentioned sale arrangements for a nominal amount. In return, the Director has agreed to provide the previously mentioned fixed subsidy payments totalling \$104 million in net present value terms, to the franchisees for this purpose. **The franchisees bear the risk of any overruns in refurbishment costs and penalties may be imposed by the Director for any failure of franchises to complete agreed refurbishment works.**

3.3.85 In addition, the franchisees are required to lease, on terms approved by the Director, a specified number of new rolling stock units (referred to as the committed rolling stock) and take possession of these units so that they are in regular service by September 2004 (trams) and December 2004 (trains). As shown in Table E, the estimated acquisition price of the new rolling stock units will be in excess of \$1.09 billion. The State's obligations in relation to these leasing arrangements under a number of "direct" agreements are outlined later in this Report.

3.3.86 As part of the leasing arrangements between the franchisees and the lessors of the rolling stock, the State required that the residual value at the end of the leasing arrangements associated with the stock must be at least 30 per cent of the build price only (excluding any financing and other related costs), thereby ensuring that the State does not acquire a beneficial interest in the rolling stock during the initial periods of the lease terms.

3.3.87 However, as shown in Table 3.3F the estimated residual value of the rolling stock at the end of the initial lease terms equates to 24 per cent of the total anticipated cost of the committed rolling stock units including the financing and other related costs over the lease period. In relation to the 3 franchises awarded to the National Express Group, the average residual value is 22 per cent.

3.3.88 In our view it is more appropriate to assess the residual risk of these rolling stock units in reference to the estimated build price and financing and other related costs, rather than the build price alone.

**TABLE 3.3F
ESTIMATED COST OF THE COMMITTED ROLLING STOCK UNITS**

<i>Details</i>	<i>Anticipated build price (a)</i>	<i>Build price plus estimated financing and other related costs (b)</i>	<i>Rolling stock adjustment subsidy payments (c)</i>	<i>Estimated residual value (d)</i>
	(\$m)	(\$m)	(\$m)	(%)
Total for all franchises	1 091	1 364	1038	24
Estimated residual values per franchise -				
Bayside Trains				20
Hillside Trains				29
Swanston Trams				20
Yarra Trams				24
V/Line Passenger				27

(a) *Source:* Franchise agreements.

(b) *Source:* Department of Treasury and Finance. Represents the anticipated build price of the rolling stock plus estimated financing costs and other related costs, which were 25 per cent on the anticipated rolling stock build price.

(c) The total net present value, (based on a discount rate of 4.5 per cent, which was the equivalent rate used by the Department of Treasury and Finance for the assessment of bids) of the rolling stock adjustment payment of \$1 038 million comprises payments of \$751 million during the franchise period and payments of \$287 million from the end of the franchise period to the end of the lease period.

(d) The estimated residual value is based on the build price plus estimated financing and other related costs.

3.3.89 The franchisees have provided the State with additional performance bonds totalling \$60 million to ensure compliance with their obligation to bring into regular service the committed rolling stock. These performance bonds will be extinguished once the acquisition and associated funding arrangements, and other direct agreements with the Director of Public Transport, for the committed rolling stock are finalised. Consistent with the security arrangements established in relation to existing rolling stock, the lessors are required to provide a security interest in favour of the Director over the committed rolling stock.

3.3.90 The Director may also, within 18 months prior to the last delivery date of the committed rolling stock, require franchisees to lease additional units of rolling stock referred to as “option rolling stock”. The franchisees and the Director are required to reach agreement as to the terms of the lease and associated maintenance arrangements. The number of units of option rolling stock, together with the anticipated construction costs (excluding financing and related costs) in aggregate, are as follows:

- Bayside Trains – \$53.9 million (5 units);
- Hillside Trains – \$54.2 million (5 units);
- Swanston Trams – \$13.6 million (5 units);
- Yarra Trams – \$14 million (5 units); and
- V/Line Passenger – \$13 million (5 units).

3.3.91 As previously mentioned, the lease costs associated with the committed and the option rolling stock will be funded by the Director through the payment of “rolling stock adjustment payment”.

3.3.92 The common franchisee of Bayside Trains, Swanston Trams and V/Line Passenger may, no later than 6 months after the franchise commencement date, seek approval from the Director to substitute the committed rolling stock and the option rolling stock with alternative rolling stock of equivalent quality, functionality and performance. In relation to the franchisee of Hillside Trains, in the event the Director does not require that franchisee to lease one or more units of option rolling stock, the franchisee will be required to pay to the Director an amount of \$1.4 million representing the value of certain conditional mandated works relating to the existing rolling stock units.

3.3.93 The Director has the power to impose significant penalties on franchisees' in the event that the committed or option rolling stock is not in regular service by the required dates. If the stock is not introduced within 12 months of the required date, then this will constitute a franchise breach and a termination event.

3.3.94 Under the arrangements, the key risks associated with the procurement and delivery of the committed rolling stock units have been effectively transferred to the franchisees. These risks relate to the franchisees' responsibility to procure and commission the units by specified timeframes, consistent with projected costs.

3.3.95 In addition, the lessors of the committed rolling stock units have accepted the following key risks associated with the construction and on-going ownership of the units:

- risk of movements in the cost of financing the purchase price of the units;
- risk of movements in the value of currencies, as certain units or components thereof may be purchased from non-Australian sources; and
- the residual risk of the units at the end of the lease period. However the Department of Treasury and Finance advised that certain franchisees have purchased insurance to mitigate this risk.

3.3.96 To protect the State's interest in respect of the committed rolling stock units, the Director has provided an undertaking to the lessor that the State will ultimately be responsible for the minimum lease payments for the units over the entire lease period which ranges up to 15 years for units which have estimated useful lives of 30 years. Therefore, in the event of early termination of the franchise arrangements where the Director is unable to procure a successor franchisee to perform the required obligations to the relevant lessor, the Director may be required to directly fund the minimum lease payments. As a result of this obligation, the Department of Treasury and Finance's accounting advisers have recommended that the Department of Infrastructure recognise a contingent liability associated with the remote possibility of the Director being required to meet these lease payments.

3.3.97 In assessing whether the arrangements associated with the acquisition and leasing of the committed and option rolling stock give rise to any assets or liabilities of the State, it is necessary to assess the extent of risks and obligations retained by the State, and in turn the benefits enjoyed by the State from the assets, under the arrangements. A major factor impacting on such an assessment is gauging the extent of any residual risk retained by the lessor. This involves determining the extent to which the State has transferred to the private sector the financing risks associated with the rolling stock.

3.3.98 Based on a number of assumptions adopted by the Department of Treasury and Finance in determining the fair value of the rolling stock (including any allowance to be added to the expected build price of these assets to reflect their financing costs, and the discount rate to be used in determining the present value of cash flows), it can be concluded that the lessor will retain some residual risk associated with these assets. These are estimated at between 20 to 29 per cent. Such an assessment would generally not give rise to the recognition of any assets or liabilities by the State in its financial statements. However, in our opinion, further work is required to be completed by the Department to support the appropriateness of the above mentioned assumptions used to determine the fair value of the rolling stock and the Department's proposed accounting treatment.

Mandated works funded by the State

3.3.99 The franchisees of Bayside Trains, Yarra Trams and Swanston Trams must design and construct certain specified mandated works in accordance with a brief determined by the Director. **While the Director is responsible for a set amount to fund the cost of designing and constructing these works, franchisees will be liable for any costs incurred in the use, operation or maintenance of the mandated works following their completion, given that these costs would have been factored into the real annual franchise subsidy sums payable by the Director to the franchisees.**

3.3.100 These works include the upgrade of key mechanical components of trains and trams and in relation to the infrastructure will include, among other things, the extension of the Mont Albert tram line and works on the Flinders Street viaduct.

Mandated works funded by the franchisees

3.3.101 The franchisees will also be required to fund, at their own cost, certain mandated works on the rolling stock and infrastructure. The total value of these works is estimated at \$24 million and will mainly include the provision of additional car parking and ticket gates (Bayside Trains), the refurbishment of the existing rolling stock, train station upgrades and information system enhancements (Hillside Trains) and the removal of certain punctuality impediments (Swanston Trams).

3.3.102 Furthermore, the franchisee of Hillside Trains is also required to fund works on the existing rolling stock and on its leased infrastructure relating to the redevelopment of the Flinders Street Station and the upgrade of signalling systems. For these specific works, in the event of an early termination of the franchise agreement, the Director is required to pay that franchisee a specified early termination amount equivalent to the value of the works performed.



Flinders Street Station.

3.3.103 As the regional rail tracks are leased to Freight Australia, the franchisee of V/Line Passenger is required to pay an access fee to that party and is not directly required to undertake any mandated works.

3.3.104 Finally, the franchisees may at their own cost and risk undertake works to enhance or modify the infrastructure beyond the required contractual obligations, provided that such works do not reduce the functionality and capacity of the infrastructure, compromise the operation of the Victorian train transport network or reduce the franchisees' ability to meet their contractual obligations. Any major works require the approval of the Director prior to commencement and the franchisees may request the Director to assist in their funding. Subject to any agreement to the contrary, these works will revert to the State.

Feasibility assessments of certain proposed works

3.3.105 The franchisees are required to conduct feasibility studies in relation to certain specified projects within certain timeframes, including the evaluation of a rail link from Spencer Street Station to Melbourne Airport and the extension of certain tracks. The cost of these studies is to be borne by the franchisees. The Government's *2000-01 Budget Statement* identified the provision of contributions of \$20 million towards the construction costs of the Airport Transit rail link. In addition, the budget provided for a further \$80 million for regional fast rail links and \$70 million for metropolitan tram and train extensions and for faster suburban trains.

3.3.106 In addition, the franchisee of Bayside Trains is required to undertake, at its own cost, a feasibility assessment to determine the viability of introducing hand-held ticketing equipment. If the study shows that the net present value of issuing such equipment is positive or exceeds a "hurdle" commercial rate of return, then the equipment must be issued by all the franchisees by March 2002. A similar arrangement is in place for an assessment by the same franchisee of the viability of the construction of 2 "park and ride" facilities and the upgrade of the train radio network. and further.

3.3.107 Furthermore, as shown in Table C, the State may be required to fund certain capital projects subject to the results of feasibility assessments undertaken by the franchisees. These projects include the extension of certain tracks and line speed improvements (V/Line Passenger), track works (Swanston Trams) and additional enhancements to the Comeng rolling stock units (Bayside Trains).

3.3.108 The Director at Government expense, can upgrade, replace or add to any of the infrastructure or construct new infrastructure and is required to give the franchisees the opportunity to tender for State works.

Additional capital investment

3.3.109 On an annual basis, the franchisees must provide the Director with a forward capacity plan, identifying the services required to meet future demand and to allow the avoidance of any breach in passenger load standards. The plan is also required to identify future capital investment over and above the committed rolling stock and other required works.

3.3.110 If at any time the franchisee considers, after having regard to the forecast passenger demand for the remainder of the franchise period, that additional capital investment is required to ensure that the franchisee does not breach its load standards, it must submit a capital investment proposal to the Director. The Director may approve or reject the proposal at his discretion, however if the proposal is rejected, the parties must agree to an alternative capacity proposal such as reducing the required load standards.

3.3.111 **To the extent that a proposal involving additional capital investment is approved by the Director, the State will fund 80 per cent of the additional cost, with the balance to be funded by the relevant franchisee.** In addition, during the period from when the franchisee has submitted such proposals, the franchisee will not be penalised for any breach of load standards.

3.3.112 The franchisees of Bayside Trains and Hillside Trains are committed to funding and implementing additional train paths by designated timeframes. The new train paths will emerge once improvements are made to the existing track and signalling equipment, which will permit more intense use of the train network.

Other works – latent defects

3.3.113 If a franchisee becomes aware, during the term of the franchise, of a latent defect (a structural defect in any part of the infrastructure existing at the franchise commencement date) which the franchisee is obligated to rectify in order to comply with its obligations under the contractual arrangements, then where the cost of rectifying that latent defect is equal to or less than \$7 million (trains) and \$3.5 million (trams), exclusive of the GST and movements in the CPI, the franchisee must, at its own cost, undertake all work required to rectify that latent defect.

3.3.114 Where the cost of rectifying that latent defect is greater than the threshold amount, the franchisee is to notify the Director of the nature of the latent defect and the estimated cost of rectifying it. The Director is responsible for meeting 90 per cent of the costs in excess of \$7 million for the train franchises and \$3.5 million for the tram franchises, up to a maximum of \$36 million in relation to the train franchises and \$18 million for the tram franchises. The franchisee may draw on the maintenance account to fund its portion of these costs.

Indemnities

3.3.115 The franchisees have indemnified the Director against all losses, costs and expenses incurred by the Director for any act, omission, breach, termination, infringement of any intellectual property rights, or any death, injury suffered by passengers or any third party unless the cause of the loss is due to the Director. In addition, the franchisees have provided an indemnity to the Director for any costs incurred as a result of any breach of an inter-operator agreement.

3.3.116 In addition, each these parties will not be liable to each other for any indirect or consequential loss incurred as a result of any breach or negligence by the guilty party. These losses will include loss of certain subsidy payments, access charges and incentive payments, loss of business opportunity and payment of liquidated sums, penalties or damages. However the indemnity excludes property damage or losses arising from claims made by third-parties in respect of property damage, personal injury or death or penalties, incentive payments or adjustments to the real annual franchise sum.

3.3.117 The Director will remain liable for any pre-existing contamination on land leased to the franchisees as at the franchise commencement date. The Department of Infrastructure advised that contamination assessments were completed for sites considered to have the most risk of contamination and asbestos registers were provided to each franchisee prior to the franchise commencement date.

Insurance

3.3.118 Insurance over the primary franchise assets and other public liability insurances are required to be purchased by the franchisees, with these policies required to nominate the Director as a beneficiary. For the short term, the State-owned Victorian Managed Insurance Authority coordinated the purchase of insurance for the franchisees under a “Director Controlled Insurance Program”, however the Authority, on behalf of the State, has not assumed any insurance risk as a result of its involvement.

Events that may lead to a Call-In, Breach, Step in or Termination

3.3.119 Under the franchising arrangements, the Director is entitled to serve notice on the franchisees outlining the nature of a “call-in event,” and may require the franchisee to provide information such as remedial plans to improve performance in the areas identified by the call-in event. Call-in events include the following:

- failure to comply with the train plan which relates to the load capacity of each train and tram;
- persistent deviation from the master timetable and the daily timetable;
- poor results from customer satisfaction surveys;

- inaccurate data in relation to concessions; and
- the condition index for rolling stock units is less than the target index.

3.3.120 If a call-in event of the same type is repeated 3 times within a period of 36 months, the notification of the third call-in event may, if the Director so elects, constitute a franchisee breach and each subsequent notification of a call-in event of the same type within that 36 month period may, if the Director so elects, also constitute a franchisee breach.

3.3.121 Franchisees must fund customer satisfaction surveys every 3 months and must use reasonable endeavours to secure continuous improvement. If the surveys indicate that the overall level of customer satisfaction is not improving, then the Director may require the franchisee to produce a service improvement plan. Although the franchisees will not receive incentive payments for high customer satisfaction ratings, where the results of two successive surveys indicate that the overall level of customer satisfaction is below a designated customer satisfaction threshold, as previously mentioned this may constitute a call-in event and a customer satisfaction penalty may be imposed on the franchisee.

3.3.122 Where a franchisee breach occurs which is capable of remedy, the Director may give the franchisee notice in writing specifying that a breach has occurred, setting out reasonable details of the breach and specifying the cure period for that breach. Franchisee breaches include any failure by franchisees to comply with their obligations under the franchise arrangements, as well as the specific items listed below:

- failure to comply with the required load standards;
- persistent deviation from the master timetable and the daily timetable;
- non-compliance with customer service standards;
- 3 “call-in” events;
- failure to bring into regular service by the first required delivery date units of the committed rolling stock;
- failure to bring into regular service more than 12 months after the last delivery date units of the committed rolling stock;
- failure to refurbish more than 12 months after the last specified date the designated rolling stock (relating to the metropolitan train franchises only);
- manipulation by a franchisee of stated performance results for the purpose of the calculation of the OPR incentive payment; and
- false or misleading information is used to materially increase payments to the franchisees or to reduce payments to the Director.

3.3.123 Where a franchise breach occurs which is not of a financial nature, the franchisee must provide to the Director a cure plan to remedy the breach within a designated period. A breach of a financial nature may only be cured by the payment of the amount owed, including interest. If the breach is not cured to the satisfaction of the Director or is not capable of remedy, the Director may impose a financial penalty on the franchisee. The maximum penalty is the greater of \$1 million or \$10 000 for each day that the franchisee breach continues, (with these amounts subject to CPI movements).

3.3.124 The Director may exercise step-in rights to remedy a termination event or a franchise breach which has materially affected passenger services, has resulted in the termination of an inter-operator agreement, has increased the risk of death or injury to passengers or has frustrated the transfer of the franchise business as a going concern to a successor operator. During the period of step-in, the Director must continue to make all payments to the franchisee but he is permitted to deduct costs which the State has incurred as a result of the intervention. Once the termination or franchise breach has been remedied to the satisfaction of the Director, the franchises must resume operation of the business. Termination events include the following:

- franchise breaches which are not adequately cured, (the agreements require that there must be a persistent failure to perform or comply to a material extent with any of the franchise obligations in order for a termination event to be triggered, however a breach of a financial nature is automatically a termination event);
- certain breaches of the direct agreement relating to the maintenance arrangements for the infrastructure and rolling stock;
- material breach under the mandatory inter-operator agreements;
- persistent deviation from the master and daily timetable, (in excess of the designated threshold);
- an insolvency event;
- change of franchise ownership without the consent of the Director;
- unlawful for the franchisee to operate all or a material part of the franchise;
- misrepresentation;
- a material part of the transaction documents become illegal;
- franchisee accreditation is revoked;
- late delivery of rolling stock units and, in the case of trains, late refurbishment of the Comeng rolling stock;
- termination of arrangements associated with another franchise where the relevant franchisee has multiple franchises;
- the acquisition of equity in the franchisee by a Government agency, either indirectly or directly;
- the provision of inaccurate or misleading information in relation to the calculation of payments between the franchise and the State; and
- certain events enabling the termination of the rolling stock lease.

3.3.125 Any franchisee that is prevented from meeting its obligations or is relieved of any call-in event, franchise breach, termination event or OPR incentive payment due to a force majeure event, must nevertheless take appropriate action to remedy or reduce the impact of the event. A force majeure event includes:

- act of god (but not high temperatures for the metropolitan franchises only);
- industrial action other than action relating to the franchise employees or the tram or train industry;

- act of war and the like;
- the effect of any change in applicable laws of any government; and
- any embargo, water or power shortage.

Re-tendering of franchise arrangement

3.3.126 In the event of early termination or the expiration of the franchise period, the Director is able to call for tenders for the operation of all or any part of the franchisee business. The franchisee must maintain and manage the franchise business in a way that a successor operator is able at any time to immediately take over the franchise business as a going concern. The franchisee must use reasonable endeavours to assist the Director in the preparation for, and the conduct of, a fair and competitive tendering process, including reasonable access to franchise employees, books, records and other materials.

3.3.127 If the franchisee has not entered into a transfer agreement with a transferee in respect of the primary franchise assets by an agreed date, the Director may request the Minister to effect the transfer of these assets using an allocation statement. If the primary franchise asset is not a unit of initial rolling stock, the Director must pay to, or at the direction of the franchisee, the lower of the cost, tax written down value or market value of the asset. If the primary franchise asset is a unit of initial rolling stock, the Director is not required to pay any amount for the stock, however in relation to Hillside Trains the Director must meet termination payments for the initial rolling stock.

3.3.128 At this time, the parties must also observe the following:

- the franchisee is restricted in making changes to the terms and conditions of employment of any franchisee employee 12 months prior to the date of expiry of the franchise period, or after the date the Director becomes aware of a termination event;
- the franchisee is to ensure that an appropriate number of franchise employees are available to be employed by a successor operator following the expiry or termination of the franchise period to enable the successor operator to carry out the franchise business;
- the franchisee must pay to the Director or the successor operator an amount equivalent to the accrued employee entitlements; and
- the franchisee will provide a transferable licence to the Director for the use of all intellectual property (whether owned by the franchisee or not) which is used by the franchisee in connection with the provision of the passenger services, for the purposes of permitting any successor operator to provide the passenger services and operate the franchise business after the expiry of the franchise period.

Other key obligations of parties

3.3.129 Other key obligations of the parties to the franchise arrangements are outlined below:

- Franchisees are unable to create or allow any security interest over the primary franchise assets, or to sell the primary franchise assets without the consent of the Director;

- Franchisees are to provide the Director with quarterly financial statements and on an annual basis, audited financial statements, business plans and budgets covering a 3 year period;
- The Director has the power of audit or inspection over information provided by franchisees in order to check or audit the information supplied under the agreement or any transaction document;
- Except with the consent of the Director, franchisees must not directly or indirectly be involved in or conduct any business or activity other than the franchise business, or to sub-contract or delegate the performance of any of its obligations;
- Franchisees are to prepare and submit to the Director on an annual basis a forward capacity plan for a 3 year period, setting-out the service capacity required to be included in the master timetable and train plan in order to ensure that the franchisee does not breach its load standards;
- Within 3 months of the franchise commencement date, each franchisee was required to prepare and provide to the Director, for approval, a passengers' charter which describes how the commitments in the State's passengers' charter will be fulfilled by the franchisees. In addition, each franchisee was required to prepare and provide for approval by the Director a passenger compensation code;
- Over the term of the infrastructure lease, a royalty-free licence is conferred on the franchisee to use the intellectual property needed to operate the leased assets, with all intellectual property reverts to the Director upon expiration or termination of the lease;
- The franchisees agreed to jointly operate the VicTrip Information Service which provides to the public the most recent and accurate transport information through a company called VicTrip Pty Ltd. Each of the franchisees and the Director (on behalf of metropolitan buses) are shareholders in the company, with the VicTrip Shareholders Agreement regulating their relationship. The shareholders, including the Director, have agreed to contribute capital to the company in accordance with an annual budget, and agreed to issue additional capital from time to time to ensure that the company remains solvent;
- In relation to Yarra Trams and Swanston Trams, the franchisees are to provide an additional level of passenger services in accordance with the Australian Grand Prix Public Transport Plan. The franchisees will not receive additional payments from the Director to provide these additional services. However, if the specified tram kilometres designed under the plan are exceeded, the franchisees will be able to make a claim under the special events conditions;
- The franchisees of Swanston Trams and Yarra Trams are required, subject to availability, to use the historic W Class trams along specified routes and must not reduce the number of tram stops on any tram route without the approval of the Director; and

- The franchisees are required to continue to provide the same number of car parking spaces at each rail station consistent at those inherited at the franchise commencement, and to provide these spaces at no charge. However, the franchisees may impose a fee on up to 50 per cent of these car parks, provided that such car parks are situated in a fenced area that is controlled by boom gates and staffed on weekdays. In addition, some franchisees may impose a fee on passengers for car parking spaces in excess of the number of car parking spaces at the station at the franchise commencement date and some franchisees are required to provide a specified number of additional car parks above a minimal dollar threshold at its own cost.

Direct agreements associated with the committed rolling stock

3.3.130 As previously mentioned, the franchisees are required to bring into regular service a specified number of committed rolling stock units to replace a portion of the current rolling stock which are approaching the end of their useful lives. Similar arrangements are also intended to apply for the procurement of the option and any additional rolling stock.

3.3.131 **As part of the procurement process for the committed rolling stock units, the Director is required to enter into direct agreements with the supplier and the purchaser (the lessor), together with the franchisee, in order to give the Director certain direct rights over the arrangements for the supply, lease and maintenance of the rolling stock units.**

3.3.132 The arrangements outlined below are based on the finalised agreements associated with the franchises of Bayside Trains and Swanston Trams and, in this instance, the purchasers are the lessors. At the date of the preparation of this Report, negotiations for the arrangements for the balance of the franchises were in progress.

New rolling stock supply direct agreement

3.3.133 Under the New Rolling Stock Supply Direct Agreement, the supplier and the lessor of the rolling stock have agreed not to make any amendments to their arrangements associated with the supply of the rolling stock or alter the specifications of the rolling stock without the prior approval of the Director. In addition, the supplier has acknowledged the Director's right to step-in under the franchise agreement and to perform any of the contractual obligations under the arrangements.

3.3.134 Furthermore, the supplier's ability to terminate its obligations to manufacture and sell the rolling stock to the lessor is restricted and may only be terminated as a result of a default by the lessor or franchisee which has not been remedied in accordance with the supply arrangements. However, the supplier may not terminate the arrangements if the Director has notified the supplier of his intention to step-in and operate a franchise.

3.3.135 The lessor has also provided an indemnity to the Director against any costs or expenses incurred by the Director in curing a default by the lessor, or performing the lessor's obligations, under the supply arrangements.

New Rolling Stock Lease Direct Agreement

3.3.136 A significant obligation of each franchisee under the franchise arrangements is the requirement to enter into leasing arrangements with the relevant lessors for the procurement of the committed rolling stock. As part of these arrangements, the Director has agreed to enter into a new rolling stock lease direct agreement with the each franchisee and the lessor of the rolling stock.

3.3.137 Under this agreement, the lessor agreed not to make any amendments to the lease agreement with a franchisee without the prior consent of the Director and not to terminate the agreement if the Director intends to exercise his step-in rights. In the event that the lessor terminates the lease agreement in breach of the lease direct agreement, or the franchisee terminates the lease early, in accordance with the terms of the lease agreement but in breach of the franchise agreement, the Director has the option to require the lessor to continue to perform the lease and to enter into a deed with the franchisee acknowledging that the lease is to continue on the same terms as if it had not been terminated. The Director can also exercise a call option requiring the lessor to sell to the Director or a new franchisee the rolling stock subject to the lease agreement.

3.3.138 Where the Director exercises the call option to purchase all of the rolling stock units, the Director must pay a termination value to the lessor which will be generally equivalent to the residual value of each unit. In addition, where the Director exercises a call option, the Director may request the Minister for Transport to sign an allocation statement to facilitate the transfer of the units.

3.3.139 Where the lessor becomes entitled to terminate the lease due to a default which has not been remedied, the expiry of the franchise agreement or early termination of the franchise agreement, the lessor and the Director must enter into a novation agreement with the existing franchisee to transfer the lease to the Director or a successor franchisee as a new lease. Under this scenario, the Director is required to ensure that any obligations of the initial franchisee outstanding under the lease at the time the parties enter into a novation agreement are discharged.

3.3.140 If the Director or another State body becomes the lessee under the transferred lease and the lessor loses its ability to claim tax deductions, the Director must compensate the lessor for that loss in accordance with an agreed formula.

3.3.141 As a result of the sale and leaseback of the existing rolling stock units acquired by the franchisee of Hillside Trains, the Director has entered into a rolling stock lease direct agreement with that franchisee and the lessor, to protect the Director's interest in the current rolling stock units. The terms of this agreement are consistent with the terms of the direct agreement outlined above, however the termination value of the units reduces to zero at the expiry of the lease period, being the expiry of the term of the franchise.

New rolling stock maintenance direct agreement

3.3.142 The new rolling stock maintenance direct agreement assigns certain rights to the Director against the party (the maintainer) responsible for the maintenance of the committed rolling stock and associated assets such as spares inventory under the arrangements between each maintainer, the lessor and franchisee.

3.3.143 Consistent with the previously mentioned direct agreements, each maintainer has agreed not to make any amendments to the maintenance arrangements without the prior consent of the Director. However, the maintainer may amend the terms of such arrangements if the variation does not result in an increase in the franchisee's obligations and does not affect the specifications of the rolling stock units.

3.3.144 The maintainer's ability to terminate the agreement is restricted, with the agreement only able to be terminated as a result of a default by the franchisee with the terms of the maintenance arrangements where the default has not been remedied within a specified period. However, the maintainer may not terminate the agreement where the Director has notified the maintainer of his intention to exercise his right to step-in.

3.3.145 Other key obligations associated with this agreement are as follows:

- If the maintenance agreement is terminated by the maintainer in breach of the maintenance direct agreement, or where the maintenance agreement is terminated by the franchisee in breach of the franchise agreement, the Director has the option to require the maintainer to continue to perform the maintenance agreement on the same terms as if the contract had not been terminated;
- On termination of the franchise agreement, the Director has the option to require the maintainer to transfer the maintenance agreement to the Director or a successor franchisee, with the Director then required to ensure that the successor franchisee performs its obligations under the maintenance agreement;
- The spares and special tools used by the maintainer are to be treated as primary franchise assets. The maintainer has undertaken to maintain the primary franchise assets in good working condition and to replace primary franchise assets lost, destroyed or damaged;
- Upon termination of the maintenance arrangements, the maintainer may enter into a transfer agreement with a transferee. If the maintainer has not entered into a transfer agreement with a transferee in respect of a primary franchise asset by the transfer date, the Minister for Transport may issue an allocation statement, allocating the primary franchise asset to the transferee. The Director has the right to acquire the primary franchise asset from the maintainer at an agreed price; and
- The maintainer grants to the Director a licence to use the intellectual property used by the maintainer in the provision of maintenance services.

Overall assessment of arrangements

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

3.3.147 The aggregate cost to the State for the delivery of these services by the franchisees over the next 15 years, in net present value terms, will be around \$2.8 billion. This level of subsidy has been impacted by the transfer and sale of the existing rolling stock units which had a book value of \$663 million to the franchisees for a nominal consideration, which had the effect of reducing the level of the subsidy.

3.3.148 As a result of establishing these new arrangements, the Government expects that savings of \$161 million per annum, representing total savings in real terms of \$1.76 billion over the next 15 years, will be achieved by the State compared with the public sector benchmark cost developed by the Transport Reform Unit. This benchmark which is based on existing levels of service and efficiency, includes an annual capital asset charge equivalent to 15 per cent of the written down replacement cost of the non-current physical assets employed compared with 8 per cent generally imposed on budget sector agencies.

3.3.149 Under the arrangements, the franchisees have accepted the following key commercial risks:

- Failure to achieve the projected levels of growth in fare revenue and movements in the rate of fare evasion. In fact, 30 per cent of the total subsidy payments payable to the franchisees, and hence the financial viability of the commercial operation of each franchise, will depend on the achievement of these growth targets; and
- The emergence of any adverse differences between the projected costs (including the impact of the GST) and the actual costs incurred in the delivery of these services and the procurement of certain works and rolling stock units.

3.3.150 However the Director on the behalf of the State has retained certain risks under these arrangements, including:

- increased subsidy payments resulting from changes in the CPI;
- the provision of additional funding associated with any changes in the scope of operations or amendments to fare regulations as approved by the Director; and
- a requirement to compensate the franchisees for any loss resulting from any changes in Victorian law.

3.3.151 In relation to the leasing arrangements for the new committed rolling stock, based on an assessment of the currently available information, the private sector lessors will substantially bear the risks associated with their financing. However, as previously mentioned in this Report, the Department of Treasury and Finance needs to complete further work to support the appropriateness of the underlying assumptions and accordingly the proposed accounting treatment.

❑ **RESPONSE** provided by the Secretary, Department of Infrastructure

Subsidy payments to the franchisees

In relation to comments in paragraph 3.3.71, they are not considered as a mitigation of the franchisee's exposure as it is not uncommon for contracts to include CPI escalation clauses and variations due to changes in the scope of work.

Where franchisees incur expenditure in excess of projected costs of operation for agreed contracted services due to inefficiencies or other factors, these costs will not be borne by the State.

Contingent liability in respect of committed rolling stock units

It is agreed that a contingent liability should be disclosed by way of a note to the financial statements. However, due to the remote possibility of the Director being required to meet these payments, the point in time when an early termination event by the franchise arrangement, and other factors it is not possible to reasonably quantify an amount for this contingent liability. As per the Accounting Standards and the Financial Management Act 1994 where a contingent liability is not quantifiable the liability will be disclosed with a full description of the nature, cause of the contingency and an indication, to the extent known, of any circumstance which could cause a liability to eventuate.

Assumption used to estimate fair trading value of rolling stock

This issue will be discussed with officers from the Department of Treasury and Finance to determine what work has been carried out to support the assumption used to determine the fair value of the rolling stock before a final decision on accounting treatment is made.

MAINTENANCE OF STATE-OWNED TRANSPORT INFRASTRUCTURE

3.3.152 A key part of the Government's public transport reform program was the creation, in July 1997, of Victorian Rail Track (VicTrack), a State-owned corporation established to manage and maintain rail infrastructure. This infrastructure mainly comprised rail track, stations and signalling equipment that was formerly owned by the Public Transport Corporation. At 30 June 1998, the rail infrastructure had a reported value of \$3.2 billion.

3.3.153 Responsibility for the management of the rail infrastructure was assigned in August 1999 to public transport franchisees under a series of contractual arrangements. VicTrack has reserved all rights in relation to non-rail transport activities, such as the laying and maintenance of telecommunication and fibre optic cables, and advertising along rail lines. VicTrack has also retained responsibility for the right to develop air space above the rail land.

3.3.154 Under the framework established to franchise the public transport services, VicTrack has leased the metropolitan and rural intrastate infrastructure to the Director of Public Transport, who administers the infrastructure leases in respect of rail transport-related activities. The Director of Public Transport has sub-leased the infrastructure to the various franchisees who are now responsible for the operational control and the provision of maintenance, as follows:

- *electrified infrastructure* – leased to the franchisees of the metropolitan passenger transport businesses;
- *non-electrified broad gauge intrastate infrastructure* - leased to Freight Australia (formerly Freight Victoria), with the arrangements including certain rural railway stations; and
- *non-core rural intrastate infrastructure* – leased to the franchise of V/Line Passenger, with the arrangements including those rural railway stations not leased to Freight Australia.

3.3.155 From 1 July 1998, VicTrack granted a 5 year lease of the *standard gauge interstate infrastructure* to the Australian Rail Track Corporation, a business enterprise of the Commonwealth Government. At the date of preparation of this Report, we were advised that the Government is currently considering a proposal to transfer the lease to the Director of Public Transport, who would, in turn, sub-lease the infrastructure to the Corporation for a 15 year term.

3.3.156 Detailed comment on the maintenance arrangements associated with the franchising agreements will be provided in a separate report on these agreements. Comment on the maintenance arrangements associated with the interstate and intrastate rail infrastructure was provided in our December 1999 *Report on the Victorian Government's Finances*.



Rail infrastructure owned by VicTrack.

Maintenance backlogs

3.3.157 Our May 1999 *Report on Ministerial Portfolios* identified that in September 1998, a consultant engaged by the former Government in relation to the sale of the net assets of V/Line Freight Corporation, concluded that the intrastate non-electrified rail infrastructure was basically fit for freight and passenger operating purposes, but a **maintenance backlog in the order of \$23 million was identified, affecting all corridors.**

3.3.158 We have been unable to assess the extent to which this backlog has been cleared as the Department of Infrastructure does not obtain information from Freight Australia on expenditure specifically incurred in addressing the backlog highlighted by the consultant. According to the Department of Infrastructure, the lease of the broad gauge intrastate infrastructure requires Freight Australia to maintain the leased infrastructure to meet certain conditions-based performance targets on an ongoing basis.

3.3.159 As part of the franchising process for the metropolitan passenger businesses, a consultant completed an engineering study on the condition of the train and tram infrastructure assets. The report estimated the condition of each asset and established a target condition for each asset type against which the future condition of assets will be measured. The report, which was finalised in May 1999, identified that as at March 1999 the estimated condition of the following asset types fell below the established target condition:

- some elements of train tracks, sub-stations and signalling assets;
- level crossings located in the franchise business of Bayside Trains;
- tram track points and crossings, and overhead power structures; and
- some elements of the communications systems.

3.3.160 However, the estimated value of works required to remediate these deficiencies was not specifically identified.

3.3.161 A recent engineering study on the condition of the interstate infrastructure identified that as at April 2000 the estimated condition of rail track, signals and communications assets was typically satisfactory. **The Department of Infrastructure has advised that the target conditions for the interstate infrastructure assets, against which the actual condition of the infrastructure will be assessed on an ongoing basis, have now been determined. However, as at the date of the preparation of this Report, the quantification of any future maintenance requirements has not been specifically identified.**

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

In should be noted that the maintenance backlog was based on an estimate of costs for works required to bring the infrastructure in all of the intrastate non-electrified corridors up to new or near-new condition as specified in engineering standards. Railways universally maintain their infrastructure at “fit for purpose” conditions. Maintenance and rehabilitation is carried out on a cyclical basis and there will always be some maintenance backlog given that the whole asset does not need to be at new or near-new condition at any one time.

Freight Australia is required to maintain the lines open for traffic at speeds and axle loads on “fit for purpose” basis. Under contractual arrangements with V/Line Passenger (National Express), Freight Australia are required to agree Asset Management Plans with V/Line Passenger to ensure that passenger lines are maintained at levels required by V/Line Passenger to meet its service requirements under its Franchise Agreement.

Freight Australia is subject to contractual penalty by V/Line Passenger in circumstances where condition of the infrastructure causes V/Line Passenger to miss its contracted service requirements.

With regard to the metropolitan passenger businesses, infrastructure maintenance programs will be monitored against a target condition for each asset type. Each franchisee is required to submit annual Asset Management Plans for approval by the Director of Public Transport. Consistent with their Asset Management Plans each franchisee is required to produce evidence of expenditure on maintenance works which is reconciled by the Director on a quarterly basis.

In addition they are subject to financial penalty under the Operational Performance Regime where condition of the infrastructure leads to late running or cancellation of services.

With respect to the interstate infrastructure the report states that its condition will be monitored on an ongoing basis in line with arrangements applying to metropolitan infrastructure. In addition capital funds to be invested by the ARTC will result in an improved end of lease condition.

**COLAC-OTWAY SHIRE COUNCIL –
EXPORT MEAT PROCESSING FACILITY DEVELOPMENT AGREEMENT**

3.3.162 The May 1999 *Report on Ministerial Portfolios* to the Parliament commented on the acquisition of an abattoir by the Colac-Otway Shire Council.

3.3.163 The Report noted that, consistent with the Council's municipal strategic statement for the 1998-99 financial year to facilitate economic development within the region and diversify the employment base of the municipality, Council in January 1998 acquired land, buildings and plant assets for \$627 000 of a local abattoir that was in voluntary liquidation.

3.3.164 The Council proceeded to operate the business as a council enterprise with the aim of attracting a developer to build and operate a new abattoir that would meet export licensing standards and, therefore, be used as an export facility.

3.3.165 Following an assessment of a number of informal expressions of interest concerning the development of an export facility, the Council identified a preferred developer and agreed, in April 1998, to enter into a Development Agreement with the preferred developer that would commit the developer to finance and build an export facility by March 1999 at a cost of \$13 million, to operate the facility for at least 5 years and employ up to 285 personnel.

3.3.166 However, in December 1998, Council ceased negotiations with the preferred developer because of the developer's inability to secure the necessary finance to construct the export facility. Subsequently, interests associated with that developer formed a consortium with a number of local investors and proceeded to submit a revised export facility proposal to the Council for its consideration.

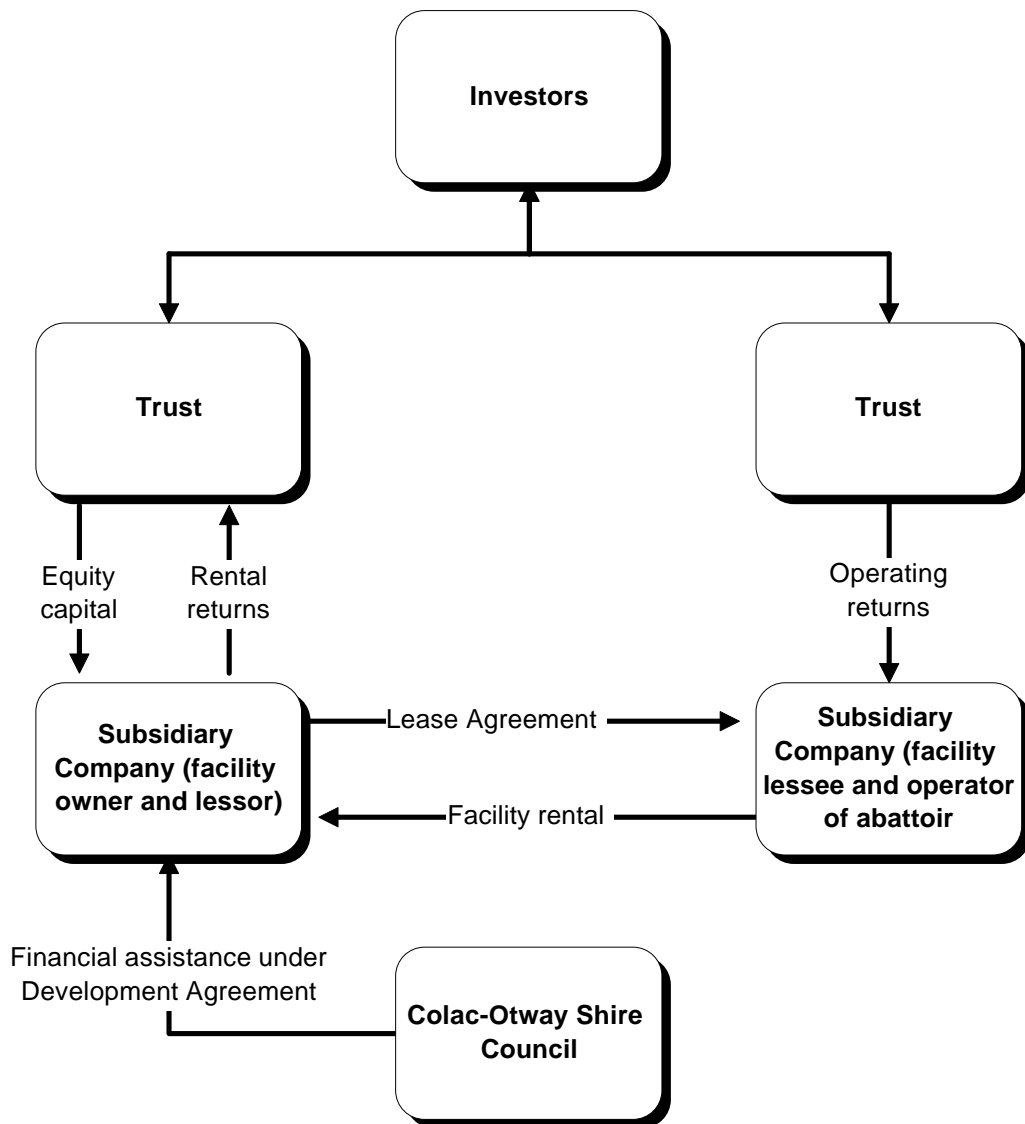
3.3.167 This Report provides an update of the arrangements entered into by the Council associated with an export meat processing facility.

Export facility secured

3.3.168 Following the receipt of a consultant's report endorsing the viability of the business plan developed by the consortium, the Council agreed in June 1999 to enter into a Development Agreement with the consortium and to contribute financial assistance in return for the consortium's commitment to build an export facility by 31 March 2000 and operate it for a least 10 years.

3.3.169 Under the Development Agreement the construction of the export facility was to be undertaken by one of the 2 companies within the consortium, which would then lease it to the other company to operate the facility for 10 years. Each company was acting as a trustee for one of 2 trusts forming part of the consortium. Table 3.3G illustrates the structure of the consortium.

**TABLE 3.3G
FACILITY CONSORTIUM**



3.3.170 The facility was expected to cost \$7.8 million, process up to 15 000 livestock units per week for both national and international markets, and employ up to 135 personnel. Construction of the new facility was completed by mid-April 2000 and commercial processing commenced 2 weeks later. The facility represents state-of-the-art technology in abattoir operations and has created 50 additional jobs within the Shire.

3.3.171 The Development Agreement does not provide for the transmission of the Council’s own abattoir business to the consortium, and consequently the Council closed its abattoir business on 31 March 2000. All of the Council’s abattoir staff were retrenched by that date. We have been advised that the consortium expects to hire most of those employees.

3.3.172 In essence, the consortium assumes all the business risks of building and operating the new export facility, and Council's involvement in the abattoir business has now ceased.



Export meat processing facility in the Colac-Otway Shire.

3.3.173 While Council's perseverance with this development project has secured a new state-of-the-art export facility within the Shire that will provide 50 additional job opportunities, the facility secured under the Development Agreement is about half the size of the facility that Council previously negotiated to have constructed.

Development Agreement financial obligations

3.3.174 As indicated previously, business risks associated with the new facility remain with the consortium with the Council's obligations under the Development Agreement limited to financial assistance to the consortium. The financial assistance provided has been in the form of cash grant contributions, land and certain asset transfers associated with the former abattoir, and rate waivers. Specific details of the assistance provided is as follows:

Grants

- Contribution of \$700 000 to meet the cost of the internal roads, landscaping and fencing of the new facility site;
- Contribution of \$20 000 to meet the cost of the consortium's feasibility study for the facility; and
- Assistance to the consortium in obtaining additional financial support from the State of \$250 000 for infrastructure. This additional assistance was approved in August 1999.

Provision of land

- Transfer of land of the existing abattoir site valued at \$220 000 at no cost; and
- Provide a residential allotment by September 2000 for the purposes of erecting a residence for use by the operator's employees and visitors valued at \$80 000 with this provision linked to the achievement of certain employment levels at the facility.

Plant transfers

- Transfer of certain plant fixtures and fittings from the existing abattoir together with the consortium's entitlement to the proceeds from the sale of materials from the demolition of the existing buildings estimated to be valued at \$360 000.

Waiver of Rates

- Annual rate waivers, currently estimated at \$34 000 per annum, for up to 5 years linked to the achievement of employment levels at the facility.

3.3.175 The Council's financial contributions and asset transfers under the Development Agreement, combined with the additional financial assistance provided by the State, will exceed \$1.8 million or equivalent to 24 per cent of the construction cost of the facility.

Pecuniary and potential conflicts of interests

3.3.176 Our review of the minutes of the Special Meeting of Council that approved the Development Agreement with the consortium, Council's Register of Interests, company extracts of the 2 companies that are party to the Development Agreement, and the trusts deeds for the 2 Trusts for which the companies act as Trustees established no evidence of any councillor holding pecuniary interests in either of the companies or the trusts associated with the consortium.

3.3.177 However, an audit examination of a consultant's report on the consortium's business plans for the export facility highlighted the following potential conflicts of interests:

- the principal consultant endorsing the viability of the consortium's business plans on behalf of Council was represented as being a director in one of the companies party to the Development Agreement and also having financial interests in the one of the trusts associated with the consortium;
- a member of the board of management responsible for overseeing the abattoir when in Council ownership and who provided advice on the proposed arrangements for the new abattoir was represented as being a director in both of the companies that are parties to the Development Agreement and also having financial interests in one of the trusts associated with the consortium; and
- a senior member of Council staff who was the manager of the abattoir when in Council ownership was represented as being a director of one of the companies that is party to the Development Agreement and also having financial interests in one of the trusts associated with the consortium, and was designated as the future Managing Director of the company operating the new facility.

3.3.178 While none of the persons referred to above were involved in Council's decision to approve financial assistance to the consortium for the development of the export facility, **in view of the substantial contribution made by the Council and the State to the consortium, and in order to ensure transparency of the approval process associated with the Development Agreement, these potential conflicts of interests should have been brought to Council's attention and recorded in the Council's minutes.**

Costs to ratepayers of retaining a local abattoir

3.3.179 As indicated previously, the Council's abattoir closed on 31 March 2000. The overall cost to the Shire's ratepayers of the Council's decision to acquire and operate the abattoir until its closure is estimated to be \$827 000, consisting of \$627 000 acquisition expenses and assets written-off on the purchase of the abattoir by the Council and net accumulated trading losses of \$200 000 for the 27 month period ending 31 March 2000.

3.3.180 **The overall cost to ratepayers associated with acquiring and operating the abattoir until its closure and contributions to the consortium of the new export facility which has provided additional employment opportunities within the Shire is around \$2.4 million, with an additional \$250 000 provided by the State.**

- **RESPONSE** provided by Chief Executive Officer, Colac-Otway Shire Council

Introduction

The decision of Council to acquire the Colac Abattoir Business (in liquidation) and facilitate a new company investment in the meat processing industry was a major economic development decision to ensure the retention of a skilled workforce in the Colac region and to provide a developer the incentive to invest new capital in developing a new meat processing business. A decision not to act would have meant the loss of 140 full and casual jobs to Colac, along with a company turnover of \$15 million per year.

The impact of Council's decision to enter into a Development Agreement with CRF (Colac Otway) Pty Ltd to build a new facility will ultimately create in excess of 150 new jobs, turnover in excess of \$100 million directly and an indirect multiplier impact of \$25 million per annum in the local economy.

Development staging

It is important to clarify that the current development is Stage 1 of the 1999 proposal and will employ up to 135 equivalent full-time (EFT) personnel of which 85 EFT positions are positions retained in Colac.

Pecuniary and potential conflicts of interest

Council wishes to clarify that the 3 representatives referred to in this section of the Report at no time were in a position to influence Council's decision on the matter of approval or contribution to the new abattoir. The Report notes that none of the people referred to were involved in Council's decision to approve financial assistance to the developer.

- ❑ **RESPONSE** provided by Chief Executive Officer, Colac-Otway Shire Council
- continued

In addition, at no time were any of the above people present at a meeting when a Council decision was made on this project. Council minutes will confirm this.

Cost to ratepayers of retaining a local Abattoir

The overall cost to date of this project to ratepayers should be explained in greater detail:

<i>Council contribution to project (Cash)</i>	
<i>Acquisition of abattoir</i>	\$627 000
<i>Infrastructure funding</i>	700 000
<i>Feasibility study</i>	20 000
<i>Trading loss (including \$146 000 for 2 week indemnity period)</i>	<u>200 000</u>
	<u>\$1 547 000</u>

It should be noted that Council's Cosworks Business Unit was successful in winning a Contract for Infrastructure works valued at \$450 000 as part of the development.

<i>Council incentive contribution to project (Non-Cash)</i>	
<i>Transfer of land (Valuation)</i>	\$220 000
<i>Proceeds of asset sales (Estimate)</i>	360 000
<i>Rates waiver (5 Years)</i>	<u>170 000</u>
<i>Total</i>	<u>\$750 000</u>

State Government infrastructure contribution

\$250 000

In summary, Council estimates the investment in this project to be \$2.297 million. The issuing of an Export Licence on 26 April 2000 by the Australian Quarantine and Inspections Service has vindicated this investment.

EXTERNAL FINANCIAL REPORTING BY THE LOCAL GOVERNMENT SECTOR

3.3.181 The local government sector comprises 78 municipal councils, 5 council-controlled companies and 16 regional library corporations. Annual outlays of the sector are around \$3 billion, while the current replacement cost of infrastructure assets deployed by the sector exceed \$23 billion.

3.3.182 The Victorian *Constitution Act 1975* gives constitutional recognition to the existence of local councils with powers provided to councils by the Parliament under the *Local Government Act 1989* to ensure the peace, order and good government of relevant municipal districts. That Act also provides conditions for the creation of regional library corporations and incorporated companies controlled by municipal councils.

3.3.183 The *Local Government Act 1989* requires each municipal council and regional library corporation to prepare an annual report that includes an audited financial statement and, for municipal councils only, an audited compulsory competitive tendering (CCT) statement which is to be discontinued from 1 July 1999, and for the first time in the 1998-99 financial year, an audited performance statement. Annual reports must be provided each year to the Minister for Local Government by 30 September each year.



Corporate governance in municipal councils ensures accountability to ratepayers.

Audit results for 1998-99 financial year

3.3.184 Previous *Reports on Ministerial Portfolios* to Parliament have provided assessments of the quality of external financial reporting by local government entities. This Report outlines the key outcomes from the financial audit of the local government sector for the 1989-99 financial year:

- Most local government entity audits were completed in time to enable annual reports to be forwarded to the Minister for Local Government by the 30 September 1999;

- Clear audit reports were issued by my Office in regard to all financial statements by entities within the local government sector except in 5 cases. In addition, clear audit reports were issued for all CCT statements prepared in accordance with the Act;
- The audit of council performance statements undertaken for the first time in the 1998-99 financial year, disclosed that all such statements were supported by appropriate records of performance results achieved for the financial year except 3 councils, which received qualified audit reports in this regard. Additionally, 36 councils received qualified audit reports for not complying fully with the legislative requirements prescribed by the Act for performance reporting;
- Annual reports of 15 local government entities contained, in varying degrees, errors, omissions and discrepancies in the published financial statements, other accountability statements and the accompanying audit reports when compared with the original financial and accountability statements and accompanying audit reports issued by my Office;
- Adjustments in excess of \$290 million had been made during the year to the value of council infrastructure asset holdings which should have been recognised in prior reporting periods;
- The Local Government Division of the Department of Infrastructure in consultation with the sector continued to facilitate improved external accountability by the local government sector, particularly regarding best practice for the operation of audit committees and internal audit in local government entities; and
- There is a need for the local government sector to address emerging issues associated with the financing of future infrastructure asset renewals, and key risks associated with the outsourcing of council functions.

3.3.185 Further comment on the above issues is provided below.

Timeliness of year-end reporting

3.3.186 For councils to satisfy the legislated reporting requirement to forward an annual report to the Minister for Local Government by 30 September, a deadline of 3 September 1999 was established by my Office for local government entities to provide their completed statements, and for audit service providers engaged to assist me in these audits to submit their reports for review by my Office to enable issue of my audit reports to achieve that deadline.

3.3.187 **Notwithstanding the additional work requirements placed both on councils and audit service providers arising from the initial introduction in the 1998-99 financial year of the performance reporting and audit regime, local government entities achieved improved levels of timeliness of financial and performance reporting compared with the preceding year.**

3.3.188 Table 3.3H illustrates the extent to which local government entities complied with the reporting deadline established by my Office.

TABLE 3.3H
TIMELINESS OF EXTERNAL REPORTING
BY LOCAL GOVERNMENT ENTITIES
(number of entities)

<i>Description</i>	<i>1996-97</i>	<i>1997-98</i>	<i>1998-99</i>
Local government entities meeting deadlines	76	82	87
Local government entities not meeting deadlines	23	17	12
Local government entities not providing accountability statements to audit by 30 September	7	2	3
Extensions of time by Minister for submission of annual reports	46	19	22

3.3.189 The table shows that for the 1998-99 financial year 12 of the 99 local government entities did not comply with the audit deadline, which is an improvement compared with the previous financial years' performance. In addition, 3 entities had not provided the requisite information to my Office by 30 September 1999. The table also indicates that the incidence of requests to the Minister for extensions of time for submission of annual reports remains high.

3.3.190 **In light of the above outcomes, scope still exists in the sector for a reduction in the number of extensions sought for the tabling of annual reports beyond the statutory deadline of 30 September.**

Compliance with Australian Accounting Standards

3.3.191 Local government entities are required by the *Local Government Act 1989* to prepare their financial statements in accordance Australian Accounting Standard AAS 27 - *Financial Reporting by Local Governments* and additional reporting requirements prescribed by the Act.

3.3.192 For the 1998-99 financial year the vast majority of local government entities fully complied with Australian Accounting Standards and the disclosure requirements of the Act.

3.3.193 Specifically, 94 local government entities received clear audit reports on their 1989-99 financial statements (95 entities for their 1997-98 financial statements), while 4 entities received qualified audit reports and one entity received an audit report containing an emphasis of matter comment. All councils received clear audit reports on CCT statements.

3.3.194 Table 3.3I outlines the key reasons for the issue of the qualified audit reports and audit reports containing emphasis of matter comments on the financial statements of local government entities.

TABLE 3.3I
BASIS OF QUALIFIED AND EMPHASIS OF MATTER AUDIT REPORTS
(number of entities)

<i>Issues</i>	1998-99	1997-98
Recognition of provisions where no present obligation existed	2	-
Non-recognition of finance leases and incorrect deferral of revenue	1	-
Inadequate or unreliable infrastructure asset records	1	2
Uncertainty regarding the future viability of the entity	(a) 1	2
Total	5	4

(a) Uncertainty relating to going concern status.

3.3.195 It is important that the relevant local government entities take appropriate remedial action in the 1999-2000 financial year to ensure resolution of issues related to audit qualifications so that clear reports can be provided for the 1999-2000 financial year.

Performance reporting

3.3.196 While many Victorian public sector agencies publish performance indicators in their annual report, local government is unique in that, as from the beginning of the 1998-99 financial year municipal councils were required under the *Local Government Act 1989* to include a performance statement in their annual report and have it audited.

3.3.197 Key features of the new performance reporting regime are:

- Councils are required to submit to the Minister by the end of each financial year a 3 year corporate plan that must include an annual business plan containing performance targets and measures by which council's achievement of the business plan can be assessed;
- Councils must prepare a performance statement that identifies the performance targets and measures previously provided in the annual business plan and describes the extent to which those targets were achieved;
- Performance statements are to be audited; and
- Performance statements and audit reports must be included in annual reports. If councils fail to achieve the targets set out in their business plans, explanations for the non-achievement of targets must be contained in their performance statements.

3.3.198 The audit of performance statements for the 1998-99 financial year disclosed that all statements were supported by appropriate records of results achieved for the year except in 3 cases, which received qualified audit reports in this regard. Additionally, 36 councils received qualification in the audit report for not complying fully with the legislative requirements of the Act. Key qualification issues included:

- corporate plans incorporating annual business plans were not submitted to the Minister (4 cases);
- business plans and related performance measures and targets had not been included in councils' corporate plans (7 cases); and
- not all performance measures and targets set out in business plans were reported in the performance statements (25 cases).

3.3.199 In addition, the following conditions, although not warranting the issue of qualified audit reports on the performance statements, were identified during the audit process and raised with the relevant councils:

- annual business plans had not been prepared as required by the Act, however, annual business plan performance measures and targets had been prepared; and
- many performance measures included in the performance statements did not directly or clearly relate to the activities set out in the business plan and consequently did not indicate the extent to which the business plan had been achieved as required by the Act.

3.3.200 The key reasons why so many qualified audit reports on council 1998-99 performance statements were issued are:

- Advice by the Local Government Division of the Department of Infrastructure to councils that 29 Annual Plan Indicators (APIs) would be promulgated by Regulation as being performance measures by which a council's performance could be judged in relation to achievement of its annual business plan. The advice appeared to overlook the statutory requirements to produce relevant measures as set out in the council's annual business plan;
- The subsequent non-promulgation of those Regulations and the resultant confusion among councils;
- The belief of many councils which had included non-API performance targets and measures in their business plans, that only APIs needed to be disclosed in the performance statement; and
- Failure of a number of councils to adequately address all the requirements of the performance reporting legislation.

3.3.201 In order to prevent a recurrence of these difficulties in the 1999-2000 financial year, the Minister has agreed to accept requests from Councils for extensions of time to revise their corporate and annual business plans to reflect learning experiences gained as a result of their 1998-99 reporting process.

Annual reports

3.3.202 To ascertain the integrity of the public annual reporting process for local government entities, my Office examined the annual reports of all municipal councils and regional library corporations to determine whether the published financial statements, CCT statements and performance statements (as applicable) and the accompanying audit reports were the same as the statements and audit reports issued through my Office.

3.3.203 Fifteen entities were observed as publishing anomalies in their annual reports including:

- 1 council published only abridged details of its financial statement, CCT statement, and performance statement while omitting a qualified audit opinion on its performance statement;
- 1 council omitted to include in its notes to the financial statements the Rate Determination budget and actual result for the 1998-99 financial year and comparative financial periods;

- 5 councils and 2 regional library corporations inserted information in the notes to the financial statements which varied from details in the financial statements cleared by my Office;
- 2 councils and one regional library corporation backdated the certification dates of the financial statements and other accountability statements compared with the certification dates cleared by my Office;
- 1 council omitted to publish its performance statement;
- 2 councils included additional information in their performance statements which was not included in the performance statements cleared by my Office;
- 1 regional library corporation excluded the audit report on its financial statement from the annual report; and
- 5 councils varied the text of the audit report issued by my Office, including, in one case, incorrect publication of the dollar amount referred to in the qualification contained in the audit report.

3.3.204 As part of our review, the relevant councils and regional library corporations were notified of the discrepancies identified in their annual reports.

3.3.205 These findings are disappointing as my Office reported similar observations to councils at the end of the 1997-98 audit cycle.

3.3.206 **These matters are of concern given that the findings act to weaken the public accountability process within local government. Accordingly, it is critical that the processes adopted by the sector for the preparation of annual reports ensure that such reports contain the audited financial and other accountability statement and the accompanying audit reports actually issued by my Office. Consideration will be given to disclosing the names of repeat offenders in future Reports to Parliament.**

Infrastructure assets

3.3.207 Infrastructure assets, such as roads, paths, drains and bridges, constitute significant resources managed by councils. The accurate recording of these assets is, therefore, essential for proper accountability and effective management of these resources.

3.3.208 When introduced in 30 June 1995, Australian Accounting Standard AAS 27 - *Financial Reporting by Local Governments* provided a 2 year transitional period for the valuation and recognition of council infrastructure assets, ending on 30 June 1997.

3.3.209 Notwithstanding the cessation of these transitional arrangements at the end of the 1996-97 financial year, **the 1998-99 financial reporting process highlighted adjustments in excess of \$290 million to the value of council infrastructure holdings because assets were mainly either not recognised, or incorrectly valued, since 30 June 1997.**

3.3.210 Deficiencies in recognition and valuation practices for infrastructure assets may adversely impact on the effectiveness of their management and may expose ratepayers to renewal and replacement costs that could have been avoided. **Councils, therefore, need to ensure that asset registers for infrastructure holdings are complete and accurate to ensure effective management of these resources.**

3.3.211 In May 1999, the Local Government Division of the Department of Infrastructure advised my Office that steps would be taken during 1999 to develop best practice guidelines for infrastructure asset accounting for municipalities. Additionally, following consultation with councils on the findings of the Government's Study of Local Government Infrastructure, the Local Government Division will recommend to Minister strategies to improve infrastructure management in councils.

Audit committees and internal audit

3.3.212 The May 1998 *Report on Ministerial Portfolios* provided the Parliament with an assessment of the operation of audit committees and internal audit within the local government sector. In particular, it was concluded that the use of audit committees and internal audit had not been universally adopted across the local government sector and, as a consequence, corporate governance within the sector was diminished.

3.3.213 Following consultation between the Local Government Division of the Department of Infrastructure, peak industry bodies within the sector and individual councils during the 1998-99 financial year, the Local Government Division has developed with assistance from the Australian Accounting Research Foundation draft *Best Practice Guidelines for Local Government Entity Audit Committees and Internal Audit*.

3.3.214 Key features of the guidelines provide that:

- municipal councils, companies controlled by councils and regional library corporations should establish and maintain effective audit committees and internal audit regimes;
- audit committees should be appointed committees of their governing bodies independent of management and should report at least quarterly;
- members of audit committees should possess appropriate skills, with a majority of members, including the chairperson, appointed as independent members; and
- the Chief Executive Officer should not be a member of the audit committee but shall attend each committee meeting along with the entity's internal auditor.

3.3.215 The role recommended for internal audit is to assist local government entities in the effective discharge of their responsibilities by reviewing key risk areas and examining issues of efficiency, economy and effectiveness while remaining independent of operational activities.

3.3.216 Smaller-sized local government entities with limited resources that find it impractical to adopt the guidelines fully will be advised to assess those elements of the guidelines relevant to their corporate governance and adopt them accordingly.

3.3.217 It is expected that the guidelines will be issued shortly and operate from 1 July 2000.

Business unit reporting

3.3.218 The May 1998 *Report on Ministerial Portfolios* provided the Parliament with an assessment of council management of municipal business undertakings. Among other matters, the review disclosed that 12 councils with contract expenditure of \$68 million in the 1996-97 financial year were unable to identify surpluses or losses from business unit operations. We therefore, recommended that the Local Government Division of the Department of Infrastructure develop best practice guidelines for financial and performance reporting by business units.

3.3.219 The Local Government Division has advised that a best practice guideline for Business Unit Reporting and Major Contracts was released in August 1999. In response to comments from councils, the Local Government Division in consultation with peak industry bodies within the sector has agreed that, despite the abolition of CCT, there was still a need to provide guidelines for councils operating under a business unit structure. The Division advised that steps will be taken to ensure the guidelines remain current and reflective of any changes that take place in the sector.

Emerging issues

Infrastructure funding

3.3.220 Due to concerns regarding the funding difficulties facing municipal councils in relation to their ageing infrastructure assets in need of renewal, the Government in 1997 initiated a study on this issue. The Government's *Victorian Local Government Infrastructure Study* report was issued in January 2000, which outlined the following:

- The current replacement cost of municipal council infrastructure asset holdings exceeds \$23 billion;
- 11 councils have been identified as needing to meet substantial asset renewal costs as early as year 2002. Two of these councils will need to increase by the year 2002 renewal outlays on infrastructure assets by up to 50 per cent compared with their current levels of capital expenditure, while 8 councils will need to increase renewal outlays on infrastructure assets by more than 50 per cent compared with their current levels of capital expenditure, and one council will need to increase renewal outlays on infrastructure assets by between 10 and 50 per cent compared with its current level of capital expenditure;
- By the year 2007, the level of funding required across the sector for the renewal of infrastructure alone will exceed current levels of outlays for renewal and upgrade of infrastructure combined; and
- By the year 2012, the level of funding required across the sector for infrastructure renewal outlays will have doubled from current levels.

3.3.221 In essence, apart from the 11 councils referred to above, the remaining councils have up to 7 years to take the necessary management action to manage the required increases in renewal infrastructure asset funding. Councils that do not use this time productively face the possibility of a degradation in service standards due to the possible lack of funding to maintain assets at appropriate levels.

3.3.222 The report recommends a number of measures for improved infrastructure asset management in councils including a recognition by councils that asset management is a corporate and not solely a technical responsibility, the need for the preparation of strategic asset management plans forming part of Council's corporate plan along with related performance targets and performance measures, and better financial management of infrastructure renewal and upgrade requirements.

3.3.223 **The Local Government Division of the Department of Infrastructure will use data generated in the study to develop a management information system to assist government and municipal councils determine long-term infrastructure asset funding needs.**

Outsourcing risks

3.3.224 A major element of the reform of the public sector and local government in recent years has been the outsourcing of services previously provided directly by agencies and councils. Recent Federal Court decisions have indicated that, under the provisions of the Commonwealth *Workplace Relations Act* 1996, previous award rates and conditions may apply to the contractor's employees performing what were previously government functions.

3.3.225 In June 1999, a particular union brought an action alleging breach of the Act against a contractor that had successfully tendered to provide services previously performed in-house by a metropolitan council. The Court resolved, by consent order, that the terms and conditions of the former council employees should apply to the company's employees.

3.3.226 Following the issue of the consent order by the Court, the company sought from council a variation to the contract on the basis that the company could not bear the extra costs of remunerating its staff at rates previously paid under the council's awards. **Council agreed to increase the cost of service provision over the life of the contract by \$500 000 while accepting reductions in annual service hours by 30 per cent.** The company has subsequently commenced negotiations with a number of other councils in regard to contracts outsourced in similar circumstances **seeking cost variations of up to 25 per cent to maintain contracted service levels.**

3.3.227 The union concerned also brought a separate action against the outsourcing council alleging breaches of the *Workplace Relations Act* 1996 on the basis that, in applying a competitive tendering process to services formerly provided by council employees, council coerced its employees to accept employment conditions different for those contained in current awards and that redundancies arising from the tendering process were prohibited under the Act. The action sought damages and penalties from council. At the time of preparing this Report, the Court has yet to determine a finding on this matter.

3.3.228 **Recent litigation under the *Workplace Relations Act* 1996 indicates councils could be exposed to significant risks arising from the outsourcing of former functions to the private sector. The sector needs to monitor developments regarding the transmission of business provisions under the *Workplace Relations Act* 1996.**

- **RESPONSE** provided by Executive Director, Local Government Division (LGD), Department of Infrastructure

Performance reporting

In July 1999, when it became known that the Regulations for the performance statement would not be passed, the Department advised all councils that “whichever performance targets and measures were included in the 1998/99 Business Plans ... must be reported on the performance statement” and therefore be subject to external audit. In consultation with the sector and its peak associations the LGD is reviewing the entire performance management system.

Infrastructure accounting and funding

The LGD is currently consulting with the sector to develop a framework of agreed strategies to improve planning and funding arrangements for local government infrastructure assets. The LGD has already developed a management information system containing data from the Infrastructure Study and distributed copies to all councils to assist them with planning and financing decisions.

Outsourcing risks

The outsourcing of council functions and the associated risks refer to existing contracts entered into as a result of CCT. Council awareness of the “transmission of business” issue should ensure that this is taken into account in future contractual arrangements.

**ACQUISITION OF
PROPOSED PRESCRIBED WASTE FACILITY SITE BY WYNDHAM CITY COUNCIL**

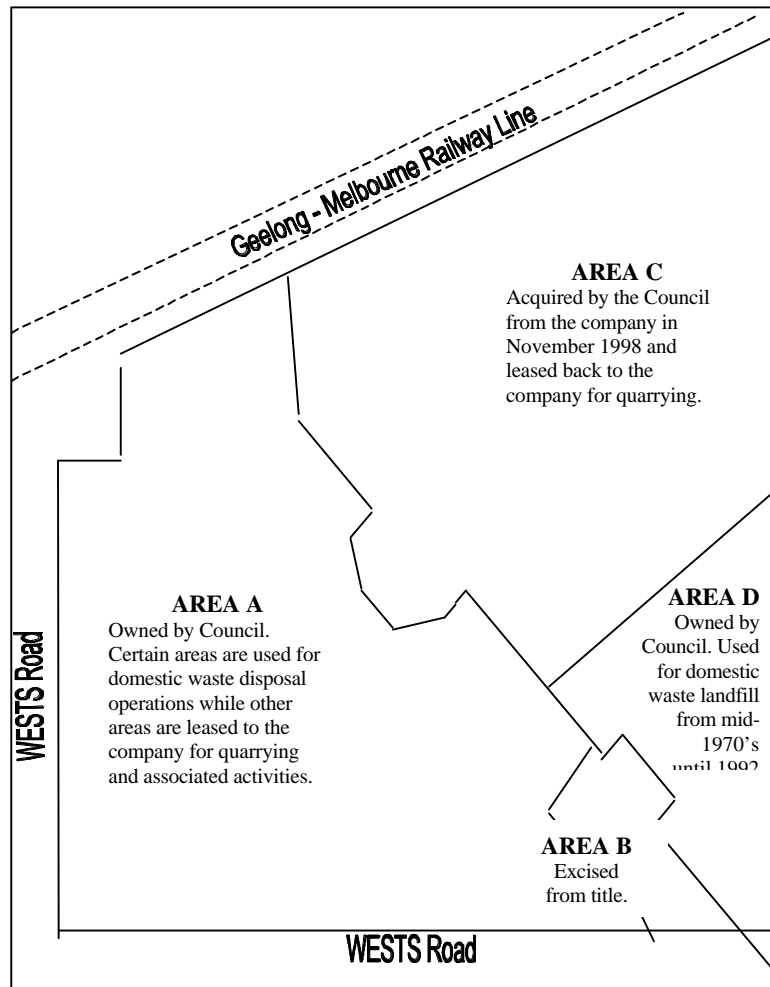
3.3.229 In November 1998, the Wyndham City Council entered into an agreement to purchase a 101 hectare site located in Wests Road, Werribee upon which the vendor company had proposed the establishment of a prescribed waste storage facility. Prescribed wastes primarily include wastes arising from industrial activity and are the subject of specifically legislated controls because they are considered to be hazardous and of potential threat to the environment and human health.

3.3.230 The company's proposal, first signalled in 1995, to establish the facility had provoked strong community opposition. The Council subsequently purchased the site in November 1998 with a view to preventing the establishment of the proposed facility and to securing access to a landfill site which would satisfy its long-term waste disposal requirements.

3.3.231 In January 1999, the Council entered into a lease agreement with the company in respect of the site purchased and part of an adjoining 105 hectare site owned by the Council which was the subject of a previous lease with the company. The term of the new lease arrangement is 50 years with an annual nominal rental of \$1 payable by the company.

3.3.232 Chart 3.3J illustrates the current status of the land located in the quarry and waste disposal landfill precinct in Wests Road Werribee. The site, marked as Area C in the precinct, was acquired by the Council from the company.

CHART 3.3J
WESTS ROAD, WERRIBEE QUARRY AND LANDFILL PRECINCT



Prior involvement of the Council and the company in the Wests Road quarry and landfill precinct

3.3.233 In December 1972, the former Shire of Werribee, the company and the then owner of Area A entered into an agreement which provided for:

- the conduct of quarrying operations on the site by both the then owner and the company;
- an option for the Shire to purchase the land at any time within 15 years from the date of the agreement; and
- the Shire to use the airspace created by quarrying activities on the land for the disposal of waste.

3.3.234 In April 1985, the former Shire exercised its option under the 1972 agreement and purchased this area of the precinct for \$1.5 million. Following the acquisition of this area, the 1972 agreement continued to have effect, allowing the company to continue quarrying operations on the land with the Shire utilising part of the area for waste disposal.

3.3.235 In August 1986, the Shire entered into a new agreement with the company which involved:

- the company continuing to conduct quarrying, rock crushing and processing operations in Area A on an exclusive rights basis;
- the company paying annual rent of \$7 500 (indexed by CPI every 5 years) and monthly royalties based on the amount of extracted product quarried from the land;
- the Shire continuing to have access to the land for the purposes of waste disposal operations; and
- a conditional option for the Shire to either acquire the whole of the Area C land if the company wished to sell it, or if the company did not wish to sell the land, provide access to 50 per cent of the land for waste disposal purposes on a fee-paying basis, if the company's quarrying operations ended prior to 31 December 2016.

3.3.236 This agreement remained in place until November 1998, with the Council receiving approximately \$2.3 million in rent and royalty payments from the company between 1986 and 1998 pursuant to the agreement.

Action precipitated by the proposal to establish a prescribed waste facility

3.3.237 The City of Wyndham (the successor to the Shire of Werribee) became aware of the proposal by the company to establish a prescribed waste facility on land owned by the company in the Wests Road precinct in late 1995. The proposal involved the establishment and operation of a landfill facility designed to store and contain prescribed waste and the establishment and operation of an organic waste, and composting facility.

3.3.238 The success of the proposal depended on obtaining various approvals from the Government and the Council. Specifically, the company was required to:

- develop an Environment Effects Statement in respect of the proposal;
- submit an application to the Environment Protection Authority to obtain approval of works involved in the establishment of the proposed facility; and
- apply to the Council for approval of a planning scheme amendment in respect of the proposed facility.

3.3.239 These processes commenced in 1996 and continued on through 1997 and 1998.

3.3.240 In March 1997, the appointed Commissioners for Wyndham City Council were replaced by an elected Council. The position adopted by the new Council was to pursue all reasonable courses of action designed to prevent the establishment of the prescribed waste facility proposed by the company while, at the same time, exercising its powers in respect of relevant planning applications in accordance with the legislated requirements. Council based its stance on a desire to give effect to the legislated purposes and objectives of Councils which include:

- facilitating and encouraging appropriate development of its municipal district in the best interests of the community; and
- representing and promoting the interests of the community and being responsive to the needs of the community.

3.3.241 During the period March 1997 to November 1998, there was ongoing communication between Council and the company regarding the proposal and related matters. Various options were explored in negotiations which took place concurrent with the relevant statutory approval processes. Three separate legal actions involving the parties were also initiated during the period:

- *September 1997* - Council took action in the Supreme Court claiming injunctive relief and damages from the company arising out of alleged breaches of the 1986 agreement. This action stemmed from Council's view that the company's proposal to establish a prescribed waste facility on its Wests Road site effectively usurped the rights of Council created by the 1986 agreement in respect of acquisition of, or access to, the company's site. The company denied any breach of the 1986 agreement and sought declarations from the Court by way of counterclaim;
- *March 1998* - Company took action in the Supreme Court claiming damages and other relief against the Council arising out of alleged trespass by the Council upon the company's land in the Wests Road precinct. The company alleged that Council had, in the conduct of its waste disposal and landfill activities, deposited waste on the company's side of the boundary between Areas A and C as illustrated in Chart 3.3J. The Council denied any such trespass; and
- *July 1998* - Company filed an application for review in the Victorian Civil and Administrative Tribunal in which the company appealed from and sought review of a decision by Council to refuse the company access to certain documents requested under the *Freedom of Information Act 1992*. The documents requested by the company related to the notes or minutes of any meeting between Council or Councillors and the Werribee Residents Against Toxic Dump Group.

3.3.242 There was widespread opposition in the Werribee community to the proposal which was demonstrated by the attendance of approximately 15 000 people at a protest meeting at Werribee Racecourse in early May 1998.

Deed of settlement and associated agreements

3.3.243 Following lengthy negotiations, the Council and the company, in November 1998, executed a Deed of Settlement and associated agreements designed to resolve the various legal actions. The key features of the Deed of Settlement and associated agreements were:

- The setting aside of the various legal proceedings and a release and discharge by each party in respect of any potential claims or liability which might have arisen from such legal proceedings;
- The assignment and transfer by the company to the Council of any right, title, interest or entitlement it had or may have in the future, to construct and operate a prescribed waste landfill and composting facility on the site;
- The purchase by the Council of the company's site for \$15 million to be paid by way of 2 instalments of \$3 million each in June and July 1999, and progressive payment of the remaining \$9 million (at the rate of \$500 000 per annum, to be indexed by CPI) over a period of 18 years on the basis of annual provision by the company of airspace created by quarrying to the Council for waste disposal operations. However, the company is not under any obligation to make available excavated airspace to the Council, and if it does not the Council is not required to pay annual instalments towards the \$9 million component of the purchase price;
- The Council becomes liable to pay the company a further \$5 million if, within 10 years from November 1998, the Council or any other person (other than the company) deposits prescribed waste, or uses the company's composting technology, on the site;
- The 1986 agreement between the parties was terminated;
- A lease arrangement was established in respect of the area purchased by the Council from the company and certain components of the area already owned by the Council which had been the subject of the 1986 agreement. The provisions of the lease arrangement include:
 - a commencement date of 31 July 1999 with a term of 50 years and an annual nominal rental payable by the company of \$1;
 - the company is permitted to conduct quarrying operations in the leased area;
 - a requirement for the company, within 4 years from 31 July 1999, to handover an area of the site in which quarrying operations have been completed to the Council for waste disposal operations; and
 - progressive handover by the company of areas which have been excavated to the Council for waste disposal operations. However, the lease provides that the economic interests of the company in terms of the continued profitability of quarrying operations override the waste disposal requirements of the Council. That is, if it proves unprofitable for the company to continue quarrying then the company is under no obligation to provide the Council with airspace for waste disposal;
- The Council to discontinue receiving royalty payments for material quarried by the company and extracted from Council land. The value of such payments was estimated to be \$2.7 million in respect of the first 20 years of the lease arrangement; and

- a confidentiality clause which precludes the disclosure of any details of the settlement by either party without the agreement of the other party, except for disclosure required by law or other statutory reporting requirements.

Impact of settlement on the financial position of the Council

3.3.244 In summary, the settlement effectively met the Council's primary objective of halting the proposal by the company to establish a prescribed waste facility on the site, while providing the company with a return for the sale of the land and the capacity to derive ongoing income from the area through the conduct of quarrying operations. In addition, the settlement has secured sufficient capacity to meet the Council's long-term waste management requirements. **It is estimated that the settlement will cost the City Council ratepayers around \$17.7 million, assuming that the Council or any other person, other than the company, does not deposit prescribed waste, or use the company's composting technology, on the site.**

3.3.245 However, based on the Council's projections of income derivable from waste management activities on the consolidated Wests Road site (including an assumption that a tripartite agreement with the Melbourne City and Port Phillip Councils involving disposal of residential waste collected by these Councils at Wests Road on a fee-paying basis will be extended beyond 2001 until at least 2018), a positive cash flow of at least \$2.3 million is expected to be generated from the precinct over the next 20 years.

3.3.246 As part of the Council's preparation for negotiation of the final settlement with the company it obtained advice from an independent valuer experienced in the valuation of extractive industry and landfill sites. A review of the advice received from the valuer indicated that it supported the reasonableness of the purchase price agreed in respect of the acquisition of the company site.

Impact of settlement on Council waste management strategies

3.3.247 The Wyndham City Council, and its predecessor councils, have utilised land in the Wests Road precinct for domestic waste disposal operations since the mid-1970s. Acquisition of, or gaining of access to, part or all of the company-owned site had formed part of Council's waste management strategies since at least the mid-1980s.

3.3.248 As indicated previously, in addition to using the Wests Road site for domestic waste disposal in respect of its residents, the Council is also involved in a tripartite agreement involving 2 other Councils which dispose domestic waste at the site on a fee-paying basis. In mid-1998, when negotiating a settlement with the company, it was estimated that the airspace remaining in the Council's landfill site at Wests Road would meet the waste disposal needs of the 3 councils for approximately 7 to 9 years, assuming that the tripartite agreement, which expires in 2001, is renewed or extended.

3.3.249 It is clear that, notwithstanding the objective of preventing the establishment of a prescribed waste facility at the Wests Road precinct, the Council had a need to acquire access to additional waste disposal facilities in the medium to long-term. Acquisition of the company's site was considered by Council to be effective and necessary in:

- achieving its first priority to avert the prescribed waste facility;
- preserving its waste disposal strategy, which might otherwise have been compromised by the removal of access to the site intended for long-term waste disposal; and
- yielding additional benefits derived from the adjacency of the sites, including the more effective utilisation of the Council's existing waste disposal operations through the removal of a need to taper the waste landfill away from the boundary between the Council land and the company-owned site.

3.3.250 The acquisition by the Council of the company site has enabled almost immediate access to sufficient airspace to meet waste disposal requirements for approximately 25 years (assuming continuation of current waste disposal requirements and the continuation of the tripartite agreement), and the progressive access to additional airspace for waste disposal which should meet requirements for a further period of at least 20 years.

3.3.251 These circumstances highlight the critical importance of Council securing a long-term extension of the tripartite agreement and seeking additional waste streams on a commercial basis to ensure maximum return on its investment in the site. Audit was advised that Council is actively pursuing a range of actions in both these areas.

3.3.252 A positive feature of the settlement is the provision by the company of airspace to be utilised for waste disposal to the Council at no cost after an 18 year period as stipulated in the deed of settlement and associated agreements. However, this eventuality will be entirely dependent on commercial decisions taken by the company regarding the viability of quarrying operations on the site.

3.3.253 The adequacy of control exercised by Council over the nature of waste deposited in its landfill sites was not the subject matter of this review. However, Council will need to continue to pay particular attention to such controls given that it becomes liable to pay the company a further \$5 million if, within 10 years from November 1998, the Council or any other person (other than the company) deposits prescribed waste, or uses the company's composting technology, on the site.

□ **RESPONSE** provided by the Chief Executive, Wyndham City Council

I believe the audit accurately reflects events and today's situation.

THE QUEEN VICTORIA SITE

3.3.254 The Queen Victoria Site (the Site) comprising 18 000 square meters of land is located within the Melbourne central business district (CBD). The Site is bounded by Swanston, Lonsdale, Russell and Little Lonsdale Streets.

3.3.255 Since 1998, the Site has been used for a mini-golf course, car park, skate park and the Queen Victoria Women's Centre.

3.3.256 Key events leading up to Melbourne City Council's 1997 decision to acquire the Site, which was formerly owned by the State, are summarised in Table 3.3K.

**TABLE 3.3K
QUEEN VICTORIA SITE
KEY EVENTS PRIOR TO COUNCIL ACQUISITION**

<i>Year</i>	<i>Key events</i>
1988	The Site was vacated following the relocation of the Queen Victoria Hospital to the Monash Medical Centre in Clayton. The State unsuccessfully offered the Site for sale by tender during 1989.
1992	A contract of sale was entered into between the State and a private developer during June 1992. The sale price of \$24.2 million was payable over 7 years with \$2.4 million paid during the year. As part of the sale arrangement, the State entered into a 200 year lease relating to the Queen Victoria Women's Centre building, located in the centre of the Site on the Lonsdale Street boundary. This heritage-listed building was to be used as a Women's Services Centre, and leased at an annual nominal rental of \$1.
1993	The sale of the Site was finalised by the State with the receipt of \$12.5 million from the private developer on the basis that it represented the present value of the then outstanding principle of \$21.8 million originally due for payment in June 1999. The total amount received by the State from the sale of the Site to the private developer was \$14.9 million. The private developer demolished certain buildings on the Site during 1993 and 1994.
1994	The private developer sold the Site to the Republic of Nauru (the Republic) for \$50.3 million, payable in instalments of \$11.8 million at the time of signing of the contract and a further \$38.5 million in September 1996 (however, this later payment was not made by the Republic).
1997	The private developer and the Republic entered into a deed of settlement under which the Republic was entitled to acquire and take title to the Site under a new contract of sale to be entered into on or before 5 December 1997, under which the Republic was to pay the private developer the balance of the purchase price of the Site of \$38.5 million.

Acquisition of the Site by the Melbourne City Council

3.3.257 In 1997, Melbourne City Council commenced negotiations with the Republic, and sought approval from the Minister for Planning and Development and the Treasurer of Victoria, for the purpose of negotiating and potentially acquiring the Site. Council's decision to negotiate the purchase of the Site was made on the basis that it would:

- assist the Republic to progress the development of 3 undeveloped sites in the CBD, comprising the Carlton and United Breweries, Southern Cross and Queen Victoria sites;
- address the shortage of affordable short-stay public car parking in the CBD;
- create adequate public open space on the Site;
- facilitate better commercial development opportunities for the City; and
- create a more appropriate subdivision for the Site.

3.3.258 The decision by Council to acquire the Site was strategically based to achieve certain outcomes while also providing an adequate return on funds invested. The Council did not conduct a cost-benefit analysis to support its decision to acquire the Site, but did subsequently verify that the acquisition cost was consistent with the estimated market value of the Site. The Council has shown, through its actions, a substantial commitment to the successful development of the Site to further the strategic aims of the City.



Queen Victoria site in the Melbourne central business district.

Queen Victoria Hospital Site Agreement

3.3.259 On 2 December 1997, Council entered into the Queen Victoria Hospital Site Agreement (the Agreement) with the Republic to enable Council to be nominated as the purchaser of the Site and to procure title to the Site from the private developer.

3.3.260 The Agreement also encompassed the following:

- Council was required to undertake the development of an underground car park comprising 3 levels and obtain the necessary planning approvals which, among other things, would allow for the use of at least 1 100 of the car parking spaces for short-stay public car parking;
- Council would grant the Republic the option to purchase an area containing a maximum of 700 car spaces at a price equal to the costs and expenses incurred by Council in designing, constructing and funding the car spaces;
- the Republic was to be responsible for the commercial development on the Site (including residential development and open space) and the Republic would buy the commercial site representing the area above the car park, except for the public open space, at a price of \$38.5 million by instalments;
- the Site was to be subdivided to create separate titles for the car park development, the public open space and the balance of the Site above the car park.

3.3.261 The Agreement prescribed several conditions to be observed by the Republic and Council prior to the Council being nominated as the purchaser of the Site. These included:

- Council to obtain approval and necessary exemptions under the *Local Government Act* 1989 from the Minister for Local Government and the Treasurer of Victoria prior to entering into the Agreement;
- the Republic to grant a first mortgage over the Southern Cross site as security for payment of all money actually or contingently owing by the Republic under the transaction agreements and an indemnity in relation to performance by the Republic of its obligations under the transaction agreements;
- Council not being liable in any way to the Republic if the transaction conditions were not satisfied within the first 37 days of the Agreement and the Council ended the Agreement;
- the Republic to procure the private developer to transfer legal and beneficial title to the Site to the Council and to deliver to the Council the original Crown Grants for the Site and all other documents required by the Council in order to procure the discharge, withdrawal or removal of all encumbrances, mortgages, charges, caveats or other dealings of any kind affecting the titles to the Site and procure registration of the Council as proprietor of the Site;
- on obtaining all required information under the Agreement, Council to provide to the private developer an amount equal to the lesser of \$38.5 million and the residue of the price (after adjustments) payable under the private developer contract with the Republic for purchase of the Site; and
- the Republic to indemnify the Council in relation to any claims of any kind that may be made against the Council in connection with any failure to pay money or perform obligations of any kind under the private developer contract.

3.3.262 On 22 December 1997, Council purchased the freehold title to the Site for \$38.5 million and at the same time the Council signed a contract of sale with the Republic selling the commercial site back to the Republic for the same amount.

Development of the car park

3.3.263 The development of the detailed design for the car park by Council was dependent upon the receipt of detailed specifications and drawings from the Republic relating to the commercial development above the car park. Under the Agreement, the Republic was required to submit the commercial development specifications by 31 March 1998, however, an extension of time of one month to the end of April 1998 was sought by the Republic to prepare the detailed drawings and specifications for the commercial development. Nevertheless, the Agreement allowed Council to proceed with the car park design in the absence of the Republic's commercial development specifications.

3.3.264 In May 1998, Council approved a planning permit for a 2 350 space car park. Seven formal objections were received. All objections were withdrawn following negotiations and amendments, and in December 1998 it was agreed that the total number of car spaces permitted on the Site should not exceed 1 500 spaces without a further permit from the Council.

3.3.265 In October 1998, external consultants were engaged by Council to prepare a report evaluating the car park development project and incorporating new information on demand and costs of construction for a range of car park capacity options. The financial evaluation revealed that the car park would only provide returns in excess of the Council's hurdle rate of return for a car park of over 940 spaces where either the whole Site, or at least the western end were developed.

3.3.266 **At that time, renegotiations of the Agreement between the Council and the Republic commenced with a view to resolving outstanding issues and commitments associated with the Agreement** and to achieve greater integration of the car park development with the commercial development.

3.3.267 In late November 1998, Council was requested by the Republic to remove the mortgage security over the Southern Cross site. The mortgage was provided as a security in the event that the Republic defaulted in making the payment to repurchase the Queen Victoria Hospital Site under the Agreement.

3.3.268 By January 1999, the Republic had not paid the remaining balance of the deposit under the Commercial Site Contract of \$1.425 million, which was due on 1 June 1998. Further, the Republic had not delivered the detailed drawings and specifications required for the commercial development that were important for Council's detailed design and development of the car park. The Republic's commercial development specifications were originally required under the Agreement by 31 March 1998.

Council's options under the Agreement

3.3.269 **Council had recourse to a number of options where the Republic failed in certain of its obligations under the Agreement**, for example where the Republic failed to produce the specifications for the commercial development by the required date or the Republic failed to purchase and pay for the commercial site. Those options included, depending upon the nature of the failure, Council's ability to:

- impose interest costs on the Republic at a rate of 2 per cent above the rate fixed under section 2 of the *Penalty Interest Rates Act* 1983 on its initial outlay of \$38.5 million;

- retain the Republic's deposit from the contract relating to the sale and purchase of the commercial site (however, as indicated above not all of the required deposit had been paid); and
- sell the Site after terminating the contract of sale of the commercial site and for Council to exercise its first ranking security held over the Southern Cross site to recover any shortfall existing after the sale of the commercial site.

3.3.270 However, Council elected not to take default action after having considered advice from its management which highlighted:

- the Republic's concerns about the viability of Council's car park development proposal in the absence of a strong commercial development;
- the likely development of the western end of the Site and the impact of that development on the car park design; and
- the Republic's ability to remedy the breaches of the Agreement before Council could terminate the agreement.

Termination of the Agreement

3.3.271 In April 1999, the Agreement with the Republic was terminated to enable Council to take control of the Site. The termination arrangements provided that Council:

- refund \$500 000 paid by the Republic as part of the deposit under the commercial site contract;
- pay the Republic \$1.4 million, which comprised an amount of \$400 000 to cover expenses incurred by the Republic since 22 December 1997 and an ex-gratia payment of \$1 million; and
- deliver to the Republic a discharge of the mortgage held by Council in relation to the Southern Cross Site, this would enable the Republic to proceed with the development of that site.

3.3.272 Advice provided to Council by its management at the time it was considering the termination payment included that the payment of \$1.4 million, when added to the original purchase price of \$38.5 million, would equate to the value of the Site around the date of original acquisition by Council, as assessed by external consultants. Further, Council was made aware of the losses that had been incurred by the Republic in connection with its earlier arrangements with the private developer for acquisition of the Site. Lastly, Council was also provided with details of the negotiations that had taken place with the Republic and alternative offers made.

3.3.273 Table 3.3L details the total costs incurred by Council to December 1999 in relation to the Site.

TABLE 3.3L
QUEEN VICTORIA SITE –
COST TO COUNCIL UP TO DECEMBER 1999
(\$million)

<i>Description of costs incurred</i>	<i>Amount (a)</i>
Purchase price (\$38.5 million) and associated costs	39.25
Holding cost (b)	7.30
Net termination payment and associated costs (c)	1.60
Realisation costs (d)	0.72
Car park revenue	(2.68)
Car park expenditure	0.50
Total cost to December 1999	46.69

(a) Based on Council estimates and actual costs.

(b) The Council's cost of capital, or opportunity cost, has been calculated at the Council's December 1999 investment hurdle rate of 9.3 per cent on the purchase price and associated costs since the date of purchase, in December 1997.

(c) The termination payment included the refund of a \$500 000 deposit paid by the Republic, however, this amount has been excluded from the table as it did not require additional outlays by Council.

(d) Realisation costs were incurred during March 2000 and relate to costs incurred by Council on the current development proposals.

Development of the Site

3.3.274 Since June 1999, Council has reviewed options for progressing the development of the Site after termination of the arrangements with the Republic. Through an expression of interest process, Council sought to sell the Site, either in whole or in part to developers who would submit concept plans for its development, including supporting documentation for the timeliness and feasibility of their proposal.

3.3.275 The main objectives of Council in selling and developing the Site, as set out in the expression of interest document, included the creation of:

- a mixture of uses across the Site, which would include retail, educational, residential, landscaped public open space (equivalent to 20 per cent of the land value), retirement accommodation, office development, entertainment and health facilities; and
- an underground car park for affordable short-term parking for up to 1 500 vehicles.

Bid evaluation process

3.3.276 The Council implemented an extensive bid evaluation process with a number of strong features, including an expression of interest phase, pre-determined criteria for evaluating bids, a tender evaluation panel which included external members and the appointment of an external probity auditor.

3.3.277 Invitations for the lodgement of formal expressions of interest closed in September 1999 and a total of 16 responses were received. Ten proposals were examined and the bid review panel, which comprised Council staff and external financial consultants, evaluated the offers.

3.3.278 In October 1999, Council approved 4 recommended short-listed proposals. The proponents were invited to submit a formal tender for the purchase and development of the Site in accordance with Council's objectives. Conforming bids were submitted by the 4 short-listed proponents in November 1999, followed by presentations to the bid review panel.

3.3.279 Table 3.3M sets out an overview of the evaluation process used by Council in respect of each of the evaluation criteria.

**TABLE 3.3M
OVERVIEW OF EVALUATION PROCESS AGAINST CRITERIA**

<i>Criteria</i>	<i>Comment</i>
Financial	An external consultant undertook a detailed financial analysis of bids with input from Council officers. This analysis examined the benefits and returns to Council, the financial and risk aspects pertaining to the proposal, projected revenues and costs, proposed sources of finance, the general viability of the development schemes contemplated and the certainty of the return to the Council.
Design	Design evaluation was conducted by Council against 8 established criteria: special concepts, innovation, development of the car park, retail uses, integration of uses across the whole Site, integration of landscaped public open space, blending of the development with the existing Queen Victoria Women's Centre and creative and integrated development on the eastern portion of the site.
Delivery	Each bid was evaluated to establish the certainty to which Council could be expected to see the delivery of the project with reference to the development program and identification of tenants.
Credibility and track record	Assessments of each bid had regard to past experience with similar projects, past and current involvement with other Melbourne developments, financial capacity, management structure and project management experience and ability to work with complex multi-tiered client and other developers.

3.3.280 The selection of the successful proposal by Council for the development and sale of the Site was based on a weighted analysis of bids, with the highest score being nominated as the preferred proponent.

Probity audit process

3.3.281 The expression of interest and tender process was subject to a probity audit undertaken by an external consultant. **The probity auditor concluded that an objective and an independent process for evaluation was adopted by Council and that the evaluation process did not advantage or disadvantage any party.**

Heads of Agreement with Preferred Developer

3.3.282 **The Council announced the selection of a Preferred Developer during December 1999. The Developer has proposed a \$500 million redevelopment** comprising 8 large retail homeware and specialty designer stores, up to 18 restaurants and casual dining cafes, 500 bed student accommodation, supermarket, 4 star hotel, at least 1 500 car parking spaces, more than 20 per cent open space, gymnasium and a crèche.

3.3.283 The Council has announced that the return to the City from the proposed development included a minimum of \$40 million, access to additional open space and a crèche facility, and public car parking. Council also expects \$2.5 million per annum in rate revenue by the time the redevelopment is completed in around 2003.

3.3.284 Work on the Site is expected to commence in mid-2001 once sale arrangements and planning permits have been negotiated.

3.3.285 The Developer has proposed 3 different price options as part of its bid proposal whereby Council could either:

- accept a single lump sum for the Site payable on completion of the contract of sale and procurement of planning permits;
- sell the Site to the Developer for a specified amount with Council purchasing ownership of the car park development for a specified amount at the end of the construction period; and
- sell the Site to the Developer at a single lump sum payable upon completion of Stage 1 of the proposed development which related to the car park and retail component, projected to be completed in March 2002.

3.3.286 In March 2000, Council advised the Developer that it preferred the third option as outlined above. The net present value of that option was marginally below the second option, which had the highest net present value of all of the Developer's price options as assessed by Council. The Council's estimate of the net present value of the preferred price option includes the additional rating revenue that will arise from the proposed development over the long-term.

3.3.287 A Heads of Agreement was entered into between the Council and the Developer in December 1999 whereby Council agreed to sell the property to the Developer and the Developer agreed to purchase and develop the property on the terms and conditions contained in the Heads of Agreement and related land sale contract. The terms and conditions of the Heads of Agreement include:

- Construction and development of the Site to proceed in accordance with the indicative development program, which provided for completion around April 2003;
- The land sale contract to contain provisions to the effect that if the Developer fails to commence the development by the later of 31 December 2000 or 6 months after the Council issued the planning permit, Council has the option to purchase the property at the purchase price set out in the Land Sale Contract;
- The Developer to provide to Council an unconditional performance bond to the value of \$400 000 in the form of a cash deposit or a bank guarantee in a form that is acceptable to Council;
- Land sale contract to be executed by 10 March 2000, being conditional only on the Developer obtaining a planning permit for the development. The Council has recourse to the performance bond for any loss, damage, costs or expense incurred if the Developer fails to execute the Contract by the specified date where Council is not responsible for the Developer's failure;

- The Developer to give Council a Development Bond (equal to 1 per cent of the estimated construction cost of Stage 1 being the car park and retail component of the proposal) on the date the Developer pays the purchase price under the land sale contract;
- Council may require the Developer to expend the full amount of the Development Bond in the event that the Developer abandons the development of Stage 1 at any time after commencement of the Stage but before the completion of 50 per cent of that Stage; and
- The Developer must not apply for planning permits for the development which contains uses which generate less rating revenue for Council than would be generated under the initial proposal.

Sale of the Site to the Developer

3.3.288 During April 2000, Council executed the following documents in relation to the sale of the Site to the Developer's company:

- Land Sale Contract;
- Development Deed;
- Management Agreement; and
- Option for Lease, including Lease Agreement.

Land Sale Contract and Development Deed

3.3.289 The Land Sale Contract sets a price of \$40 million for the Site, which is to be paid by the Developer, and/or its nominee as purchaser, to the Council by 31 December 2002, or other earlier date, should certain specified circumstances arise as set out in the contract.

3.3.290 The Developer is required under the contract to commence construction of Stage 1 works by 31 December 2000 or 6 months after the planning permit for the development has been issued on terms acceptable to the Developer. Should this not occur, the Council has the right to rescind the contract and exercise any enforcement rights it has under the contract. The Developer is required to use its reasonable endeavours to obtain the planning permit on or before 31 December 2000, subject to any extension of approval dates, and is required to construct a car park of not less than 2 000 car spaces.

3.3.291 The Development Deed requires the Developer to develop the property in accordance with the Indicative Development Program contained in the Developer's proposal and pay a development bond of \$1.4 million within 7 days of the date the planning permit is issued.

3.3.292 Under the Deed, the Council may require the Developer to make good, safe and secure, and improve the amenity of the Site and the Stage 1 works (car park and retail works identified in the proposal) immediately and expend the full amount of the development bond if the Developer abandons the Stage 1 works at any time after commencement, but before completion of 50 per cent of the Stage 1 works. Alternatively, Council is required to return the development bond to the Developer upon completion of 50 per cent of the Stage 1 works.

3.3.293 Council's prior approval is required under the Deed where the Developer seeks to apply for planning permits which contain uses which would generate less rating revenue for Council than would have been generated by the Developer's proposal.

3.3.294 Council also has a first right of refusal on commercial terms to take a lease of, or purchase, the childcare centre facility, if the proposed childcare centre facility ceases to operate.

Management Agreement

3.3.295 Under the Management Agreement, the Council has agreed to grant management rights over the Site to the Developer from 1 May 2000 whereby:

- **the Developer must pay the Council a management fee calculated at the rate of 9.5 per cent per annum of \$40 million compounding monthly on the same day as the land purchase price is payable under the land sale contract;**
- Council assigns income from tenancy, licence and management arrangements in relation to the Site to the Developer from the date of commencement of the agreement;
- the Developer is not granted any leasehold interest or any rights of possession or occupation and the Council continues to possess and occupy the Site during the currency of the management agreement; and
- the management agreement will terminate upon settlement of the land sale contract, or when the land sale contract is terminated or when the Developer exercises its option to lease the Site.

Option for Lease and Lease Agreement

3.3.296 Under the Option for Lease, the Council has granted the Developer an option to take a lease of the Site under certain terms and conditions, including:

- the Developer must pay the Council rent calculated at the rate of 9.5 per cent per annum of \$40 million compounding monthly and calculated from 1 May 2000 on the same day as the land purchase price is payable under the Land Sale Contract (the Lease also makes provision for payment of an alternative rental amount under certain circumstances);
- the Developer must pay all periodic charges in relation to all or part of the Site levied by any municipal authority, government agency, service or utility provider including without limitation, rates, water rates and land tax;
- the Developer may assign the Lease to any person who becomes the purchaser in accordance with the Land Sale Contract; and
- the termination date of the lease is the earlier of the date upon which settlement of the Land Sale Contract occurs or the contract is terminated, or any other date as agreed in writing between the parties.

3.3.297 **The total costs incurred by Council on the Site to December 1999 of \$46.7 million, as previously outlined in Table 3.3L, are greater than the sale price of \$40 million. Nevertheless the sale price was consistent with an independent valuation of the Site, which was obtained during January 2000, and the sale will ultimately result in additional rating revenue for Council, open space, public car parking and a crèche.**

❑ **RESPONSE** provided by the Chief Executive Officer, Melbourne City Council

Termination of the Agreement

The City of Melbourne does not consider the payment of the \$1 million to be an “ex-gratia” payment. This payment was made as a contractual settlement to obtain unencumbered control of the Queen Victoria site and subsequently to progress the development.

In reaching this settlement with the Republic of Nauru an informal agreement was made to maintain confidentiality of the settlement amount. Both parties have maintained this confidentiality.

Management Agreement

The execution of the agreement on 1 May 2000 has resulted in the commencement of returns to the City of Melbourne in excess of the opportunity cost of the capital invested. This means that the total costs incurred by Council will commence reducing from this date.

In all other aspects, the City of Melbourne accepts the report as an accurate statement of the events surrounding the City’s involvement in this important project.

**SCHEDULE A
STATUS OF MATTERS RAISED IN PREVIOUS REPORTS**

<i>Report</i>	<i>Subject</i>	<i>Status at date of preparation of this Report</i>
MATTERS RESOLVED OR ACTION COMMENCED		
LOCAL GOVERNMENT		
<i>Ministerial Portfolios, May 1998, pp. 110-13.</i>	The use of audit committees and internal audit had not been universally adopted across the local government sector and, as a consequence, corporate governance within the sector had been diminished.	The Local Government Division of the Department of Infrastructure in conjunction with the local government sector has developed draft <i>best practice</i> guidelines for the operation of audit committees and internal audit in local government entities. Further comment on this matter is provided in this Part of the Report.
<i>Ministerial Portfolios, May 1998, pp. 114-20.</i>	A survey in the 1996-97 financial year of the management of municipal business undertakings indicated that 12 councils were unable to identify surpluses or losses generated from their business unit operations, covering contract expenditure in excess of \$68 million.	The Department's Local Government Division in conjunction with the local government sector has developed a <i>best practice</i> guideline for internal and external financial reporting by councils on business unit financial performance and major contracts. Further comment on this matter is provided in this Part of the Report.
<i>Ministerial Portfolios, May 1999, pp. 154-57.</i>	The overall cost to ratepayers of the Colac Shire Council's decision to acquire and operate an abattoir is estimated to be around \$1 million.	Further comment on this matter is provided in this Part of the Report.
<i>Ministerial Portfolios, May 1999, pp 158-60.</i>	Legislative amendments should be considered for local government entities requiring annual reporting to the responsible Minister and the Auditor-General of all instances of theft, arson, irregularity and fraud.	The <i>Local Government Act 1989</i> is proposed to be the subject of a general review during 2000-01. The Department of Infrastructure advised that amendments requiring annual reporting to the responsible Minister and the Auditor-General of all instances of theft, arson, irregularity and frauds similar to those required of other public sector agencies will be considered as part of the general review.

SCHEDULE A
STATUS OF MATTERS RAISED IN PREVIOUS REPORTS - continued

<i>Report</i>	<i>Subject</i>	<i>Status at date of preparation of this Report</i>
MATTERS RESOLVED OR ACTION COMMENCED - continued		
DOCKLANDS AUTHORITY		
<i>Ministerial Portfolios, May 1999, pp 167-9.</i>	As part of the Stadium arrangements, the developer provided finance of \$29.1 million to the Docklands Authority. However, the Authority did not obtain the required prior formal approval of the Treasurer for the loan.	After this breach was identified by this Office, the Docklands Authority investigated what action could be undertaken to correct the matter and concluded that it was not possible to obtain the Treasurer's approval retrospectively at law. The Authority also considered cancelling the loan and substituting a new loan which did have the requisite prior approval of the Treasurer. However, this arrangement could not rectify the earlier technical breach of the <i>Borrowing and Investment Powers Act 1987</i> and was considered to be uncommercial. The Authority's investigations revealed that such a new loan could incur unnecessary stamp duty, would incur unnecessary legal fees and was likely to disrupt the accounting and taxation treatment of the transaction by the parties, without any commensurate benefit to the State. The Authority has now adopted a protocol to only borrow from Treasury Corporation of Victoria and each draw-down is only made with the prior written approval of the Treasurer.
PUBLIC TRANSPORT		
<i>Ministerial Portfolios, May 1989, p. 236.</i>	The adequacy and quality of disclosure within the financial reports of the transport authorities is inadequate as financing costs related to centralised debt are not included.	As identified in our November 1999 <i>Report on the Government's Finances</i> , at 30 June 1999 the transport rolling stock leasing arrangements were terminated at a total cost of around \$385 million.
<i>Ministerial Portfolios, May 1997, p. 121.</i>	The Department of Infrastructure has not performed a post-implementation review of the contracting-out of the Melbourne to Warrnambool and Melbourne to Cobram services and, accordingly, there is a possibility that the experiences gained from these arrangements may not be factored into future privatisation proposals.	Although the Department of Infrastructure has not conducted a post-implementation review of the contracting-out of these services, the relevant contracts are currently being reviewed in order to determine an appropriate course of action to ensure the continuation of these services after the expiry date of the existing arrangements of 30 June 2001.

**SCHEDULE B
COMPLETED/INCOMPLETE AUDITS**

<i>Entity</i>	<i>Financial year ended</i>	<i>Reporting to Parliament</i>	<i>Financial statements signed by entity</i>	<i>Auditor-General's report signed</i>
COMPLETED AUDITS				
Department of Infrastructure	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.46.</i>	28 Oct. 1999	28 Oct. 1999
PORTS				
Marine Board of Victoria	30 June 1999	" "	28 Oct. 1999	28 Oct. 1999
TRANSPORT				
Roads Corporation	30 June 1999	" "	30 Aug. 1999	31 Aug. 1999
Public Transport Corporation	30 June 1999	" "	27 Aug. 1999	17 Sept. 1999
PLANNING				
Architects Registration Board of Victoria	30 June 1999	" "	14 Sept. 1999	16 Sept. 1999
Building Control Commission	30 June 1999	" "	16 Aug. 1999	24 Aug. 1999
Docklands Authority	30 June 1999	" "	29 Oct. 1999	29 Oct. 1999
Heritage Council	30 June 1999	" "	28 Oct. 1999	28 Oct. 1999
Melbourne City Link Authority	30 June 1999	" "	28 Sept. 1999	28 Sept. 1999
Plumbing Industry Board (a)	Period 1 July 1998 to 31 Dec. 1998	" "	25 May 1999	17 Aug. 1999
Plumbing Industry Commission	Period 1 Jan. 1999 to 30 June 1999	" "	9 Sept. 1999	16 Sept. 1999
Urban Land Corporation	30 June 1999	" "	27 Aug. 1999	31 Aug. 1999
ULC Real Estate Services Pty Ltd	Period 23 Oct. 1998 to 30 June 1999	31 Oct. <i>Financial Management Act 1994, s.53A.</i>	27 Aug. 1999	31 Aug. 1999

SCHEDULE B
COMPLETED/INCOMPLETE AUDITS - continued

<i>Entity</i>	<i>Financial year ended</i>	<i>Reporting to Minister for Planning and Local Government</i>	<i>Financial statements signed by entity</i>	<i>Auditor-General's report signed</i>
COMPLETED AUDITS - continued				
LOCAL GOVERNMENT				
Alpine Shire Council	30 June 1999	30 Sept. <i>Local Government Act 1989, s.126.</i>	23 Sept. 1999	29 Sept. 1999 (b)
Ararat Rural City Council	30 June 1999	“ “	14 Sept. 1999	17 Sept. 1999 (b)
Ballarat City Council	30 June 1999	“ “	15 Sept. 1999	24 Sept. 1999 (b)
Banyule City Council	30 June 1999	“ “	10 Sept. 1999	17 Sept. 1999
Bass Coast Shire Council)	30 June 1999	“ “	15 Sept. 1999	22 Sept. 1999 (b)
Baw Baw Shire Council	30 June 1999	“ “	23 Sept. 1999	27 Sept. 1999
Bayside City Council	30 June 1999	“ “	22 Sept. 1999	24 Sept. 1999 (b)
Boroondara City Council	30 June 1999	“ “	25 Oct. 1999	4 Nov. 1999 (b)
Brimbank City Council	30 June 1999	“ “	30 Sept. 1999	4 Oct. 1999 (b)
Buloke Shire Council	30 June 1999	“ “	21 Sept. 1999	27 Sept. 1999 (b)
Campaspe Shire Council	30 June 1999	“ “	22 Sept. 1999	27 Sept. 1999 (b)
Cardinia Shire Council	30 June 1999	“ “	28 Sept. 1999	29 Sept. 1999
Casey City Council	30 June 1999	“ “	15 Sept. 1999	17 Sept. 1999
Casey - Cardinia Regional Library Corporation	30 June 1999	“ “	15 Sept. 1999	22 Sept. 1999
Central Highlands Regional Library Corporation	30 June 1999	“ “	27 Sept. 1999	29 Sept. 1999
Central Goldfields Shire Council	30 June 1999	“ “	31 Aug. 1999	13 Sept. 1999 (b)
CityWide Service Solutions Pty Ltd	30 June 1999	“ “	21 Oct. 1999	21 Oct. 1999 (b)
Colac-Otway Shire Council	30 June 1999	“ “	24 Sept. 1999	29 Sept. 1999

SCHEDULE B
COMPLETED/INCOMPLETE AUDITS - continued

<i>Entity</i>	<i>Financial year ended</i>	<i>Reporting to Minister for Planning and Local Government</i>	<i>Financial statements signed by entity</i>	<i>Auditor-General's report signed</i>
COMPLETED AUDITS - continued				
LOCAL GOVERNMENT - continued				
Corangamite Shire Council	30 June 1999	30 Sept. <i>Local Government Act 1989, s.126.</i>	28 Sept. 1999	30 Sept. 1999 (b)
Corangamite Regional Library Corporation	30 June 1999	“ “	24 Sept. 1999	29 Sept. 1999
Darebin City Council	30 June 1999	“ “	23 Sept. 1999	28 Sept. 1999
Delatite Shire Council	30 June 1999	“ “	15 Sept. 1999	27 Sept. 1999
East Gippsland Shire Council	30 June 1999	“ “	10 Sept. 1999	17 Sept. 1999
Eastern Regional Library Corporation	30 June 1999	“ “	16 Sept. 1999	24 Sept. 1999
Frankston City Council	30 June 1999	“ “	24 Sept. 1999	29 Sept. 1999
Gannawarra Shire Council	30 June 1999	“ “	17 Sept. 1999	27 Sept. 1999
Geelong Regional Library Corporation	30 June 1999	“ “	22 Sept. 1999	29 Sept. 1999
Glen Eira City Council	30 June 1999	“ “	21 Sept. 1999	29 Sept. 1999 (b)
Glenelg Shire Council	30 June 1999	“ “	16 Sept. 1999	17 Sept. 1999 (b)
Glenelg Regional Library Corporation	30 June 1999	“ “	17 Sept. 1999	30 Sept. 1999
Golden Plains Shire Council	30 June 1999	“ “	15 Nov. 1999	18 Nov. 1999 (b)
Goulburn Valley Regional Library Corporation	30 June 1999	“ “	3 Sept. 1999	10 Sept. 1999
Greater Bendigo City Council	30 June 1999	“ “	14 Sept. 1999	28 Sept. 1999 (b)
Greater Dandenong City Council	30 June 1999	“ “	5 Oct. 1999	7 Oct. 1999
Greater Geelong City Council	30 June 1999	“ “	13 Sept. 1999	15 Sept. 1999 (b)
Greater Shepparton City Council	30 June 1999	“ “	2 Sept. 1999	10 Sept. 1999

SCHEDULE B
COMPLETED/INCOMPLETE AUDITS - continued

<i>Entity</i>	<i>Financial year ended</i>	<i>Reporting to Minister for Planning and Local Government</i>	<i>Financial statements signed by entity</i>	<i>Auditor-General's report signed</i>
COMPLETED AUDITS - continued				
LOCAL GOVERNMENT - continued				
Hepburn Shire Council	30 June 1999	30 Sept. <i>Local Government Act 1989, s.126.</i>	16 Sept. 1999	29 Sept. 1999 (b)
High Country Regional Library Corporation	30 June 1999	" "	2 Sept. 1999	14 Sept. 1999
Hindmarsh Shire Council	30 June 1999	" "	6 Oct. 1999	22 Oct. 1999
Hobsons Bay City Council	30 June 1999	" "	21 Sept. 1999	29 Sept. 1999 (b)
Horsham Rural City Council	30 June 1999	" "	18 Oct. 1999	21 Oct. 1999
Hume City Council	30 June 1999	" "	16 Sept. 1999	24 Sept. 1999 (b)
Hume-Moonsee Valley Regional Library Corporation	30 June 1999	" "	28 Sept. 1999	30 Sept. 1999
Indigo Shire Council	30 June 1999	" "	22 Sept. 1999	28 Sept. 1999 (b)
Kingston City Council	30 June 1999	" "	24 Sept. 1999	29 Sept. 1999 (b)
Knox City Council	30 June 1999	" "	21 Sept. 1999	30 Sept. 1999
La Trobe Shire Council	30 June 1999	" "	22 Sept. 1999	24 Sept. 1999
Loddon Shire Council	30 June 1999	" "	20 Sept. 1999	27 Sept. 1999
Macedon Ranges Shire Council	30 June 1999	" "	15 Sept. 1999	24 Sept. 1999
Manningham City Council	30 June 1999	" "	27 Sept. 1999	30 Sept. 1999 (b)
Maribyrnong City Council	30 June 1999	" "	30 Sept. 1999	30 Sept. 1999 (b)
Maroondah City Council	30 June 1999	" "	15 Sept. 1999	17 Sept. 1999
Melbourne City Council	30 June 1999	" "	21 Oct. 1999	21 Oct. 1999 (b)
Melbourne Wholesale Fish Market Pty Ltd	30 June 1999	" "	14 Sept. 1999	14 Sept. 1999
Melton Shire Council	30 June 1999	" "	27 Sept. 1999	28 Sept. 1999 (b)

SCHEDULE B
COMPLETED/INCOMPLETE AUDITS - continued

<i>Entity</i>	<i>Financial year ended</i>	<i>Reporting to Minister for Planning and Local Government</i>	<i>Financial statements signed by entity</i>	<i>Auditor-General's report signed</i>
COMPLETED AUDITS - continued				
LOCAL GOVERNMENT - continued				
Mildura Rural City Council	30 June 1999	30 Sept. <i>Local Government Act 1989, s.126.</i>	28 Sept. 1999	30 Sept. 1999
Mitchell Shire Council	30 June 1999	“ “	6 Sept. 1999	28 Sept. 1999 (b)
Moira Shire Council	30 June 1999	“ “	10 Nov. 1999	15 Nov. 1999 (b)
Monash City Council	30 June 1999	“ “	27 Sept. 1999	29 Sept. 1999
Moonee Valley City Council	30 June 1999	“ “	21 Sept. 1999	23 Sept. 1999
Moorabool Shire Council	30 June 1999	“ “	15 Sept. 1999	30 Sept. 1999
Moreland City Council	30 June 1999	“ “	29 Sept. 1999	30 Sept. 1999
Mornington Peninsula Shire Council	30 June 1999	“ “	27 Sept. 1999	29 Oct. 1999 (b)
Mount Alexander Shire Council	30 June 1999	“ “	28 Sept. 1999	29 Sept. 1999
Moyne Shire Council	30 June 1999	“ “	22 Sept. 1999	27 Sept. 1999
Murrundindi Shire Council	30 June 1999	“ “	17 Sept. 1999	27 Sept. 1999
Nillumbik Shire Council	30 June 1999	“ “	23 Sept. 1999	28 Sept. 1999 (b)
North Central Goldfields Regional Library Corporation	30 June 1999	“ “	21 Sept. 1999	29 Sept. 1999
Northern Grampians Shire Council	30 June 1999	“ “	6 Oct. 1999	11 Oct. 1999
Port Phillip City Council	30 June 1999	“ “	29 Sept. 1999	7 Oct. 1999 (b)
Prahran Market Pty Ltd	30 June 1999	“ “	15 Sept. 1999	22 Sept. 1999
Pyrenees Shire Council	30 June 1999	“ “	22 Sept. 1999	5 Oct. 1999 (b)
Queenscliffe Borough Council	30 June 1999	“ “	21 Sept. 1999	29 Sept. 1999 (b)
Queen Victoria Market Pty Ltd	30 June 1999	“ “	14 Sept. 1999	14 Sept. 1999

SCHEDULE B
COMPLETED/INCOMPLETE AUDITS - continued

<i>Entity</i>	<i>Financial year ended</i>	<i>Reporting to Minister for Planning and Local Government</i>	<i>Financial statements signed by entity</i>	<i>Auditor-General's report signed</i>
COMPLETED AUDITS - continued				
LOCAL GOVERNMENT - continued				
Regent Management Company Pty Ltd	30 June 1999	30 Sept. <i>Local Government Act 1989, s.126.</i>	1 May 2000	9 May 2000
South Gippsland Shire Council	30 June 1999	“ “	8 Sept. 1999	17 Sept. 1999 (b)
Southern Grampians Shire Council	30 June 1999	“ “	5 Oct. 1999	11 Oct. 1999
Stonnington City Council	30 June 1999	“ “	21 Sept. 1999	28 Sept. 1999
Strathbogie Shire Council	30 June 1999	“ “	24 Sept. 1999	29 Sept. 1999 (b)
Surf Coast Shire Council	30 June 1999	“ “	14 Sept. 1999	21 Sept. 1999 (b)
Swan Hill Rural City Council	30 June 1999	“ “	27 Sept. 1999	29 Sept. 1999 (b)
Swan Hill Regional Library Corporation	30 June 1999	“ “	28 Sept. 1999	29 Sept. 1999
Towong Shire Council	30 June 1999	“ “	29 Oct. 1999	29 Oct. 1999
Wangaratta Rural City Council	30 June 1999	“ “	2 Sept. 1999	15 Sept. 1999 (b)
Warrnambool City Council	30 June 1999	“ “	13 Sept. 1999	30 Sept. 1999
Wellington Shire Council	30 June 1999	“ “	31 Aug. 1999	15 Sept. 1999 (b)
West Wimmera Shire Council	30 June 1999	“ “	20 Sept. 1999	29 Sept. 1999 (b)
West Gippsland Regional Library Corporation	30 June 1999	“ “	30 Sept. 1999	4 Oct. 1999
Whitehorse City Council	30 June 1999	“ “	28 Sept. 1999	29 Sept. 1999
Whitehorse Manningham Regional Library Corporation	30 June 1999	“ “	29 Sept. 1999	30 Sept. 1999
Whittlesea City Council	30 June 1999	“ “	29 Sept. 1999	30 Sept. 1999
Wimmera Regional Library Corporation	30 June 1999	“ “	1 Oct. 1999	11 Oct. 1999
Wodonga Rural City Council	30 June 1999	“ “	15 Sept. 1999	21 Sept. 1999 (b)

SCHEDULE B
COMPLETED/INCOMPLETE AUDITS - continued

<i>Entity</i>	<i>Financial year ended</i>	<i>Reporting to Minister for Planning and Local Government</i>	<i>Financial statements signed by entity</i>	<i>Auditor-General's report signed</i>
COMPLETED AUDITS - continued				
LOCAL GOVERNMENT - continued				
Wyndham City Council	30 June 1999	30 Sept. <i>Local Government Act 1989, s.126.</i>	29 Sept. 1999	30 Sept. 1999
Yarra City Council	30 June 1999	“ “	21 Sept. 1999	27 Sept. 1999
Yarra Ranges Shire Council	30 June 1999	“ “	27 Sept. 1999	28 Sept. 1999
Yarra Melbourne Regional Library Corporation	30 June 1999	“ “	16 Sept. 1999	22 Sept. 1999
Yarra Plenty Regional Library Corporation	30 June 1999	“ “	24 Sept. 1999	27 Sept. 1999
Yarriambiack Shire Council	30 June 1999	“ “	21 Sept. 1999	30 Sept. 1999

(a) Entity abolished at reporting date and reconstituted as the Plumbing Industry Commission.

(b) Qualified audit report issued.

Part 3.4

Justice

KEY FINDINGS

Outsourcing of traffic camera and fine collection services

- Based on a consultant's report prepared for the Department of Justice in 1997, the estimated cost associated with the internal provision of these services was \$35 million per annum. However, consistent with the earlier expectations of the Government, the cost of service provision had increased as a result of the outsourcing arrangements, with the Department incurring total costs of around \$49.4 million per annum.

Paras 3.4.19 to 3.4.21

- Since the commencement of the service agreement in November 1998, the overall performance of the service provider, as indicated by its ability to meet or exceed the standards set in the service agreement, has been good.

Paras 3.4.23 to 3.4.26

- It is unlikely that the long outstanding debt of \$169 million which was not allocated to the service provider for collection will be recovered, given the rationalisation of internal resources.

Paras 3.4.34 to 3.4.39

- Under the service agreement, payments to the service provider in respect of City Link services were to begin in April 1999 in line with the expected opening of the toll roads. Due to a number of delays, the first toll road was not opened until January 2000. The service provider was, however, paid \$2.8 million for the period from April 1999 to December 1999.

Paras 3.4.40 to 3.4.41

KEY FINDINGS - *continued***Residential Tenancies Bond Authority**

- Our review of the Residential Tenancies Bond Authority's tender evaluation processes for outsourcing tenancy bond management functions identified a number of factors which could reasonably have caused the Authority to question the adequacy of the successful service provider's tender, which have resulted in additional costs to the Authority.

Paras 3.4.65 to 3.4.74

- The Authority needs to prepare annual financial statements in accordance with the *Financial Management Act 1994* to provide public accountability over its operations.

Paras 3.4.80 to 3.4.81

Construction of Children's Court

- Substantial deficiencies were identified in the Department of Justice's tendering processes associated with the construction of the Children's Court.

Paras 3.4.91 to 3.4.115

- Despite deficiencies in its tendering process, the Department has managed to replace an inadequate court facility with a purpose-built world class facility, the construction of which was completed without significant cost overruns, although 15 months later than initially planned.

Paras 3.4.121 to 3.4.123

3.4.1 The Attorney-General, the Minister for Corrections, the Minister for Consumer Affairs and the Minister for Police and Emergency Services, have responsibility for operations within the Justice sector. These Ministers have collective responsibility for the Department of Justice.

3.4.2 Details of the specific ministerial responsibilities for public bodies within the Justice sector are provided in Table 3.4A. These public bodies, together with the Department of Justice, were subject to audit by the Auditor-General during the 1998-99 financial year.

**TABLE 3.4A
MINISTERIAL RESPONSIBILITIES
FOR PUBLIC BODIES WITHIN THE JUSTICE SECTOR**

<i>Ministerial portfolio</i>	<i>Entities subject to audit</i>
Attorney-General	Equal Opportunity Commission Legal Practice Board Office of Public Prosecutions Office of the Legal Ombudsman Office of the Public Advocate Queen Victoria Women's Centre Trust Senior Master of the Supreme Court Victoria Legal Aid Victorian Electoral Commission Victorian Financial Institutions Commission Victorian Institute of Forensic Medicine
Police and Emergency Services	Country Fire Authority Metropolitan Fire and Emergency Services Board National Institute for Forensic Science National Police Ethnic Advisory Bureau Office of the Chief Commissioner of Police
Consumer Affairs	-
Corrections	-

3.4.3 Comment on matters of significance arising from the audit of entities within the Justice sector is provided below.

OUTSOURCING OF TRAFFIC CAMERA AND FINE COLLECTION SERVICES

3.4.4 During 1998-99, certain functions associated with the Enforcement Management Division (EMD) of the Department of Justice and the Traffic Camera Office (TCO) of Victoria Police were outsourced.

3.4.5 The EMD within the Department of Justice is responsible for the administration and enforcement of all unpaid fines and criminal warrants issued to the Sheriff's Office by the Penalties Enforcement by Registration of Infringement Notices (PERIN) Court and the Magistrates (Open) Court. The EMD is also responsible for the execution of all civil warrants issued by the Supreme, County and Magistrates' Courts, and interstate, Commonwealth and international jurisdictions.

3.4.6 The TCO within Victoria Police deploys detection and prosecution systems designed to deter motor vehicle drivers from speeding and travelling through intersections when traffic lights are red. One of the units within the TCO is the Fixed Penalties Payments Office (FPPO), which is responsible for receiving and recording all infringement notices issued by Victoria Police and other agencies that have authority to issue such notices, and for the administration and collection of infringement notice penalties.

3.4.7 In relation to the above functions, the following aspects were subject to the outsourcing arrangements:

- operation of traffic cameras;
- processing of fines, collection of fine revenue and responding to public queries regarding fines; and
- managing outstanding fines, which involves ensuring fines imposed are paid in a timely manner and the reduction of the level of long outstanding fines.

3.4.8 Following a comprehensive tender process, a service agreement to outsource the administrative and IT functions of the EMD and TCO was formalised in September 1998 between the State and LMT Australia, a consortium of Lockheed Martin and Tenix Defence Systems. The service provision under this agreement was to commence in November 1998, with LMT Australia providing enhanced public counter and telephone services as from March 1999.

3.4.9 In the period from the commencement of the outsourcing arrangements in November 1998 to February 2000, payments made under the service agreement have totaled approximately \$40 million, or \$2.5 million per month.

3.4.10 This Report outlines the findings from our review of the establishment and operation of these outsourcing arrangements.



In-car speed camera.

Establishment of outsourcing arrangement

3.4.11 Following the receipt of expressions of interest from 4 private sector organisations for the provision of administration services to EMD and TCO, the Department of Justice conducted an analysis in May 1995 which compared the cost of outsourcing these administrative functions with the internal provision of these services. The analysis concluded that, with the exception of some components of EMD's operations, the outsourcing of the administrative functions would generate savings for the State.

3.4.12 In September 1995, the Department conducted a further review to assess the impact on the collection of fines from the amalgamation and re-engineering of the common business elements of the EMD and TCO, including the FPPO. The review also assessed the possible implementation of an integrated information system to replace the existing information systems. **Although this review considered the potential for outsourcing, it did not conclude on this matter or attempt to identify the costs and benefits of outsourcing. Nevertheless, the review indicated that the Department should further investigate the outsourcing of the administrative functions of EMD and TCO.**

3.4.13 In December 1996, the Government approved the issue of a project brief for the outsourcing of the administrative functions of EMD and TCO, with the approval conditional on the Department, following the selection of a preferred tenderer, demonstrating to the Government that the tenderer had met the requirements outlined in the project brief and that the net financial benefits of outsourcing exceeded an established financial benchmark.

3.4.14 Following a pre-qualification and expression of interest process for the provision of the required services, proposals were received in May 1997 from 3 organisations which were evaluated over a 3 month period from June to August 1997.

3.4.15 The Department established 7 evaluation teams, with each team having responsibility for the evaluation of specific financial or technical aspects of each proposal. In addition, another team was established to oversee the progress of each of the evaluation teams and to recommend a preferred tenderer to a departmental steering committee. The evaluation process involved assessing each tender against pre-established and weighted selection criteria, and the process was subject to review by an independent probity auditor.

3.4.16 On completion of the evaluation process, it was concluded that none of the tenders substantially met all the tender requirements. As a result, the Department entered into a bid refinement process, with each of the 3 tenderers requested to:

- improve their respective bids in a number of specific areas; and
- confirm their acceptance of the Department's risk allocation and the conditions outlined in the proposed service agreement.

3.4.17 The tender process was concluded in January 1998, with LMT Australia selected as the preferred tenderer for the final negotiation phase. Following the successful negotiation of all service agreement arrangements and a detailed probity investigation, a formal service agreement was entered into between the State and LMT Australia in September 1998, with LMT Australia providing fine collection services from November 1998.

3.4.18 **The probity auditor, in his final report, concluded that the process adopted by the Department throughout the tendering process had been fair and equitable.**

Assessment of the benefits flowing from outsourcing arrangements

3.4.19 The preferred tenderer was selected by the Department on the basis that the bid would provide net financial benefits to the State exceeding the established financial benchmark by 20 per cent. The departmental assessment of the net financial benefits of the tender was premised on an expectation that the tenderer would raise additional revenue of \$127 million, which would offset the higher costs associated with the outsourcing arrangement.

3.4.20 However, the assessment did not indicate how the additional revenues were to be generated and why these additional revenues could not be generated by upgrading existing systems and purchasing new equipment, while still providing these services internally. **Without this information, we considered that there was insufficient information available at the time of outsourcing to make an informed decision on whether this form of service provision provided the best outcome for the State.**

3.4.21 In relation to the cost of service provision, we identified that based on a consultant's report prepared for the Department in 1997, the estimated cost associated with the internal provision of these services was \$35 million per annum. However, consistent with the earlier expectations of the Government, the cost of service provision had increased as a result of outsourcing arrangements, with the Department incurring total costs of around \$49.4 million per annum, consisting of \$30 million in service provider payments and \$19.4 million for internal costs associated with the provision of these functions and the management of the outsourcing arrangements.

Performance of outsourced arrangements

3.4.22 As part of the outsourced arrangements, the Department has amalgamated the common elements of the operations of EMD and TCO and has developed an integrated information system that records information formerly held on 5 separate systems. This significant achievement has been carried out with minimal disruption to the operation of traffic cameras, the recording and collecting of fines and the management of fine debtors.

Performance measurement

3.4.23 For each of the services outsourced, namely, the operation of traffic cameras, processing of fines and collection of fine revenue, and the management of outstanding fines, the Department has established a comprehensive set of performance measures to ensure that the service provider meets pre-determined standards of service delivery. Under the arrangements, the service provider will receive bonuses where the performance standards have been exceeded and incur penalties where such standards have not been met.

3.4.24 However, the service agreement did not require the payment of any bonuses or incurrance of penalties within the first 6 months of its operation.

3.4.25 Since the commencement of the service agreement in November 1998, the overall performance of LMT Australia, as indicated by its ability to meet or exceed the standards set in the service agreement, has been good. From the commencement of the outsourcing arrangements to the date of preparation of this Report, LMT Australia has earned net bonuses of approximately \$700 000 (bonuses of \$1.18 million less \$481 000 of penalty payments).

3.4.26 Details of the service provider's performance for each major service area are outlined below.

Traffic camera operations

3.4.27 Under the outsourced arrangements, Victoria Police has determined that traffic cameras should be in operation for a set number of hours to ensure road users comply with road rules. By penalising drivers who speed, drive through red lights and drive in bus lanes, Victoria Police hopes to moderate driver behaviour and as a result reduce the incidence of motor vehicle accidents.

3.4.28 In order to ensure an adequate coverage of motor vehicle journeys, Victoria Police has determined the number of hours cameras are to be in operation each month, the location of each camera, and the time period for which they are operational. Compliance with these requirements is monitored by the contract monitoring unit of the EMD to ensure appropriate service provider performance.

3.4.29 Another objective of the arrangement is to ensure that, where photographs of offending drivers have been taken, the right vehicle has been identified and the fine is enforceable. The service agreement includes a performance measure requiring the percentage of prosecutable photographs to be 65 per cent at the commencement of the service agreement and to progressively increase to 75 per cent by the end of the agreement.

3.4.30 In respect of traffic camera operations, the performance measures associated with delivering the required percentage of prosecutable photographs for enforcement, providing a set number of hours of camera operation and appropriately locating cameras, as directed by Victoria Police, have been met or exceeded by LMT Australia. The net bonuses payable to LMT Australia as a result of it exceeding the performance requirements in the service agreement, up to the preparation of this Report, amounted to \$397 000.

Processing of fines

3.4.31 The key aims of the Department in relation to the processing of fines is to minimise the duration of time taken to:

- raise a traffic infringement notice from the date a prosecutable photograph is taken;
- process an infringement notice; and
- respond to customer queries.

3.4.32 As with other services provided under the agreement, performance measures have been established to determine the efficiency of the service provision in this area.

3.4.33 With the exception of one month where the traffic infringement notices were not processed within the required period following receipt of prosecutable photographs, the service provider met all of the standards outlined in the service agreement. There were no bonuses or penalty payments made since the establishment of the service agreement.

Debt management

3.4.34 To ensure that outstanding fines are collected promptly the service agreement includes a number of debt management performance measures. For long outstanding fines, LMT Australia accepted responsibility for the collection of \$49 million of the \$218 million of debt outstanding greater than 6 months old (excluding expired warrants greater than 5 years old) as at January 1998. The service agreement required this debt to be progressively recovered over 3 years, with a specified amount to be collected every 6 months.

3.4.35 LMT Australia recovered \$28.9 million of this long outstanding debt in the first 12 months of the service agreement. This exceeded the amount required to be collected by that date and entitled the company to a bonus payment of \$730 000.

3.4.36 In relation to the long outstanding debt of \$169 million which was not allocated to LMT Australia for recovery action, it is unlikely that this amount will be recovered given the rationalisation of internal resources.

3.4.37 To ensure the effective recovery of fines raised since the establishment of the outsourced arrangements, the service agreement identifies 8 dates over the 5 year period covered by the agreement, and specifies a percentage of the debt that must be recovered by each of these dates. In addition, the service agreement specifies a required number of customer contact hours and response times for public inquiries regarding outstanding debts.

3.4.38 From the commencement of the service agreement up to the date of preparation of this Report, LMT Australia's performance in relation to TCO and FPPO debt has been below that specified in the agreement, resulting in a possible reduction in payments to the service provider of \$475 000. However, this reduction had not been applied as at the date of preparation of this Report due to concerns over the accuracy of certain related information.

3.4.39 In relation to fines originating from the PERIN Court and the Sheriff's Office, LMT Australia's performance for PERIN Court fines was within the acceptable recovery range established in the service agreement and as a result no bonuses or penalties were payable. Its performance in relation to the recovery of fines originating from the Sheriff's Office was above that specified, resulting in a bonus payment of \$48 000.

Provision of services relating to City Link

3.4.40 City Link is a private toll road project operated by Transurban City Link Limited under agreement with the Government. In respect of the traffic traveling on City Link toll roads, LMT Australia was contracted to provide a number of services including:

- provision of photographs of prima facie driving offences to the TCO;
- printing and mailing caution and infringement notices;
- receiving payments; and
- handling public inquiries.

3.4.41 Under the service agreement, payments to LMT Australia in respect of City Link services were to begin in April 1999 in line with the expected opening of the toll roads. However, due to a number of delays, the first toll road was not opened until January 2000 and then only part of the road was operational. **Despite these delays, LMT Australia was paid \$310 000 per month for the period from April 1999 to December 1999 with payments over this period totaling \$2.8 million.**

Deed of variation

3.4.42 As indicated earlier in this Report, LMT Australia is entitled to bonuses where it has provided to the Department a higher percentage of prosecutable photographs each month than required under the service agreement.

3.4.43 In respect of the prosecutable photographs, the performance standards were established on the basis of information provided by Victoria Police prior to the commencement of the service agreement. **However, the information provided understated the percentage of prosecutable photographs taken by Victoria Police prior to the commencement of the service agreement and, as a result, performance measures for this service were set too low, effectively enabling LMT Australia to earn bonuses every month.**

3.4.44 Subsequent to the signing of the service agreement, a number of municipal councils have engaged debt collection agencies to recover fines which the councils considered would be difficult to collect and have forwarded the remaining fines to the PERIN Court. **In relation to the more collectable debt forwarded to the PERIN Court, the debt clearance levels are expected to be higher, and consequently, bonus payments to LMT Australia are also expected to be higher.**

3.4.45 In order to rectify these 2 issues, the Department entered into an agreement to amend the original service agreement with LMT Australia through a Deed of Variation. At the date of preparation of this Report, the Deed of Variation had not been finalised and negotiations were continuing between LMT Australia and the Department.

Introduction of privacy legislation

3.4.46 Until recently, there was no State Government privacy legislation that applied to information held by the public or private sectors. With recent departmental outsourcing initiatives providing private sector organisations with access to public sector databases, the adequacy of current legislation to protect the privacy of the public has been called into question by segments of the community. Under the service agreement with the Department, LMT Australia has been granted access to information such as the VicRoads motor vehicle registration and driver licensing database, and the vehicle securities register to enable it to perform its duties under the service agreement with the Department.

3.4.47 In the absence of legislation, the Department has established confidentiality agreements with LMT Australia to ensure that it does not abuse its right to access public information. In addition, the contract contains several other security clauses, which prohibit misuse of data, thereby protecting the privacy of individuals.

3.4.48 There have been a number of recent developments in the area of privacy legislation relevant to this issue, including:

- enactment, in April 2000, of Commonwealth Government privacy legislation dealing with personal information held in the private sector; and
- the introduction into the Victorian Parliament of an Information Privacy Bill, which aims to safeguard the privacy of personal information held by public sector bodies.

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

Establishment of outsourcing arrangements

The issuing of the project brief was after an expression of interest was conducted where the market indicated that it was willing and capable of providing the complete range of services required. The project brief sought firm proposals that would better the cost to government of providing these services. This phase of the project comprised 2 parts: the release of the project brief and the establishment of an internal cost, (being the “benchmark cost”) which the bidders would have to better.

If none of the bidders were able to better the benchmark cost then the Treasury Infrastructure Investment Policy for Victoria and the Cabinet’s conditional approval would have prevented the acceptance of any of the bids.

It needs to be emphasised that the Government had established the cost of providing these services prior to receiving a bid from the short-listed bidders in May 1997.

In respect of the criticism of the cost-benefit analysis which showed a net benefit to government of outsourcing, the government costings included the costs of upgrading existing systems and purchasing new equipment. However, an assessment of the likely revenue improvements which could be achieved if the Government employed a similar approach to the bidders was not undertaken because the Government would effectively have had to present a separate in-house bid for the project.

The bidders estimated the benefits to the Government on the basis of their detailed analysis of existing systems and their design and costing of new processes. To provide a fair government benchmark which incorporated a similar methodology would have required funding and resources which were simply not available. It would of course have been unethical to analyse the bids then use the information about the proposed systems and processes to construct a new government benchmark.

Even if such a methodology was adopted and the assessment resulted in services being kept in-house, the commercial risk of not achieving the benefits of the investment would have remained with the Government rather than be transferred to the private sector as part of the contract.

In respect of the costs of the outsourcing contracts, these will be offset against the substantially increased revenue to be generated which is referred to in the Report.

Performance of outsourced arrangements

Performance measurement

The Department notes the Auditor-General’s comments on LMT’s high standard of performance. The bonuses paid to LMT reflect this and are more than offset by the consequent increase in revenue to government. Bonuses are paid in respect of improved traffic camera images and debt pool clearance which are estimated to have generated an additional \$11.2m of benefit. This amount comprises \$5.7m in additional revenue from Traffic Camera performance and \$5.5m in revenue and non-cash clearance from debt pool performance.

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

Debt management

The Department notes that LMT's target figure for debt pool clearance of \$49m is higher than would have been achieved by government and that the balance is judged to be irrecoverable. The writing-off of old, uncollectible debt is being addressed in the review of infringements legislation currently being undertaken.

Provision of services relating to City Link

The payment structure for LMT to provide City Link services incorporates a base service fee and a menu of activity-based items. Only the base service fee has been charged, which is meant to cover LMT's costs of developing the infrastructure necessary to process images and data received from City Link.

RESIDENTIAL TENANCIES BOND AUTHORITY

3.4.49 The Residential Tenancies Bond Authority, which commenced operation on 1 July 1998, was established under the *Residential Tenancies Act* 1997 to hold bond moneys paid by tenants renting residential properties in Victoria. The Authority is a body corporate with perpetual succession, and as such has the power to acquire, hold and dispose of real and personal property, and sue and be sued in its corporate name.

3.4.50 The major functions of the Authority are to:

- collect and disburse bond moneys paid to the Authority under the Act;
- establish and administer a Residential Bonds Account and a Residential Bonds Investment Income Account; and
- invest moneys held in those accounts in accordance with the Act.

3.4.51 The introduction of a centralised bond management system was intended to ensure that:

- bonds are held by a party not associated with tenancy agreements;
- returns on the investment of bond moneys are maximised; and
- non-compliance with bond lodgement requirements are minimised.

3.4.52 On 31 December 1999, the Residential Bonds Account held approximately 260 000 bonds amounting to \$184.5 million.



Bond moneys are paid to the Residential Tenancies Bond Authority in relation to tenants renting residential properties.

3.4.53 The collection and repayment of bonds and maintenance of bond records has been outsourced to a contractor providing commercial registry services. The Office of Fair Trading and Business Affairs (OFTBA) within the Department of Justice, on behalf of the Authority manages the external contractor to ensure that the operations of the bond registration and banking processes are conducted efficiently, provide for adequate security over bond moneys and meet the needs of stakeholders (agents, landlords and tenants). In addition, OFTBA:

- operates a telephone and counter inquiry service to answer inquiries from the public;
- provides an investigation service to ensure landlord compliance with the lodgement requirements;
- manages the investment of funds held in the Residential Bonds Account; and
- provides for the ongoing education of agents and landlords through presentations at industry seminars and circulation of printed information.

3.4.54 The Authority's income, which is primarily generated from the interest earned on bond moneys held, is paid into the Residential Bonds Investment Income Account. The Act restricts the use of this income to:

- meeting the expenses and liabilities associated with administering tenancy bonds;
- making payments to the Residential Tenancies Fund to assist in the financing of the Fund's activities, as determined by the Authority; and
- making additional payments to bond providers (tenants) following recommendation by the Residential Tenancies Fund's actuary and approval of the Minister.

3.4.55 The payments to bond providers as referred to above relate to circumstances where interest earned on bond moneys exceed the level of funds required to meet the costs of administering the scheme. In the current low interest rate environment, any amounts available for distribution are likely to be very small when spread across all tenants. As a result, to date no such payments have been made.

Bond management arrangement – engagement of external service provider

3.4.56 Prior to the establishment of the Authority, it was decided that the bond collection, repayment and maintenance processes would be outsourced. This decision was based on OFTBA having no prior experience in the management of bonds and a lack of experienced staff and suitable systems within OFTBA.

3.4.57 Consequently, in January 1998, advertisements were placed in the daily newspapers requesting expressions of interest to manage the central bond management system, with the registrations of interest closing in February 1998. A Committee was established consisting of both public and private sector representatives to assess the expressions of interest received. Of the 7 expressions of interest received, 3 were short-listed and requested to submit tenders by April 1998.

3.4.58 Tenders were received from 2 of the 3 short-listed organisations which were subsequently evaluated against various criteria relating to professional competence and other considerations.

3.4.59 In May 1998, National Registry Services Pty Ltd was selected as the successful service provider, with the arrangements formalised through a contract for the management of tenancy bonds.

3.4.60 Following the implementation of the central bond management system by the external service provider, significant problems emerged. Specifically, tenants were experiencing:

- significant delays in receiving bond refunds, with the period between the date of claim lodgement and receipt of their bond moneys taking up to 9 weeks in late 1998 and early 1999; and
- difficulties in communicating with the Authority on issues relating to their bond moneys.

3.4.61 In addition, the Authority experienced difficulties with the service provider, including slow responses to information requests and delays in initiating action to address problems raised by the Authority.

3.4.62 As the Authority became aware of these problems, it introduced a number of initiatives including:

- requiring the service provider to establish a temporary call centre in February 1999 to deal with queries from tenants, estate agents and landlords;
- improving its communication process with real estate agents and the service provider; and
- enhancing its procedures in respect of the repayment of bonds.

3.4.63 Despite these initiatives, the Authority was still experiencing a number of problems with the service provider. Consequently, in June 1999, the Authority wrote to the service provider outlining the problems and seeking a significant improvement in the quality of the service provided. The service provider agreed to improve the quality of the service provided as well as engage its external auditor to undertake a review of its internal control systems.

3.4.64 **By March 2000, the Authority paid around \$387 000 in additional fees to meet reprocessing costs incurred by the service provider. A further \$553 000 had been invoiced to the Authority of which \$330 000 related to the establishment and operation of the call centre and \$223 000 related to additional reprocessing costs incurred by the service provider.**

Shortcoming in tendering process

3.4.65 Our review identified a number of factors, associated with the Department's tendering processes for the appointment of the external service provider, which may have contributed to the difficulties experienced in the central management of tenancy bonds.

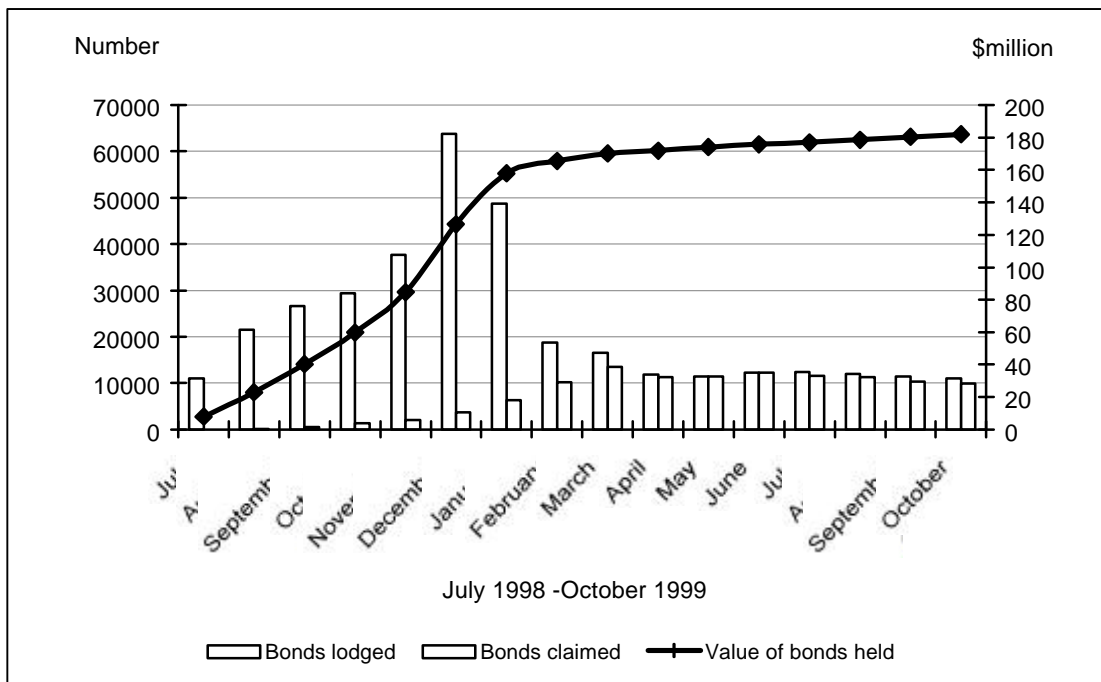
3.4.66 In order for an organisation to successfully outsource the provisions of goods and services to third parties, it needs to have a sound knowledge of the business to be subject to tender. Our review of the tendering process and the subsequent problems encountered with the contract indicated that both the Authority and the appointed service provider did not anticipate:

- the poor standard of information provided with the bonds and as a result, the need to reprocess lodgements and claims; and
- the level of queries which were received following the establishment of the central bond system.

3.4.67 Furthermore, the service provider was not prepared for the significant volume of bond lodgements received from real estate agents and landlords, immediately before the statutory deadline of 31 December 1998 for lodgement of bonds previously held by real estate agents and landlords.

3.4.68 Table 3.4B highlights the volume of activity and volume of bonds held by the Authority over the period July 1998 to October 1999.

**TABLE 3.4B
BOND LODGEMENTS AND CLAIMS**



3.4.69 As centralised bond authorities have been established in both New South Wales and Queensland, it would have been expected that the Authority and tenderers would have sought information from the relevant authorities in those States on their experiences in establishing and operating such a function.

3.4.70 Once obtained, this information could have been analysed to generate indicative data regarding the quantum of the bond transactions requiring processing under the Victorian system. The availability of information would have assisted in the development and evaluation of more informed tenders.

3.4.71 A review of the contract specifications and the information provided to the tenderers indicated that the above information was not provided.

Evaluation process

3.4.72 Our review of the Authority's tender evaluation processes identified a number of factors which could reasonably have caused the Authority to question the adequacy of the successful service provider's tender price, including:

- The contract price tendered for lodgements was substantially higher than that tendered for claims or transfers. However, due to the nature of the tenancy bonds, where there is a high incidence of claim reprocessing, the cost of processing claims is usually higher than the cost of processing lodgements. The current cost per claim incurred by the service provider is approximately 23 per cent higher than the cost per lodgement.

It would have been expected that the evaluation team's understanding of the business would have led the team to question why the successful service provider's price per claim and transfer was considerably less than for lodgements.

Despite this, we could find no evidence of such questioning by the evaluation team or any information provided by the successful service provider during the tender evaluation process to justify its comparatively low contract price for claims;

- The average costs for bond lodgements and claims in New South Wales and Queensland, as indicated in an inquiry into the New South Wales Ministry of Housing in 1993, are approximately 4 times higher than the prices tendered by the successful service provider.

There are a number of features associated with the New South Wales and Queensland systems, which are different from Victoria including, that their respective bond management systems are managed internally rather than outsourced to a private contractor, lodgements and claims are processed manually while processing in Victoria occurs via electronic scanning, and the other States provide a facility to resolve disputes between landlords and tenants, whereas in Victoria, dispute resolution is handled by a tribunal.

Although we concede that there are legitimate reasons for differences between the successful service provider's tender prices and those incurred in other States, no evidence was found to suggest the Authority had attempted to reconcile these differences; and

- There was a significant difference in the prices submitted by the 2 short-listed tenderers with the successful service provider's total contract costs being almost half that of the other tenderer.

3.4.73 Our review of the tender process also indicated that the tender specification did not require a call centre to be established to address bond queries and the successful service provider did not include a call centre in its original tender submission. **This suggests that both the parties underestimated the quantum of queries likely to be raised in regards to bond moneys and the need for a call centre.**

3.4.74 Commencing in February 1999, the service provider was to be paid approximately \$30 000 per month to establish a temporary call centre to respond to queries relating to bond moneys. The call centre averaged approximately 1 100 queries per week in the February to March 1999 period which reduced to approximately 200 calls in the January to February 2000 period, as OFTBA call centre took more of the load with the centre officially closing on 31 March 2000.

Other issues impacting on the difficulties experienced

Legislative timeframe

3.4.75 The Act was enacted in December 1997, with the relevant sections dealing with the formation of the Authority and the requirement for real estate agents and landlords to pay bond moneys into a central bond account coming into effect on 1 July 1998. This timeframe effectively provided a 6-month period to establish the Authority and engage an external contractor to operate the central bond management system. The significance of the tasks involved, combined with the short timeframe for implementation was a major contributor to the abovementioned difficulties.

Education and assistance to the public and real estate industry

3.4.76 With the establishment of the Authority, new forms were introduced for bond lodgements, claims and transfers. These forms received no public trialling and landlords, tenants and real estate agents were not provided with detailed information explaining how to complete the forms prior to the implementation of the new system. Furthermore, seminars presented by the Authority to assist the public and the real estate industry to complete the new forms commenced in the fourth quarter of 1998, even though the implementation of the centralised system occurred in July 1998.

Internal resources

3.4.77 Subsequent to the contract for the management of the bond system being signed, the Authority established a number of additional internal positions including a manager to oversee the Authority's operations. The fact that the Authority had not originally planned to have these additional positions may indicate that it had to reassess its resource requirements in the light of its experience in the early period of implementation.

Internal review of the Authority's operations

3.4.78 A review of the operations of the Authority, which was undertaken in January 2000 by the Department of Justice, identified a number of issues including:

- At 30 November 1999, there was approximately \$27 million held by estate agents and landlords in 7 financial institutions, a significant portion of which was likely to relate to residential bonds;
- The controls in place to ensure that all bond moneys collected are paid to the Authority are inadequate, with the likelihood that some bond moneys will continue to be held privately by landlords;

- The required approvals had not been sought from the Victorian Government Purchasing Board or the responsible Minister in respect of the additional costs incurred by the Authority under the contractual arrangements with the service provider;
- There were no formal procedures in place in respect of unclaimed moneys;
- Bond lodgements and transfers were not received within the timeframes established in the Act; and
- The Authority did not prepare an annual financial report to provide for public accountability over its operations for tabling in the Parliament.

3.4.79 Discussions with the Authority indicated that certain of the above issues raised have been subsequently addressed.

Accountability over Authority's operations

3.4.80 The *Financial Management Act 1994* requires public bodies, which includes “public statutory authorities” to prepare annual financial statements. As the Authority satisfies the definition of a public body, it is required to prepare financial statements in accordance with the *Financial Management Act 1994*. However, for the 1998-99 financial year, the only disclosure of the Authority's operations was the value of bond holding as at 30 June 1999 as disclosed in the Department of Justice's annual financial statements.

3.4.81 It is recommended that the Authority prepare annual financial statements in accordance with the *Financial Management Act 1994* to provide public accountability over its operations.

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

Bond management arrangement – engagement of external service provider

Difficulties were experienced in the early stages, in the areas of timeliness of processing and communication with the Authority. As discussed below, a significant cause of these difficulties was the short time frame within which arrangements for the administration of bonds were put in place. There were a higher than anticipated number of forms requiring reprocessing, which involved additional costs; and further additional costs were incurred in the establishment by the service provider of a temporary call centre. That call centre has now been closed; the proportion of reprocessing has reduced and is anticipated to reduce further; and the Authority is now generally satisfied with the service provided by the service provider.

Shortcoming in tendering process

Evaluation process

The tender process was conducted in accordance with the Government's Purchasing Policy and Guidelines and resulted in competitive market bids to obtain the required outputs.

❑ **RESPONSE** provided by the Secretary, Department of Justice - continued

Evaluation process - continued

It is acknowledged that the participants in the tender process did not anticipate the high level of reprocessed forms, or the number of bond-specific inquiries that resulted.

This outcome arose notwithstanding that reasonable processes were followed: The Committee established to review the received tenders included representation from the Tenants Union of Victoria and the Real Estate Institute of Victoria, both major stakeholders in residential bonds. It also included officers experienced in the operation of the then existing decentralised system of management of bonds via trust accounts maintained by individual landlords and agents. It further had the services of the consultant which had prepared the report relied upon by the Government in determining to establish a central bond authority. This composition ensured that there was considerable practical knowledge of bond issues.

The Authority notes audit's comments that the low bid of the successful tenderer should have been queried, particularly in relation to their unit cost of bond repayment. It is contended, however, that the lower unit cost of claims processing was plausible as the bid provided for substantially more manual involvement in the receipt of lodgements than in the envisaged automated processing of repayments. The manual steps involved in lodgements included the opening of mail, separation and handling of payments, and attendance to banking. Furthermore, the other tender evaluated did not have an established electronic link with major banks and so did not have as low a cost structure for claims handling.

The Authority also notes audit's comments that the cost of processing bonds in NSW and Queensland should have raised issues for the evaluation panel to address. However, the cost data from these States includes significant services that are administered separately in Victoria – for example, the resolution of disputes, the conduct of investigations, and the handling of general residential tenancy inquiries. In 1998-99, the Victorian Government spent \$14.7 million on a range of residential tenancy services, but only \$2.8 million of this related to the administration of the Authority. Because of these differences in the way the various States report their expenditures on residential tenancy services, reported costs are not a useful basis for comparison of the cost of services delivered.

Other issues impacting on the difficulties experienced

Legislative time frame

Most of the time between the passage of the legislation in December 1997 and the commencement of operations on 1 July 1998 was occupied by the tender process, with the contract with NRS being signed on 15 May 1998, just 6 weeks prior to the implementation date of 1 July 1998. This extremely short time frame precluded a carefully planned and measured implementation program, and required the bypassing of important steps such as the market testing of forms.

Education and assistance to the public and real estate industry

Education and assistance were always recognised as a priority with a series of public seminars commencing in June 1998 being held across Victoria. Changes were made to the design and processing of forms once problems were identified and analysed, and education activities targeted specifically at the completion of forms were put in place following stakeholder consultation.

❑ **RESPONSE** provided by the Secretary, Department of Justice - continued

Internal resources

Additional resources were applied to the Authority's work after operations commenced. The Authority is confident that it is now adequately resourced to operate efficiently and effectively.

Internal review of the Authority's operations

All of the above issues either have been or are being addressed. On the specific points raised:

- *Funds remaining in landlord and agent trust accounts: Much of this money relates to commercial rather than residential bonds. These accounts are being systematically queried and, where appropriate, arrangements made for transfer.*
- *Controls to ensure bonds are paid to the Authority: A review of real estate agents has disclosed a very high compliance with the lodging requirements. To maximise compliance by agents and private landlords the Authority engages in programs involving public awareness campaigns, inspections, systematic review of tenancy data and promotion of successful prosecutions. There has also been considerable success in attracting more bonds into the centralised system as evidenced by the growth from the \$165.2 million identified under the old system to a total of \$184.5 million just 18 months later.*
- *Additional costs: On the basis of legal advice received, staff working on the Authority's matters were of the view that additional costs incurred were allowable under the contract with the service provider. They were also of the view that, as commitments under the contract did not exceed approved levels, further approvals were not required at that time. Those views were subsequently challenged by the Department's Internal Audit, and all relevant approvals are now being sought.*
- *Unclaimed moneys procedures are now in place.*
- *Time frames for lodgements and claims are monitored with a view to taking action where necessary.*
- *Financial reports will be prepared for tabling in Parliament.*

Accountability over Authority's operations

This recommendation is accepted.

CONSTRUCTION OF THE NEW CHILDREN'S COURT

3.4.82 From January 1990 to December 1998, the Children's Court was located in Queensbridge Street in Melbourne's Southbank precinct. The premises were leased and not originally designed as a courthouse. They were not adequate to accommodate the court's needs over the long-term and were not easily accessible by the public and legal profession. In order to address these inadequacies, the Government provided the Department of Justice with \$500 000 in 1995-96 to undertake a feasibility study into the relocation of the court.

3.4.83 The report resulting from the feasibility study recommended that a new 'purpose-built' court be constructed within the Flagstaff precinct of the Melbourne central business district. Other options considered included upgrading the Queensbridge Street facilities, relocating the court to the former Births, Deaths and Marriages building in Queen Street, Melbourne (which would need to be modified to meet the court's requirements), or leasing and fitting-out an existing commercial building.

3.4.84 **The report also recommended that options be examined to facilitate private sector involvement in the financing of the new court, however the Department was unable to demonstrate that this alternative had been investigated in detail.**

3.4.85 In May 1997, the Government announced its decision to construct a new Children's Court, and in August 1997 announced that the court would be located on a site, the majority of which was occupied by the former Peter MacCallum Clinic in Little Lonsdale Street, Melbourne. The site was selected as a major part of it was owned by the Government, it was in close proximity to other courts, provided good public accessibility and was an appropriate size.

3.4.86 Construction of the new court was planned to commence in early 1998, after the site had been cleared and was to be completed within 12 months at an estimated cost of \$18.5 million (including the \$500 000 allocated for the feasibility study).

3.4.87 The proposed new court complex comprised 8 court rooms of varying sizes, with the family and criminal divisions separated, each with their own pre-hearing and custodial facilities, remote witness linkages, video conferencing, and areas set aside for the provision of legal aid, community and support services.



A hearing room in the criminal division of the new Children's Court.

Engagement of consultants and contractors

3.4.88 In August 1997, following a selective tendering process, a private sector firm was engaged to manage the project on behalf of the Department. A Project Control Group, comprising the newly appointed project manager and representatives from the Department, and the Magistrates and Children's Courts was established to oversee the project in October 1997.

3.4.89 Following consideration of a number of alternative methods of delivering the project, a design, novate and construct method was selected by the Department in order to achieve time savings. This method involved engaging a consultant to design the Court, who was then assigned to the construction contractor for the remainder of the project, and allowed the construction contractor to commence work on site earlier than what would have otherwise been possible.

3.4.90 The Department decided not to publicly advertise for expressions of interest prior to appointing both the design consultant and the construction contractor due to the specialist nature of the project and the short time frame for its completion. However, expressions of interest were sought from firms on a preferred contractor list maintained by the Office of Building and Development, within the Department of Infrastructure.

Selection of design consultant

3.4.91 Following an evaluation of expressions of interest received, 5 firms were invited to submit tenders for the position of design consultant by October 1997.

3.4.92 To ensure that the Department achieved the best design, each tenderer was requested to include with their submission a master plan outlining how the site could be developed. The Department paid each tenderer \$5 000 to meet the costs of preparing a master plan, which was to be based on a brief prepared by the Department setting out the site parameters and key requirements of the project.

3.4.93 The evaluation of tenders consisted of 2 stages: the first of which addressed criterion relating to the tenderer's knowledge and understanding of the design requirements, and the extent to which the master plan addressed those requirements. This stage involved each design consultant presenting their master plan to a panel of 8 people comprising key stakeholders from the Magistrates and Childrens Courts, 3 departmental staff, an independent architect and the project manager.

3.4.94 Following the completion of the first stage of the evaluation process, 3 firms were selected to proceed to the second stage, which involved the assessment of tenders against a further 3 selection criteria, namely, the adequacy of the resources identified for the design of the court, appropriateness of the tenderer's proposed strategy and program, and the proposed fee.

3.4.95 For this stage of the process, the selection panel was restricted to the 3 departmental staff and the project manager. The Department advised that they changed the composition of the selection panel because the other panel members were primarily only interested in the design of the court and did not have any experience in evaluating the proposed resources and delivery of the project.

3.4.96 In November 1997, following the completion of the tender evaluation process, the Department announced the appointment of the design consultant at a fee of \$540 000. The winning tender was initially considered by the Department to be non-conforming, as the fee tendered was based on a building cost which was less than the cost stated in the request for tender document. **A non-conforming tender would normally preclude a tenderer from further consideration in a tender process. However, following the completion of the tender evaluation process and identification of the preferred tenderer, it was verbally agreed between the preferred tenderer and the project manager that the tender would be changed so that the fee tendered would be based on the building cost stated in the request for tender document.**

3.4.97 The outcome of the conversation with the preferred tenderer was not formally documented by the project manager, nor was an amended tender received. Subsequently, there was a dispute between the design consultant and the Department over the adequacy of the tender fee, which was ultimately settled in the Department's favour.

3.4.98 It is important that all communication, including verbal discussions, with tenderers be formally documented to ensure that there is adequate information to support decisions made in the tender evaluation process.

3.4.99 In addition, from a probity perspective, government best practice guidelines indicate that non-conforming tenders should be rejected. Where the fees quoted by design consultants are generally based on a percentage of construction costs, allowing one tenderer to set their fee on a lower construction cost than that stipulated in a request for tender document places that tenderer in a more favourable position in respect of the tender price compared with other tenderers.

Selection of construction contractor

3.4.100 In late 1997, 19 construction contractors were approached to provide expressions of interest for the construction of the Children's Court. Of those approached, 12 provided responses which were evaluated against a range of weighted criteria by a panel of 5 people comprising 2 departmental staff, the project manager, the quantity surveyor and the design consultant.

3.4.101 In April 1998, 5 firms were short-listed and invited to submit tenders. However, one of the firms subsequently advised that it would not be submitting a tender.

3.4.102 The closing date for tenders was originally set for 21 May 1998, however, this date was subsequently amended on 19 May 1998 to 28 May 1998 to allow the Department additional time to answer questions raised by the tenderers. We were advised that all tenderers were formally notified of the change and verbally agreed to the amended closing date, but the Department was unable to provide any evidence of the tenderers' agreement. As the amendment to the closing date had the potential to unfairly favour one or more of the tenderers, it would have been prudent to obtain written agreement to the change from all of the tenderers.

3.4.103 The tender process allowed each tenderer to submit 2 tenders; one which complied with the Department's tender specifications, and another non-conforming tender. The non-conforming tender was to provide alternatives to the Department's specifications in order to reduce the overall cost of the court facility.

3.4.104 The tenders received were submitted to the project manager, who in conjunction with an independent quantity surveyor completed a tender assessment and provided the Department with a report recommending a preferred tenderer.

3.4.105 The Department advised that price was the only factor considered when selecting the preferred tenderer from the short list, as the other selection criteria had already been assessed during the evaluation of expressions of interest phase. We are of the view that the selection criteria, excluding price, should have been developed and utilised to evaluate each tender. Following that process, the results of the evaluation and tender price submitted by each tenderer should have been analysed to determine the most cost-effective tender.

3.4.106 As all tenders received were in excess of the budgeted construction cost, the Department amended the scope of the proposed works to obtain an acceptable tender price. The tenderer with the highest tender price was advised that they would no longer be considered for the construction contract, with the 3 lowest tenderers requested to submit amended tender prices incorporating the scope changes.

3.4.107 In the interest of equity and fairness, given that none of the tenders satisfied the Department's selection criteria, all 4 tenderers should have been permitted to re-submit amended tender prices based on the changed scope of the project.

3.4.108 Following receipt of revised tenders, the project manager entered into negotiations with the tenderer providing the lowest tender price with a view to agreeing on a contract price that was within the Department's budget. This was despite the fact that there was only \$67 000, or 0.5 per cent, difference in the price of all 3 tenders. Following negotiations, a contract price was agreed between the tenderer and the Department.

3.4.109 **As there was virtually no difference in the 3 tender prices submitted, in the interest of fairness, each of the tenderers should have been given the opportunity to enter into post-tender negotiations with the aim of providing a proposal that met the Department's budget.**

3.4.110 Prior to departmental approval of the preferred tenderer, a contractual dispute between the tenderer and another organisation prompted the Department to question the tenderer's financial viability. Following receipt of advice requested from the Victorian Government Solicitor, the Department commissioned a due diligence review of the preferred tenderer's capacity to complete the Children's Court project, and financial assessments of the other tenderers.

3.4.111 The due diligence report raised questions over the financial viability of the preferred tenderer and recommended that the Department not enter into a contract with the tenderer unless its contractual obligations to the Department were guaranteed by the tenderer's parent company. However, as the preferred tenderer was reluctant to obtain such a guarantee, the Department accepted, as an alternative, an increase in the bank guarantee required under the contract from 5 per cent to 10 per cent of the contract sum (increasing the amount of the guarantee from \$640 000 to \$1.3 million). This requirement added \$6 000 to the cost of the project.

3.4.112 The due diligence report also highlighted a number of probity issues including:

- The preferred tenderer being subject to adverse findings by the 1992 *New South Wales Royal Commission into Building Industry Productivity* in relation to collusive tendering practices. In an appendix to its report, the Commission found *prima facie* evidence of the contractor and its parent company having agreed to pay or receive unsuccessful tender fees amounting to \$2 million on public sector projects during a 4 year period ending 1990; and
- In October 1994, the preferred tenderer pleaded guilty to having set up a bogus scaffolding account scheme to defraud a New South Wales agency of \$280 000 during the construction of the Darling Harbour Convention Centre. Three charges of making false or misleading statements in invoices were found to be sustained.

3.4.113 **Considering that all 3 contractors met the non-price tender requirements and effectively tendered equivalent prices, the probity issues associated with the preferred tenderer should have placed that firm at a disadvantage compared with the other 2 tenderers.**

3.4.114 In August 1998, following the provision of the higher bank guarantee, the construction contract was awarded to the preferred tenderer.

3.4.115 Further to the issues raised earlier in this Part of the Report in relation to the selection of the design consultant and construction contractor, consideration should be given to improving the Department's tendering process by:

- appointing an independent probity auditor to ensure the fairness and equity of the tendering process; and
- undertaking due diligence reviews of all short-listed tenderers prior to determining which firms the Department should enter into post-tender negotiations, taking into account any previous assessments undertaken as part of any pre-qualification process.

Claim for additional fees by the design consultant

3.4.116 Following the completion of design documentation in April 1998, the Department received a number of claims for additional fees from the design consultant. These claims were settled by the Department in August 1998 following the payment of an additional amount of \$268 000 (49.6 per cent of the contact fee), bringing the total fee payable to the design consultant under the contract to \$808 000.

3.4.117 In agreeing to the additional fee, the Department acknowledged that the initial fee of \$540 000 was extremely competitive, with minimal allowances for any change to the design or scope of works. The additional fee was based on the following variations to the original agreement:

- an increase in the gross building area from 4 400 to 5 600 square metres (\$86 000);
- revisions to the design of the court in order to contain building costs (\$70 000);
- an extension of 7 weeks in the duration of the design documentation period (\$24 000);
- audio, communications, security and data consultancy services outside the original engagement (\$69 000); and
- design revisions necessary to comply with building and local government requirements (\$19 000).

Construction of the Children's Court

3.4.118 In March 1998, the budget for the Children's Court project was increased by \$500 000 to \$19 million. This was to allow for the following costs not included in the original budget:

- increase in the gross building area of the court;
- relocation of the court to the new premises; and
- increase in the allowance for furniture and fittings, including IT hardware.

3.4.119 This cost increase was partially offset by lower than anticipated cost of demolition of the existing buildings.

3.4.120 The final cost of completing the Children's Court project was approximately \$19.2 million, which included additional costs of \$250 000 associated with construction of a concrete retaining wall against the western boundary of the site.



*Front of the new Children's Court,
Little Lonsdale St, Melbourne.*

Time delays

3.4.121 At the time the feasibility study was conducted, the Department intended that the new court would be ready by September 1998, in order to meet the expiry date of the lease on the premises in Queensbridge Street. **This time frame was contingent on the immediate commencement of the project with the selection of the site and contractors, however, project delays caused a number of revisions to this date and resulted in the court opening 15 months later than initially planned in January 2000.** The main reasons for the project delays were:

- difficulty in identifying a suitable available site for the court (delay of approximately 4 months);
- town planning issues, which delayed the demolition of existing buildings on the site;
- revisions to the design of the court and an extended design documentation period;
- delayed appointment of the construction contractor due to amendments required to the scope of the project to achieve an acceptable tender price and concerns over the recommended tenderer's financial viability; and
- inclement weather and industrial action.

3.4.122 The construction contract required practical completion of the court building by September 1999 and provided for the payment of liquidated damages of \$10 000 per day by the contractor if this date was not met, with no cap on the amount payable. However, extensions of time granted to the contractor deferred practical completion until December 1999. As the Children's Court was not completed by the revised September 1999 deadline, it was necessary to extend the lease on the court's existing premises until December 1999, at an additional cost of \$60 000.

3.4.123 Despite a number of deficiencies identified with its tendering process, the Department has managed to replace an inadequate court facility with a purpose-built world class facility, the construction of which was completed without significant cost overruns.

❑ **RESPONSE** provided by the Secretary, Department of Justice

Construction of the new Children’s Court

Audit states the Department could not demonstrate that the feasibility study’s recommendation concerning private sector financing of the new court was investigated. The Department did not accept the study’s conclusion in this regard. In considering the conclusion that private sector financing would deliver a marginal financial benefit over 20 years, the Department was of the view that the consultants had not taken into account the comparatively small size of the Children’s Court project, and that consequently the benefits identified by the study would not in fact be realised.

The Department considered that private sector involvement in the Children’s Court project would realise a financial benefit if the project could be developed jointly with the County Court project. This possibility was raised with the Attorney-General in March 1997, and confirmed in a memorandum from the Executive Director, Corporate Management (copy provided to audit). It was evident when considering the issue that the lead-time for the new County Court project would preclude a joint development with the Children’s Court project because of the pressing need to improve the Children’s Court facility. Consequently, this option was rejected by the Attorney-General. Funding was then sought and obtained in the 1997-98 budget.

Engagement of consultants and contractors

With regard to the selection of the design consultant, the Department accepts that verbal communication with tenderers should be formally documented to ensure that there is adequate information to support decisions in the tender evaluation process. The Department also acknowledges that consideration of a materially non-conforming tender could place a successful tenderer in a more favourable position. However, it was not considered that the design consultant tender was materially non-conforming as the fee structure was readily amended (albeit verbally) to the Department’s requirements once clarification was sought.

With regard to the selection of the construction contractor, audit’s comment that it would have been prudent to have obtained the written agreement to the changed closing date for tenders is noted. It should be noted in this instance, however, that no tenderer was actually disadvantaged by the amended closing date as is evidenced by their verbal agreement to the change.

Tender assessment in major construction projects is highly complex process which should only be undertaken by individuals with the requisite skills. The latest Code of Practice for the Building and Construction Industry (1999) specifies that “tenders should be assessed by persons with the relevant skills and knowledge”. It was considered that the requisite skills and knowledge in this instance resided with the project managers and the quantity surveyor who then presented the evaluation findings to the Project Control Group of Departmental representatives. The matter was reviewed at length by the Project Control Group before agreement was reached on the selection of the builder and approval given.

❑ **RESPONSE** provided by the Secretary, Department of Justice - continued

In using price as the determining factor in the construction tender, the Department was following guidelines specified in the then current Code of Practice for the Building and Construction Industry (1994) issued by the Department of Planning and Development (copy provided to audit). The Code of Practice states “generally the lowest-priced tender should be accepted” and “the principal must exhaust negotiations with the lowest-priced tenderer before negotiating with subsequent tenderers...”. Most importantly the Code of Practice clearly states that “if no tender is acceptable, and the principal seeks to negotiate an amended tender, negotiations must first be conducted with the initial lowest-priced tenderer with the aim of achieving an acceptable tender”.

The Department indicated its view to audit officers that to have given the 4 tenderers the opportunity to resubmit amended tender prices would have amounted to repeat tendering. This would have been undesirable both in the context of the building industry and having regard to the delays which had already occurred in the project. The Code of Practice states that the re-calling of tenders should only be undertaken in “compelling and unavoidable circumstances”. The Department did not consider the points of clarification sought from the tenderers sufficiently unusual in the building industry to consider recalling tenders. These comments also apply to the comments on the post-tender negotiations.

The Department has indicated to audit officers that it does not accept that the probity issues associated with the preferred tenderer (Baulderstone Hornibrook) should have placed the firm at a disadvantage compared with the other 2 tenderers. The advice of the Department of Infrastructure at the time was that all Children’s Court tenderers were “pre-qualified” and that an assessment of their business structures and financial strengths indicated “there is nothing in these reports which would lead one to prefer one contractor over the others. No adverse information was reported on any of the companies in the areas investigated”. The Department was aware that Baulderstone Hornibrook had undertaken several other major government projects including the Exhibition Centre, Tennis Centre, State Aquatic Centre, State Library and Museum. On this basis, it was considered that the additional probity checks were not required.

In passing it is noted first, that the activities of Baulderstone Hornibrook in New South Wales occurred during the 1980s when such activities were widespread in the NSW building industry, and secondly that there was no evidence of such activity in Victoria. It is assumed that, when affording Baulderstone Hornibrook the status of a pre-qualified contractor, the Department of Infrastructure took into account the fact that the events identified by audit occurred many years earlier and may have involved different personnel.

The Department in some circumstances considers the use of a probity auditor appropriate. However, for a project of this relatively small size it is considered that the use of a probity auditor adds a layer of expense and potential delay which is not commensurate with the associated risk. It could assist the Department in future projects if audit could indicate the circumstances in which it felt a probity auditor should be engaged.

SCHEDULE A
STATUS OF MATTERS RAISED IN PREVIOUS REPORTS

<i>Report</i>	<i>Subject</i>	<i>Status at date of preparation of this Report</i>
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MATTERS RESOLVED OR ACTION COMMENCED

DEPARTMENT OF JUSTICE

Infants Investment Trust Accounts

Ministerial Portfolios, May 1998, pp. 150-1.

Enhancements to the infant investment trust accounts system should be implemented at the County Court and the Victims of Crime Assistance Tribunal to enable the regular production and issue of transaction statements to trust fund beneficiaries.

A departmental review of the constitutional, legislative and administrative framework, and the performance of the Courts in the management of funds held on behalf of minors and persons under disability was completed in 1999. The Auditor-General's recommendation was raised within the Courts by the previous Attorney-General and Treasurer prior to the change of government and are currently under consideration by the current Attorney-General and the Assistant Treasurer.

Victoria Legal Aid – Funding changes

Ministerial Portfolios, May 1999, pp. 186-207

There is a need for Victoria Legal Aid to undertake an assessment of the need for legal aid within the Victorian community to assist it in allocating scarce legal aid funding in the most effective and equitable manner, and to determine the impact of changes to legal aid guidelines on the provision of legal aid services in Victoria.

A report addressing the community's legal aid needs in Australia has recently been issued by the Commonwealth Attorney-General's Department. This report did not identify specific legal aid needs within Victoria.

In addition, the Law Reform Committee of Parliament has commenced a review of legal services in rural and regional Victoria. As the scope of this review includes an assessment of legal aid needs, VLA intend to consider the outcomes of this inquiry before committing additional resources to any further review.

Need for enhanced public accountability covering non-judicial functions of Victorian courts

Ministerial Portfolios, May 1999, pp. 208-16

The scope of several audits of administrative functions within judicial bodies since June 1996 has been curtailed because of legal advice provided to the Department. This situation is totally unsatisfactory in terms of the serious public accountability implications to the Parliament and the community. Urgent action by way of legislative change is necessary to redress the position.

The need for early legislative change on this matter has been raised by my Office with the Government in the context of the Government's consideration of further amendments to the *Audit Act 1994*.

The Government is currently assessing issues associated with the non-judicial functions of Courts and has indicated that any action on the scope of the Auditor-General's authority in this area will need to await the outcome of its deliberations.

**SCHEDULE A
STATUS OF MATTERS RAISED IN PREVIOUS REPORTS**

<i>Report</i>	<i>Subject</i>	<i>Status at date of preparation of this Report</i>
MATTERS RESOLVED OR ACTION COMMENCED		
SHERIFF'S OFFICE <i>Ministerial Portfolios, May 1996, pp. 152-9.</i>	The Department of Justice has over a number of years introduced various initiatives to improve its effectiveness in the enforcement and collection of fines and is considering a number of further initiatives.	See comments on Outsourcing of traffic camera and fine collection services in this Part of the Report.

**SCHEDULE B
COMPLETED/INCOMPLETE AUDITS**

<i>Entity</i>	<i>Financial year/period ended</i>	<i>Reporting to Parliament</i>	<i>Financial statements signed by entity</i>	<i>Auditor- General's report signed</i>
COMPLETED AUDITS				
Department of Justice	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.46.</i>	28 Oct. 1999	29 Oct. 1999
ATTORNEY-GENERAL				
Equal Opportunity Commission	30 June 1999	“ “	7 Oct. 1999	22 Oct. 1999
Legal Practice Board	30 June 1999	“ “	25 Aug. 1999	2 Sept. 1999
Office of Public Prosecutions	30 June 1999	“ “	23 Aug. 1999	22 Oct. 1999
Office of the Legal Ombudsman	30 June 1999	“ “	15 Sept. 1999	23 Sept. 1999
Office of the Public Advocate	30 June 1999	“ “	19 Oct. 1999	22 Oct. 1999
Queen Victoria Women's Centre Trust	30 June 1999	“ “	16 Sept. 1999	29 Sept. 1999
Senior Master of the Supreme Court	30 June 1998	No reporting requirements (a)	5 May 1999	27 May 1999
“ “	30 June 1999	“ “	4 April 2000	2 May 2000
Victoria Legal Aid	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.46.</i>	18 Aug. 1999	19 Aug. 1999
Victorian Electoral Commission	30 June 1999	“ “	16 Sept. 1999	1 Oct. 1999
Victorian Financial Institutions Commission	30 June 1999	“ “	12 Oct. 1999	20 Oct. 1999
Victorian Institute of Forensic Medicine	30 June 1999	“ “	28 Sept. 1999	25 Oct. 1999
POLICE AND EMERGENCY SERVICES				
Country Fire Authority	30 June 1999	“ “	20 Aug. 1999	26 Aug. 1999
Metropolitan Fire and Emergency Services Board	30 June 1999	“ “	23 Aug. 1999	3 Sept. 1999 (b)
National Institute of Forensic Science	30 June 1999	No reporting requirements (a)	1 Dec. 1999	22 Dec. 1999
National Police Ethnic Advisory Bureau	30 June 1999	“ “	1 Dec. 1999	22 Dec. 1999
Office of the Chief Commissioner of Police	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.46.</i>	5 Nov. 1999	5 Nov. 1999

(a) In the absence of a statutory requirement for the audit of these financial statements they are audited by arrangement.

(b) Qualified audit report.

Part 3.5

Natural Resources and Environment

KEY FINDINGS

Catchment management authorities' funding arrangements

- The Government, in November 1999, directed catchment management authorities to discontinue charging property owners catchment management tariffs.
Paras 3.5.7 to 3.5.9
- A number of authorities have indicated that it is not economic for them to pursue uncollected catchment management tariffs. However, the decision not to pursue the collection of these tariffs is inequitable given that a significant proportion of property owners have paid their tariffs.
Paras 3.5.14 to 3.5.16
- The 4 power generation companies in the LaTrobe Valley owed \$2.1 million in catchment management tariffs for the 1997-98 and 1998-99 financial years to the West Gippsland Catchment Management Authority. Negotiations are continuing with these companies regarding the collection of the outstanding amounts.
Paras 3.5.14 to 3.5.16

Water storage management by non-metropolitan urban and rural water authorities

- Remedial works are being undertaken by authorities to improve dam safety. These works are not prioritised across the State according to risk, and therefore, it is likely that works are completed on some dams that have a comparatively low risk rating ahead of others with a high risk rating.
Paras 3.5.37 to 3.5.42
- The estimated cost of remedial works to dams required to be undertaken by authorities over a 5 year period commencing from the 1998-99 financial year is \$122 million, while further works amounting to \$23.5 million are required over a further 5 year period.
Paras 3.5.43 to 3.5.51

KEY FINDINGS - *continued*

Water storage management by non-metropolitan urban and rural water authorities - *continued*

- With the value of improvement works identified in risk assessments undertaken by many Authorities varying from those works originally anticipated when government funding decisions were made, there has been a mismatch between the actual cost of the works required to be undertaken and the government funding provided to authorities.
Paras 3.5.43 to 3.5.51
- Authorities have a duty of care to convey information to the community on the risks associated with dam failure and flooding.
Paras 3.5.60 to 3.5.64
- In respect of large private dams where there is a potential risk to local residents, there is a need for more formalised surveillance and monitoring processes to pro-actively identify and address any potential safety problems.
Paras 3.5.70 to 3.5.72

Electronic procurement within the Department of Natural Resources and Environment

- The Department of Natural Resources and Environment should be commended for its achievement in establishing the first Victorian public sector electronic procurement system.
Paras 3.5.91 to 3.5.94
- The Department estimates that in the first year of implementation, the electronic procurement system generated savings of more than \$1.3 million by eliminating outdated manual processes.
Paras 3.5.91 to 3.5.94

3.5.1 The Minister for Agriculture, the Minister for Energy and Resources and the Minister for Environment and Conservation, have responsibility for operations within the Natural Resources and Environment sector. These Ministers have collective responsibility for the Department of Natural Resources and Environment.

3.5.2 Details of the specific ministerial responsibilities for public bodies within the Natural Resources and Environment sector are provided in Table 3.5A. These public bodies, together with the Department of Natural Resources and Environment, were subject to audit by the Auditor-General during the 1998-99 financial year.

**TABLE 3.5A
MINISTERIAL RESPONSIBILITY FOR PUBLIC BODIES
WITHIN THE NATURAL RESOURCES AND ENVIRONMENT SECTOR**

<i>Ministerial portfolio</i>	<i>Entities subject to audit</i>
Agriculture	Agriculture Victoria Services Pty Ltd Australian Food Industry Science Centre Emu Industry Development Committee Food Quality Services Pty Ltd Food Science Australia Melbourne Market Authority Murray Valley Citrus Marketing Board Murray Valley Wine Grape Industry Development Committee Northern Victorian Fresh Tomato Industry Development Committee Veterinary Practitioners Registration Board of Victoria Victorian Dairy Industry Authority Victorian Meat Authority Victorian Strawberry Industry Development Committee
Energy and Resources	Renewable Energy Authority of Victoria
Environment and Conservation	Alpine Resorts Co-ordinating Council Casey's Weir and Major Creek Rural Water Authority Catchment management authorities (9) Central Highlands Region Timber Pty Ltd City West Water Ltd Eco Recycle Victoria Environment Protection Authority Falls Creek Alpine Resort Management Board First Mildura Irrigation Trust Gippsland and Southern Rural Water Authority Goulburn Murray Rural Water Authority Lake Mountain Alpine Resort Management Board Marine and Fresh Water Resources Institute Melbourne Parks and Waterways Melbourne Water Corporation Mount Baw Baw Alpine Resort Management Board Mount Buller Alpine Resort Management Board Mount Hotham Alpine Resort Management Board

TABLE 3.5A
MINISTERIAL RESPONSIBILITY FOR PUBLIC BODIES
WITHIN THE NATURAL RESOURCES AND ENVIRONMENT SECTOR - *continued*

<i>Ministerial portfolio</i>	<i>Entities subject to audit</i>
Environment and Conservation - <i>continued</i>	Mount Stirling Alpine Resort Management Board Non-metropolitan water authorities (15) Parks Victoria Phillip Island Nature Park Board of Management Regional waste management groups (16) Royal Botanic Gardens Board Shrine of Remembrance Trustees South East Water Limited Sunraysia Rural Water Authority Surveyors Board of Victoria Trust for Nature (Victoria) Victorian Plantations Corporation Water Training Centre Wimmera Mallee Rural Water Authority Yarra Bend Park Trust Yarra Valley Water Limited Zoological Parks and Gardens Board

3.5.3 Comment on matters of significance arising from the audit of entities within the Natural Resources and Environment sector is provided below.

CATCHMENT MANAGEMENT AUTHORITIES' FUNDING ARRANGEMENTS

3.5.4 Victoria's 9 catchment management authorities were established on 1 July 1997 to undertake the statutory functions established by the *Water Act* 1989 of waterway, floodplain and regional drainage.

3.5.5 These authorities were created following the 1998 amendments to the *Catchment and Land Protection Act* 1994. Through the creation of these authorities, the Government aimed to integrate the roles of the Catchment and Land Protection Boards, Waterway Management Authorities, salinity implementation groups, water quality groups and sustainable regional development committees.

3.5.6 The specific responsibilities of the authorities include:

- catchment and land protection;
- river management;
- salinity management;
- water quality; and
- sustainable regional development.

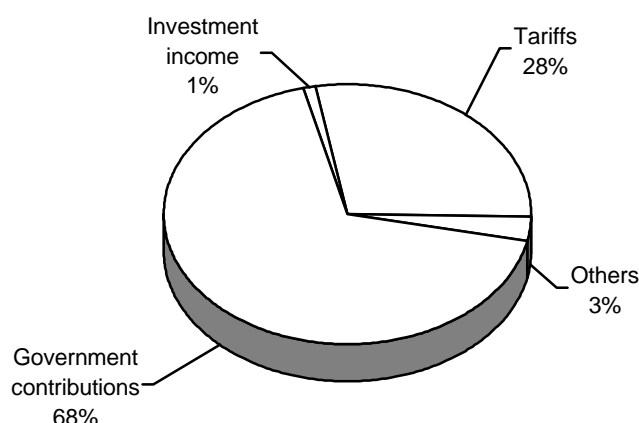


Responsible management of the environment, particular waterways and catchment areas, is a key focus of catchment management authorities.

Changes to funding arrangements

3.5.7 As indicated in Chart 3.5B, the operations of the authorities in the 1998-99 financial year were primarily funded by contributions by the State and Commonwealth Governments, which provided approximately 68 per cent of the total revenue received by the authorities. The next most significant source of funding was \$18 million in catchment management tariffs, which represented on average approximately 28 per cent of the authorities' total revenue for the 1998-99 financial year. The tariffs were generally levied on local commercial, industrial and residential properties based on the valuation of the individual properties, with the exception of one authority which levied a fixed charge of \$20 per property and another 2 authorities which did not levy charges.

CHART 3.5B
CATCHMENT MANAGEMENT AUTHORITIES
FUNDING FOR 1998-99 FINANCIAL YEAR
 (per cent)



3.5.8 Table 3.5C discloses the reliance of individual authorities on catchment management tariffs.

TABLE 3.5C
CATCHMENT MANAGEMENT AUTHORITIES
RELIANCE ON CATCHMENT MANAGEMENT
TARIFFS
 (per cent)

<i>Catchment Management Authority</i>	<i>Tariffs as a percentage of total revenue</i>
Corangamite	64
East Gippsland	6
Glenelg Hopkins	46
Goulburn Broken	19
Mallee (a)	-
North Central	38
North East	13
West Gippsland	53
Wimmera (a)	-
Average	28

(a) Not applicable as catchment management tariffs not raised by the Wimmera and Mallee Catchment Management Authorities.

3.5.9 In November 1999, the newly elected Government directed authorities to discontinue charging property owners the tariffs and subsequently agreed to provide grants to these authorities in the 1999-2000 financial year of \$12.9 million in lieu of tariffs and \$1.4 million to meet one-off costs associated with the abolition of the tariffs.

Impact of reduced funding

3.5.10 The funding available to the authorities has been impacted by:

- the Government's decision to abolish tariffs, that would have increased in line with the change in property values and replace them with government grants which are not indexed; and
- the previous Government's decision to reduce tariffs in 3 authorities, namely, Corangamite (\$2 million), Glenelg Hopkins (\$900 000) and North Central (\$1.6 million) which have been reflected in the government grants to these authorities.

3.5.11 The authorities have indicated that the reductions in funding are likely to result in delays in the implementation of some waterway management works programs.

Authority projects

3.5.12 Under the former funding arrangements, although projects required Ministerial approval and had to be consistent with the Catchment Management Plans, the Department did not approve expenditure or monitor the performance of individual projects.

3.5.13 The new arrangements require applications for funding to be made on a project-by-project basis, with the provision of funds subject to each Authority meeting the Department's performance requirements. **However, with the new funding arrangements only recently introduced, the Department is currently developing appropriate procedures and controls to ensure that funding is expended efficiently in accordance with the Department's performance requirements which includes compliance with authority catchment management plans.**

Unpaid tariffs

3.5.14 Based on information provided by authorities, some 5 to 10 per cent of tariffs raised in the 1998-99 financial year had not been received by February 2000. With the Government's decision to discontinue such tariffs, some authorities are experiencing difficulty in collecting these outstanding amounts.

3.5.15 Due to the small dollar value of individual tariffs, a number of authorities have indicated that it is not economic for them to pursue their collection. **However, the decision by some authorities not to pursue the collection of these tariffs is inequitable given that a significant proportion of property owners have paid their tariffs.**

3.5.16 In addition to the abovementioned outstanding tariffs, the 4 power generation companies in the LaTrobe Valley owed \$2.1 million in catchment management tariffs for the 1997-98 and 1998-99 financial years to the West Gippsland Catchment Management Authority. Negotiations are continuing with these companies regarding the collection of the outstanding amounts.

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

In general, the findings are accepted, but the Department has reservations as to whether any reductions in funding as directed by the previous Government has resulted in delays in implementation of waterway management works programs in the 3 catchment management authorities identified, as the income was not recognised in the first place – a timing issue.

WATER STORAGE MANAGEMENT BY NON-METROPOLITAN URBAN AND RURAL WATER AUTHORITIES

3.5.17 There are in excess of 200 dams managed by non-metropolitan urban and rural water authorities in Victoria. Substantial volumes of water are retained by these dams, which if released in an uncontrolled manner as a result of dam failure could result in a loss of life and significant damage to property and the environment.

3.5.18 With only one significant dam failure in the history of our nation, which occurred in Tasmania over 70 years ago and resulted in the death of 14 people, Australia has an enviable safety record in this area. Nevertheless, a number of major dams throughout Australia have experienced near failures and, given the potential consequences, effective management of water storage facilities is critical.

Review of dam safety in Victoria

3.5.19 In October 1993, the Department of Treasury and Finance released a policy document outlining a future direction for Victoria's water industry. The report, titled *Reforming Victoria's Water Industry – A Competitive Future*, sought to address a number of difficulties faced by the non-metropolitan water authorities at that time, including:

- a lack of appropriate procedures and systems in place to accurately assess the condition of water infrastructure assets;
- inadequate understanding of good asset management practices; and
- inability of the authorities to finance capital expenditure without government assistance.

3.5.20 In order to assess the condition of Victoria's water infrastructure, a number of subsequent reviews were initiated, the largest of which was commissioned by the former Department of Conservation and Natural Resources and undertaken by a group of international consultants in March 1995. That review aimed to assess the overall condition of the State's headworks assets, including trunk pipelines and all significant and high hazard water storage facilities, and provide advice regarding their future management. In order to achieve this objective, a sample of 102 large dams (based on height and storage capacity) was selected for assessment by the consultants.

3.5.21 Of the sample of dams reviewed by the consultants, almost 50 per cent were at risk of failure from major flooding and slightly less than 25 per cent were at risk of failure from seismic activity or day-to-day operations, or were not properly operated and maintained. Storage dams managed by smaller water authorities were generally found to be in poorer condition than those managed by the larger authorities.

3.5.22 The unsatisfactory condition of the State's water storage dams, identified in the above review, was largely due to changes in dam engineering standards and the improved understanding of climatic conditions since most of these dams were constructed, in the late 1800s to early 1900s. Original dam specifications and spillway capacities were based on the best estimates of likely flood conditions at the time of construction, whereas current dam specifications and capacities are based on better information, collated over many years.

3.5.23 As Australia is not located on the edge of the Earth's major tectonic plates, it is relatively earthquake free in comparison with many other countries. With the exception of the Adelaide Hills and the Western Australian wheat belt, there was little history of earthquake activity when most of Australia's dams were constructed. As a result, these dams were built on the assumption that the risk of earthquake in Victoria was negligible.

3.5.24 This assessment was still broadly held into the late 1970s, when it was incorporated into the Standards Association of Australia's 1979 Earthquake Code, but changed significantly in the 1980s with several major earthquakes in areas previously considered to have negligible earthquake risk, most notably in Tennant Creek (Northern Territory) in 1988 and Newcastle (New South Wales) in 1989. This led to a review of the existing earthquake risk assessments and the introduction of a new Earthquake Code in 1993.

3.5.25 At the same time that Australia was reassessing its risk of earthquake, the techniques used to assess the impact of seismic activity on dam structures were also improving. The combination of these events has resulted in changed engineering standards for dam safety.

3.5.26 **The major recommendation of the review undertaken in 1995 was for each water authority to complete an evaluation of storage dam safety and develop a prioritised program of works, based on the level of assessed risk, to upgrade and improve the condition of storage dams.**

3.5.27 In October 1997, the Government announced a comprehensive package of financial assistance to the water sector aimed at achieving a range of government objectives, which included improvements to dam safety. To qualify for government financial assistance, water authorities were required to enter into a Memorandum of Understanding which required the authorities to:

- complete risk assessments for all significant or high hazard dams and undertake further detailed investigations of individual dams where warranted;
- notify the responsible department of any substantial variations to the agreed improvement programs;
- complete the highest priority improvement projects within 5 years; and
- provide annual reports of the progress of improvement works to the responsible Minister.

3.5.28 Government funding was distributed to the non-metropolitan urban and rural water authorities in January 1998 and July 1998, respectively. While rural water authorities were required to complete their risk assessments prior to receiving the funding, the non-metropolitan urban water authorities were not required to complete their assessments until September 1998.

3.5.29 The majority of non-metropolitan urban water authorities managing dams had difficulty completing their risk assessments by the September 1998 deadline, with delays in submitting risk assessments extending to December 1999. The major causes of the delays, which were generally accepted by the Department of Natural Resources and Environment, were:

- a limited number of experienced and competent consultants available to undertake the required work due to commitments with other authorities; and
- the impact of organisational changes resulting from water authority amalgamations.

Outcome of risk assessments

3.5.30 The risk assessments undertaken by the water authorities were designed to provide a preliminary appraisal of dam safety and to identify priorities for remedial works. Specifically, the assessments involved:

- an engineering assessment of whether each dam complied with current operational, earthquake and flood design guidelines, and the associated likelihood of failure;
- a determination of the potential impact of dam failure, including the costs associated with property damage and repair of the dam, potential loss of life and the effect on each authority's business; and
- an analysis of the expected costs and benefits associated with the proposed remedial works.

3.5.31 For the purposes of the risk assessments, the consequences of dam failure were specifically determined for normal operating, seismic and flood conditions. While guidelines published by the Australian National Committee on Large Dams (ANCOLD) were used to assess the severity of loss of life expected to result from dam failure, acceptable levels of economic loss were established for each authority with reference to the size of its operations and the maximum loss sustainable by each authority.

3.5.32 ANCOLD was formed in 1937 as the Australian chapter of the International Committee on Large Dams (ICOLD), with the overall objective of encouraging improvements in the safety and operation of large dams in Australia. The specific guidelines developed by ANCOLD for flood and earthquake design, and general guidelines for risk assessment, have been adopted by water authorities in undertaking their risk assessment.

3.5.33 Our review of the risk assessments, and where available, detailed investigations undertaken by the water authorities, identified a number of dams that at the date of preparation of this Report did not meet modern engineering standards. In relation to these dams, the probability of dam failure per annum ranged from 1 in 100 to 1 in 10 000. **Table 3.5D details 23 dams where improvement is required to meet ANCOLD guidelines, and where in the event of dam failure there would be potential for significant loss to the community and the respective authorities.**

TABLE 3.5D
DAMS NOT MEETING ANCOLD GUIDELINES, WITH SIGNIFICANT EXPOSURES

<i>Dam</i>	<i>Potential impact of failure</i>		
	<i>Third party cost (a)</i>	<i>Direct cost</i>	<i>Status of improvement works</i>
	<i>(\$m)</i>	<i>(\$m)</i>	
1	\$236.3 (flood) \$124.9 (non-flood)	\$20.1	Remedial works due to commence January 2001.
2	\$40.7 (flood) \$26.6 (non-flood)	\$10.7	Primary investigations undertaken in early 1999.
3	\$15 (flood) \$13.3 (non-flood)	\$2.1	Remedial works due to commence October 2000.
4	\$15 (flood) \$13.3 (non-flood)	\$4.6	Remedial works due to commence October 2000.
5	\$20.1 (flood and non-flood)	\$4.8	Remedial works due to commence July 2000.
6	\$110.3 (non-flood)	\$6.0	Remedial works due to commence October 2000.
7	\$305.4 (non-flood)	\$19.4	Remedial works due to commence October 2001.
8	\$25.1 (non-flood)	\$68.4	Remedial works due to commence 2000-01.
9	\$8 (non-flood)	\$1.5	Remedial works not due to commence until 2002-03.
10	\$5.6 (non-flood)	\$1.5	Remedial works not due to commence until 2002-03.
11	\$533 (flood)	\$36.0	Remedial works not due to commence until 2002-03.
12	\$40 (flood and non-flood)	\$72.0	Remedial works due to be completed mid 2001.
13	\$7.4 (flood and non-flood)	\$1.7	Remedial works not due to be complete until mid 2003.
14	\$22 (flood and non-flood)	\$15.8	Remedial works due to be completed early 2001.
15	\$6.85 (flood and non-flood)	\$6.8	Remedial works due to be completed beginning of 2000.
16	\$4.15 (flood and non-flood)	\$0.3	Remedial works due to be completed beginning of 2000.
17	\$100 (flood) \$85 (non-flood)	(b)	Remedial works due to be completed mid-2000.
18	\$95 (flood) \$80 (non-flood)	(b)	Remedial works due to be completed mid-2003.
19	\$160 (flood) \$145 (non-flood)	(b)	Remedial works completed mid-2002.

TABLE 3.5D
DAMS NOT MEETING ANCOLD GUIDELINES, WITH SIGNIFICANT EXPOSURES -
continued

Dam	<i>Potential impact of failure</i>		
	<i>Third party cost (a)</i>	<i>Direct cost</i>	<i>Status of improvement works</i>
	<i>(\$m)</i>	<i>(\$m)</i>	
20	(c)	(d)	Design review currently being undertaken. Construction not due to commence until 2001.
21	(c)	(d)	Design review to be undertaken 2003.
22	(c)	(d)	Design review to be undertaken 2002. Construction not due to commenced until 2007.
23	> \$1 billion (flood and non-flood)	(d)	Design review and construction due to be undertaken 2002-04.

(a) "Flood" means failure as a result of flooding. "Non-flood" means failure as a result of normal operations or earthquake.

(b) Direct cost to the authority is included in third party costs.

(c) Insufficient information available at the date of preparation of this Report.

(d) Direct cost to the authority is greater than \$10 million, however, exact figure not available at the date of preparation of this Report.

3.5.34 In the case of Goulburn-Murray Rural Water Authority, definitive analysis of the risk associated with its dams had not been completed in sufficient detail at the date of preparation of this Report as the required information was unavailable for a number of its dams.

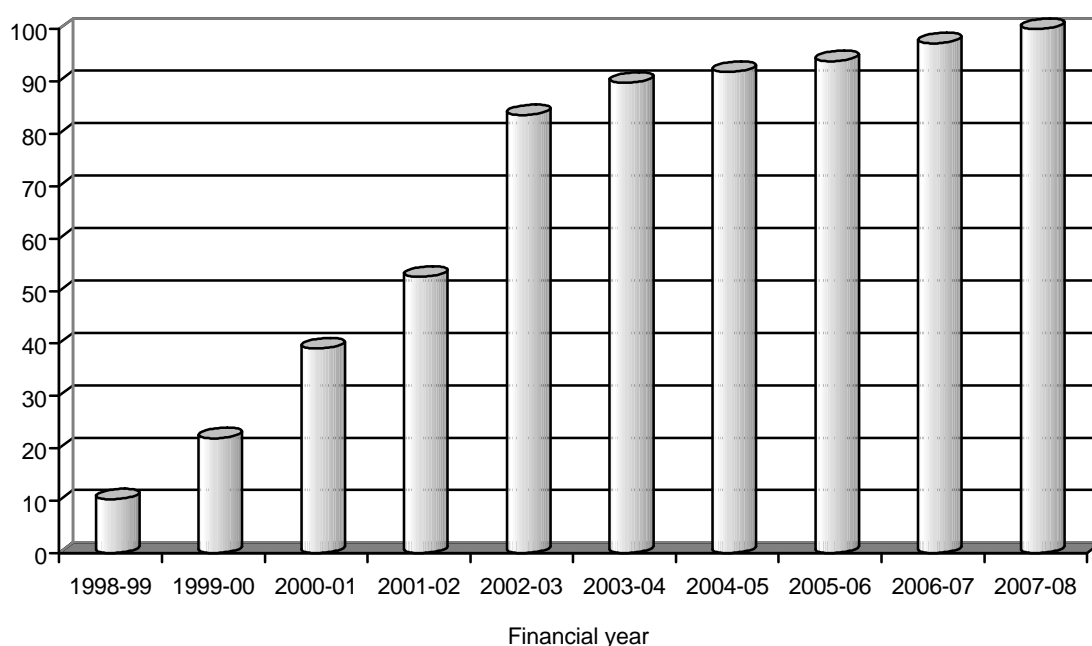
3.5.35 The Memorandum of Understanding between the Government and the water authorities required authorities to develop, as part of their risk assessments, 5 year programs which identified and scheduled improvement works to address deficiencies in dam safety. Authorities are currently into the second year of their improvement programs.

3.5.36 While it is pleasing to report that many authorities have already completed remedial works on some high-risk dams, due to the extent of outstanding works significant risk to the State still exists. In many cases, before essential works can be undertaken, authorities need to carry out detailed investigations to determine the exact extent of necessary remedial works.

Improvement works to be undertaken

3.5.37 Chart 3.5E outlines the estimated timeframe for the completion of the remedial works under the dam improvement program. As demonstrated by the chart, these works will be substantially complete by the 2002-03 financial year, with some works taking a further 5 years to complete.

CHART 3.5E
TIMEFRAME FOR COMPLETION OF DAM IMPROVEMENT WORKS
 (per cent completed - cumulative)



3.5.38 Based on the risk assessment improvement programs submitted by individual authorities to the Department of Natural Resources and Environment, the risk of loss of life and financial loss will be reduced by 75 and 50 per cent, respectively, by the end of 2000 as a result of dam improvement works expected to be completed by that date.

3.5.39 However, based on discussions with authorities, it is likely that the original timeframes built into the risk assessments may not be met by some authorities. For example, Goulburn-Murray Rural Water Authority, the authority having responsibility for most of the State's largest non-metropolitan dams, has indicated that the majority of its dam improvement works is not expected to be finalised prior to 2007.

3.5.40 As well as addressing the various engineering deficiencies in the storage dams identified during the risk assessments, the remedial works are designed to upgrade the storage facilities to comply with modern design standards.

3.5.41 The remedial works were prioritised by each authority according to the level of assessed risk, taking into account the probability of each dam failing and potential loss of life and financial loss. However, remedial works are not prioritised across the State according to risk. Therefore, it is likely that works are completed on some dams that have a comparatively low risk rating ahead of others with a high risk rating.

3.5.42 **In our view, it would be more appropriate to prioritise dam safety improvement works based on a Statewide risk assessment.**



Construction works to improve spillway capacity at Rosslynne Reservoir, near Gisborne.

Funding of dam improvement works

3.5.43 The estimated cost of remedial works to dams required to be undertaken by authorities over a 5 year period commencing from the 1998-99 financial year is \$122 million, while further works amounting to \$23.5 million are required over a further 5 year period.

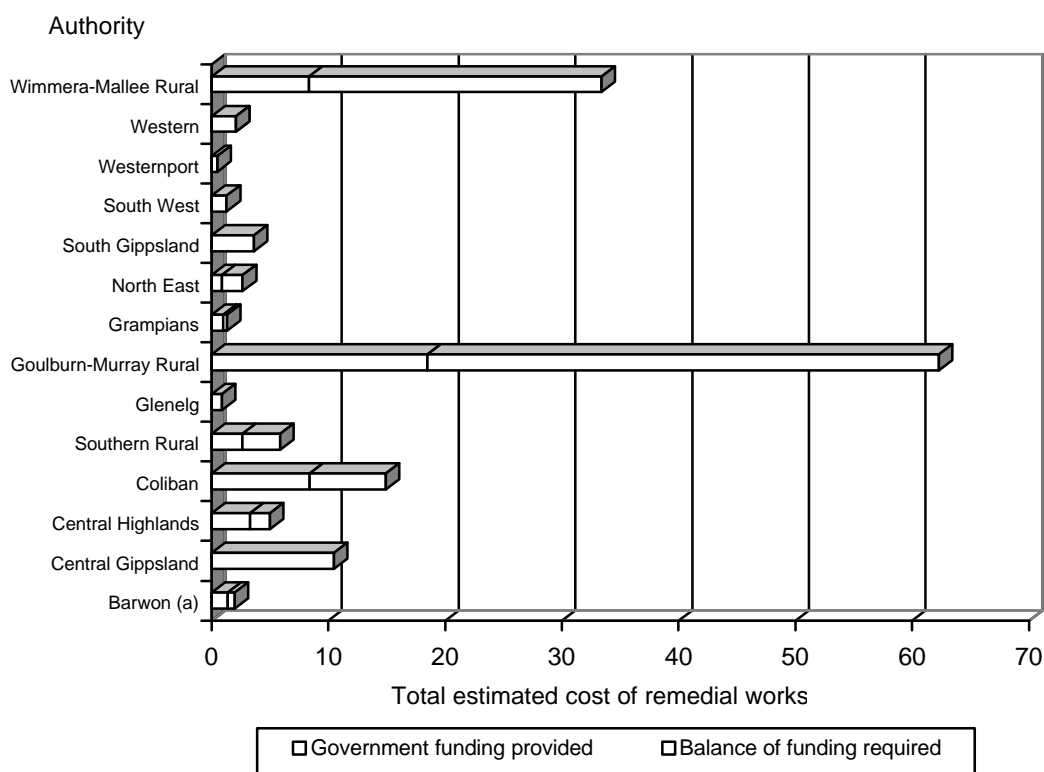
3.5.44 In accordance with the Memorandum of Understanding, in July 1998, an amount of \$29.5 million was provided to rural water authorities by the Government for dam improvement projects, which represented half of the estimated total cost of improvement works as determined by the 1995 review of headworks assets. In contrast, urban water authorities received funding for dam improvement projects as part of a larger \$410 million package which also provided funding for debt reduction, improvement to the quality of drinking water and improvements to wastewater treatment plants to ensure compliance with the EPA standards. Of this funding, \$17.3 million was provided to finance the improvement works identified by the 1995 review of headworks assets.

3.5.45 However, with the value of improvement works identified in the risk assessments of many authorities varying from those works originally anticipated, there has been a mismatch between the actual cost of the works required to be undertaken and the government funding provided to authorities.

3.5.46 We identified that some authorities did not receive any government funding to meet the cost of remedial works, while other authorities received up to double the amount required. Furthermore, 3 out of 4 authorities required to undertake works greater than \$10 million received funding from the Government of only up to 30 per cent of the cost. Two of these authorities were rural water authorities, which the Department of Natural Resources and Environment advised are likely to apply for additional funding in the future.

3.5.47 Chart 3.5F outlines the funding sources for the remedial works to be undertaken by the authorities over the 10 year period, commencing from the 1998-99 financial year. The amount of funding provided by the Government as at the date of preparation of this Report totals \$46.8 million, or approximately 32.1 per cent of the \$145.6 million estimated total cost of the works.

CHART 3.5F
FUNDING OF REQUIRED REMEDIAL WORKS
((\$million))



(a) Cost was for detailed dam safety investigations, with no major works identified.

3.5.48 Water authorities have indicated that the cost of improvement works is likely to change as identified design deficiencies are assessed through more detailed investigations.

3.5.49 At the time government funding was made available to the authorities, it was intended that any difference between the Government's contribution and the remaining cost of the improvement works would be funded by the authorities through their capital works program. However, given the significant cost of the required works, a number of rural water authorities have indicated that they will be unable to fund their share of works without significant price increases, some of which have already been implemented.

3.5.50 Non-metropolitan urban water authorities have been unable to increase prices as they have been subject to a tariff freeze imposed by the Government until 30 June 2001, after which time any pricing increases are expected to be generally below the annual increase in the Consumer Price Index. The Department has indicated that a pricing review is about to commence which will form the basis of determining pricing post 30 June 2001.

3.5.51 **In our opinion, provision of future funding for dam improvements should be based on updated risk assessments and allocated to prioritise works to reduce risk of dam failure from a Statewide perspective.**

Dam decommissioning

3.5.52 While undertaking the risk assessments and costing any remedial works required for dams to meet appropriate safety standards, some authorities have identified facilities where the costs associated with their upgrade is greater than the economic return to be received from their continued operation, which has raised the issue of dam decommissioning.

3.5.53 The issue faced by water authorities considering decommissioning is that dams are often heavily utilised by local communities for recreational and social purposes and, as a result, the potential loss of this resource is not met favourably by these communities.

3.5.54 The dilemma is that although authorities may be willing to transfer the responsibility for dams no longer required to other organisations, such as local councils, these bodies are unlikely to accept responsibility for these facilities until any safety issues are addressed.

Other risk reduction measures

3.5.55 In addition to structural remedial works, the risk assessments that were undertaken by the water authorities identified a number of other areas where improvements could be made to reduce the risks associated with dam safety, including the preparation of:

- operations and maintenance manuals;
- enhanced maintenance programs;
- detailed emergency plans; and
- dam surveillance programs.

3.5.56 While some authorities had already implemented these risk reduction measures, at the date of preparation of this Report, other authorities were in the process of implementing risk reduction measures in accordance with their dam improvement programs.

Emergency plans

3.5.57 In Victoria, the State Emergency Service (SES) has responsibility for flood planning and prepares an overall flood plan for the State, with local governments having responsibility for preparing local flood plans where a flood threat exists. Water authorities work with local governments and SES staff to develop appropriate local flood emergency plans for areas downstream from dams.

3.5.58 Dam emergency plans outline the procedures that need to be implemented in the event of an emergency that may threaten the security of a dam and may cause flooding. These plans should be developed for all dams where there is a risk to human life or significant risk to the community or environment in the event of a dam failure.

3.5.59 The risk assessments indicated that approximately 60 per cent of authorities needed to prepare or review specific dam emergency plans particularly for high hazard dams.

Dam surveillance programs and provision of public information

3.5.60 ANCOLD standards require inspections of dams at specified intervals by authorities depending on the magnitude of the potential impact of dam failure.

3.5.61 Our review of the risk assessments identified 2 authorities that did not have dedicated surveillance programs. In addition, the risk assessments identified a need for almost half the authorities to review their dam surveillance practices.

3.5.62 Dam failure can have significant consequences for those individuals living downstream from the dam, including loss of life, property damage, loss of business, as well as significant environmental effects. In these circumstances, individuals likely to be impacted by a dam failure have a right to be informed of risks of dam failure and the likely impact on their lives.

3.5.63 It was pleasing to note that following the completion of risk assessments, certain authorities increased surveillance, installed early warning devices and initiated community consultation processes with the local communities in relation to these risks. However, in a number of other authorities, although surveillance had been increased, local communities down stream from dams had not been informed of the risks identified in the risk assessments.

3.5.64 Authorities have a duty of care to convey information to the community on the risks associated with dam failure and flooding.

Dam Safety Regulator

3.5.65 In 1979, the New South Wales Government established the Dams Safety Committee as a statutory corporation created under the *Dam Safety Act 1978*. The Committee's major objective is to ensure that all prescribed dams (determined by their size and hazard rating) in New South Wales are in such a condition as to not pose an unacceptable danger to downstream residents and properties, or to adversely affect public welfare and the environment.

3.5.66 Monitoring of dam safety is undertaken by the Committee through its review of periodic dam surveillance reports, required to be submitted by dam owners. Where these reports raise safety issues, the Committee requires the dam manager to conduct a review into particular aspects of dam safety. If the Committee considers that a prescribed dam is unsafe or potentially unsafe, it has the power under the Act to require the dam owner to take such actions as it considers necessary to ensure the continuing long-term safety of the dam.

3.5.67 By using a number of questionnaires, linked to various key stages in the development of each dam, the Committee also ensures that new dams are designed and constructed according to appropriate engineering standards.

3.5.68 In contrast, responsibility for dam safety in Victoria is mainly spread across the following organisations:

- Water authorities, with primary responsibility for condition monitoring, risk assessment and dam improvement in respect of the facilities under their control;
- The Department of Natural Resources and Environment, which oversees the State's water industry, provides ongoing information to the Minister and assists in the development of government policy in this area. Authorities are required to submit their risk assessments and proposed remedial works programs to the Department;
- The rural water authorities and Melbourne Water Corporation, which have delegated responsibility for licensing waterway dams on private property; and
- Municipalities, where planning permits have design and construction requirements that would cover, among other things, waterway dams and non-waterway dams.

3.5.69 Given the importance of dam safety and the significant consequences of dam failure, consideration should be given to the establishment of a single independent body to oversee dam safety within Victoria.

Private dams

3.5.70 As mentioned above, where waterway dams are constructed on private property, rural water authorities and Melbourne Water Corporation have responsibility for ensuring that they are designed and constructed by appropriately qualified individuals and according to appropriate engineering standards, so as to minimise the risk to the community and the environment. This is achieved through a licensing system, whereby the person wishing to build a dam applies to one of the authorities for a licence. Once the authority is satisfied with the proposed design and construction of the dam, a licence is issued. On completion of the dam, the structure is inspected to ensure that it has been soundly constructed and complies with the design submitted.

3.5.71 **However, at present there is no ongoing dam safety surveillance undertaken on existing private dams to ensure that they do not pose a threat to the public or the environment.** If a member of the public has concerns with a dam located on private land, these concerns can be raised directly with the Minister. Under the *Water Act 1989*, the Minister has various powers available to deal with this situation, including inspecting the dam, requiring the dam owner to undertake appropriate remedial works, instructing one of the water authorities to undertake such works, or directing the removal of the dam.

3.5.72 **In respect of large private dams, where there is a potential risk to local residents, there is a need for more formalised surveillance and monitoring processes to pro-actively identify and address any potential safety problems.**

- **RESPONSE** provided by the Acting Secretary, Department of Natural Resources and Environment

Outcome of risk assessment

Goulburn-Murray Rural Water Authority conducted a business risk assessment which recognised the need to undertake more detailed analyses of a number of its dams in view of the potentially high cost of upgrades. These analyses are currently being undertaken and will provide more definitive risk information and required improvement works.

Improvement works to be undertaken

Each authority has assessed the need for improvements against ANCOLD guidelines, thus establishing their highest risk reduction priorities. While prioritising dam safety improvement works based on a Statewide risk assessment is also possible, undertaking such works in such priority order is not feasible. Authorities must be responsible for implementing improvements and will have varying capabilities in undertaking these improvements depending on the level of further analyses required and number and extent of upgrades. The key criterion is to achieve all high priority Statewide risk reductions by the end of the program period. The Business Risk Assessment is designed to achieve this.

Funding of dam improvement works

Government-assisted funding for improvements under the Memoranda of Understanding between the previous Government and the authorities was based on best available dam safety information at that time.

ELECTRONIC PROCUREMENT WITHIN THE DEPARTMENT OF NATURAL RESOURCES AND ENVIRONMENT

3.5.73 In June 1997, the Government announced a policy to introduce electronic commerce throughout the public sector. Electronic commerce involves the conduct of business with the assistance of telecommunication-based tools such as the internet.

3.5.74 The Department of Natural Resources and Environment was the first agency to introduce a fully electronic procurement system. This Report reviews the implementation of electronic procurement within the Department.

3.5.75 In 1996, the then newly created Department, which incorporated segments of 5 former departments, undertook a comprehensive review of its existing procurement procedures. This review identified that:

- many of its procedures were inefficient and inconsistent with other procedures operating in the Department and many requisition and approval processes were duplicated;
- the system utilised for ad hoc purchasing resulted in the Department paying higher prices for goods and services than other agencies, as it was not in a position to take advantage of supplier discounts;
- purchasing policies were designed to ensure compliance with set procedures, resulting in responsibilities and accountabilities being satisfied by staff obtaining the correct approvals and quotes rather than undertaking sound purchasing practices;
- there were inconsistent and inappropriate delegations to staff across the Department associated with procurement; and
- the procedures in operation resulted in the oversupply of goods and services or the purchase of goods and services which did not meet the Department's requirements.

3.5.76 The Department's objective at that time was to create a system that encouraged better procurement planning, eliminated duplication, provided accessible information to management and reduced procurement costs. In addition, the Department wanted to develop a paperless system which had a major focus on the purchasing phase rather than the payment phase of the procurement process and covered requisition, approval, receipt of goods and services, payment and reconciliation of accounts payable.

Implementation of the new system

3.5.77 One of the first tasks undertaken by the Department in reforming its procurement processes was to rewrite its purchasing policies to place less emphasis on the price of goods and services and place greater emphasis on value for money and accountability.

3.5.78 Another key element of the Department's reform process was to realign the delegation authorities of staff with their level of responsibility. This contrasted with the situation in place at that time where staff were required to obtain multiple approvals before they could spend even small amounts of funds.

3.5.79 Once the purchasing policies and delegations had been revised and the electronic procurement system acquired and enhanced to meet the Department's requirements, training courses were developed and presented to the Department's 1 500 staff involved in the procurement process.

3.5.80 During 1998, the Department's electronic procurement system was implemented in 3 stages which involved:

- 3 months of initial testing, modification and development in early 1998;
- pilot testing at the Ballarat regional office for 3 months in the second quarter of 1998; and
- implementation of the new system across the Department in July 1998.

3.5.81 The Department's electronic procurement process involved 3 distinct elements, its Web purchasing system, corporate card and an electronic petty cash system.

Web purchasing system

3.5.82 Following a detailed analysis of available systems, the product *Web Requisitions* (a product of US-based software manufacturer Oracle) was selected to provide the core requirements for the Department's Web purchasing system, with in-house applications developed to complement the Oracle software and provide the additional functionality required by the Department.

3.5.83 The system runs on the Department's intranet site for the transmission of internal electronic data known as *ResourceWeb*, and communicates with vendors via e-mail. The procurement process involves the following steps:

- Staff members access the system by using personal identification codes and passwords to create purchase orders directly onto a Web page. These purchase orders are then automatically forwarded by e-mail to an independent person who electronically approves or rejects the purchase order;
- Once the order is approved, the system generates an e-mail message in the form of an electronic order to the supplier (the system also generates a hard copy of the order for faxing or posting to suppliers who do not have the facility to receive e-mails);
- On receipt of the goods or services, the officer ordering the goods or services confirms their receipt directly onto the system. An invoice from the supplier is not required or retained if received; and
- The confirmation that the goods and services have been received triggers the generation of an internal electronic invoice and payment to the supplier. This payment is generally made by electronic funds transfer to the supplier's bank account, accompanied by an e-mail message to the supplier, providing details of the payment (the system also generates cheques and printed advice if the supplier does not wish to be paid by electronic funds transfer).

3.5.84 At each stage of the procurement process, the finance system is updated with each purchase and related approvals. Transaction reports are generated automatically to assist supervisors in monitoring purchases and facilitating accountability.

Electronic corporate card processing

3.5.85 In addition to the Web purchasing system, the Department also expanded the use of its corporate card facilities and organised with its card provider for information on purchases to be received and payments to be made electronically.

3.5.86 Each month, cardholders receive an electronic statement outlining corporate card purchases, along with an e-mail message requesting them to confirm the transaction details. The system has the capability to enable the cardholder to enter additional information directly onto the electronic statement to enable the provision of a more detailed description of the purchases or to amend charge codes.

3.5.87 Once the cardholder has verified the purchases, the statement is accepted electronically. A copy of the monthly statement is then sent to the cardholder's supervisor who acknowledges receipt of the statement, ensures the cardholder has verified the purchases and electronically endorses the statement. The bank periodically transfers funds from the Department's account to pay the amount outstanding to the card provider.

Electronic petty cash system

3.5.88 The final component of the Department's procurement system is its electronic petty cash system, known as *Web Cash*. Staff authorised to make claims create a petty cash claim on the system by entering the description of the goods and services purchased, an authorised charge code, the amount purchased and their name or identification code. The receipt or other supporting documentation is then provided to the petty cash manager who approves the payment and reimburses the claimant. When the petty cash float is low, the manager enters a reimbursement request into the system, which automatically generates a cheque to reimburse the float.

Quality and probity monitoring

3.5.89 The Department has developed quality and probity monitoring procedures, which involve selected staff randomly sampling transactions to review individual purchases made, and evaluate the effectiveness of the approval processes. The procurement system provides the "financial" checks and balances while the monitoring process is designed to identify areas where the Department is undertaking inappropriate purchases and not obtaining "value for money" from the goods and services as required.

3.5.90 The Department also generates information on specific suppliers, types of purchases and supplier locations. This information is used to improve purchasing practices, and assist in analysing purchasing requirements and negotiating supply agreements.

Benefits arising from the introduction of electronic procurement

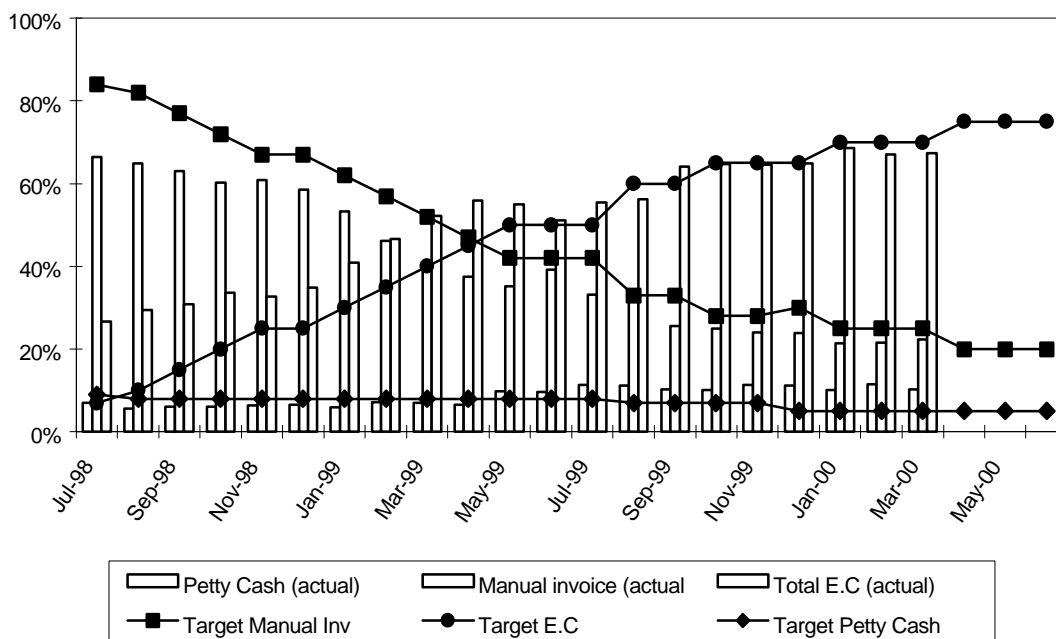
3.5.91 The following significant benefits have been obtained from the introduction of electronic procurement processes:

- reduced paperwork, duplication and errors;
- released resources, previously tied up in the procurement process to perform other departmental activities;

- provided more relevant information on all purchases;
- enabled recognition of liabilities on receipt of goods and services, rather than on receipt of an invoice;
- improved accountability as the system prevents unauthorised transactions, purchases which exceed delegation limits and charges to incorrect charge codes;
- reduced the time required to pay suppliers by up to 6 weeks; and
- provided accurate and timely information for budgeting and funds management.

3.5.92 As indicated in Table 3.5G, the percentage of transactions undertaken utilising the Department’s electronic procurement system have dramatically increased from 28 per cent in July 1998 to approximately 70 per cent in March 2000.

TABLE 3.5G
DEPARTMENT OF NATURAL RESOURCES AND ENVIRONMENT,
TREND IN ELECTRONIC AND MANUAL PURCHASE TRANSACTIONS,
JULY 1998 TO MARCH 2000
 (per cent)



Note: EC = electronic commerce.

3.5.93 The Department estimates that in the first year of its implementation, the electronic procurement system generated savings of more than \$1.3 million by eliminating outdated manual processes.

3.5.94 The Department should be commended for its achievement in establishing the first Victorian public sector electronic procurement system.

Electronic catalogue system

3.5.95 The Department does not currently operate an electronic catalogue system which records details of goods and services available to be purchased, but is working closely with the Victorian Government Purchasing Board and the Department of Treasury and Finance to develop such a facility.

3.5.96 Once such a system is developed and operational, the electronic catalogue which will form part of the Department's Web purchasing system will record details on a range of goods and services purchased by the Department, such as product description and price, with each product allocated a catalogue number.

3.5.97 The use of these catalogues reduces the time taken to order goods and services as product details can be immediately recorded on a purchase order once the item has been selected from the catalogue. In addition, the catalogues facilitate bulk purchases of similar goods which can be used by government agencies to obtain discounts on the purchase price.

3.5.98 The Department has been chosen to pilot test the Government's first electronic catalogue system and has appointed an external catalogue provider. Once the pilot testing is completed, it is envisaged that the system will be available to other public sector agencies.

Development of electronic procurement in other departments

3.5.99 The State Government has set the end of 2001 as the deadline for the full implementation of electronic procurement within all government departments and Victoria Police. As indicated earlier in this Report, the first year of implementation of the Department's electronic procurement system has generated savings of more than \$1.3 million. If these savings were extrapolated across all government departments, the total annual savings to the State would be more than \$6.5 million. The Department anticipates further savings will be generated as it gains more knowledge of its purchasing requirements and implements other aspects to enhance the efficiency of its electronic procurement system. Furthermore, if all agencies within the public sector were to introduce electronic procurement systems, the savings would be considerable greater than the above identified savings.

3.5.100 Aside from the Department of Natural Resources and Environment, the only other department with an electronic procurement system is the Department of Treasury and Finance, although the system is not as well advanced. The Departments of Education, Employment and Training, Infrastructure, and State and Regional Development, and Victoria Police are at the early stage of the implementation of electronic procurement. The remaining 2 departments, namely, the Departments of Human Services and Justice have not commenced the planning phase for the implementation process.

3.5.101 The implementation of electronic procurement across State Government departments is centrally monitored by a project team, headed by a project manager, with representatives from Victorian Government Purchasing Board, Department of Treasury and Finance, Multimedia Victoria and the Department of Natural Resources and Environment. This centralised monitoring process has been established to ensure that the introduction of electronic procurement within the departments will make the best use of public moneys, achieve targeted savings and introduce compatible systems to provide ease of access for suppliers throughout Australia.

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

The Department appreciates the recognition afforded to its efforts in this area.

SCHEDULE A
STATUS OF MATTERS RAISED IN PREVIOUS REPORTS

<i>Report</i>	<i>Subject</i>	<i>Status at date of preparation of this Report</i>
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MATTERS RESOLVED OR ACTION COMMENCED

DEPARTMENT OF NATURAL RESOURCES AND ENVIRONMENT

<p><i>Second Reports, 1985-86 and 1986-87. Ministerial Portfolios, May 1989, pp. 45-6. May 1990, pp. 68-70.</i></p>	<p>Deficiencies in the debtors and revenue collection system, including long overdue debtors balances.</p>	<p>Details of outstanding debtors balances are included in the monthly business reports submitted to Senior Management who have primary responsibility for managing their business debt.</p>
<p><i>Ministerial Portfolios, May 1997, pp. 158-62.</i></p>	<p>There is a need for the Department to review the current reporting framework relating to committees of management and trustees, to provide a proper accountability process. The receipt and review of limited financial information once every 3 years, together with the absence of an appropriate departmental program to inspect Crown land reserves, does not ensure that the Department is aware, on a timely basis, of potential problems arising in committees of management.</p>	<p>To address the concerns raised regarding the accountability of committees of management, a financial reporting framework for these committees has been developed, which takes into account the risks associated with individual committees. The framework report is to be implemented progressively during the 2000-01 financial year.</p> <p>Another approach to ensuring accountability of committees was to assess the feasibility of devolving community use Crown land to local government. However, due to the impact of Native title claims on much of this Crown land, the Department is now focusing on a pilot project to partner local government in its control and management. The project aims to bring responsibility for such land closer to those who use it, increasing local community participation in, and scrutiny of, the management of local land.</p>

SCHEDULE A - continued
STATUS OF MATTERS RAISED IN PREVIOUS REPORTS

<i>Report</i>	<i>Subject</i>	<i>Status at date of preparation of this Report</i>
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MATTERS RESOLVED OR ACTION COMMENCED - continued

DEPARTMENT OF NATURAL RESOURCES AND ENVIRONMENT - continued

<p><i>Ministerial Portfolios, May 1997, p. 156.</i></p>	<p>In relation to a number of forest management areas, the Department is incurring costs to allow operators to remove native trees and wood products, with limited financial benefits accruing back to the State.</p>	<p>Forestry Victoria, a business centre within the Department was created on 1 July 1999 to separate the commercial operations in native forest from non-commercial activities.</p> <p>The business centre reported an operating profit of \$10.5 million for the 1998-99 financial year.</p> <p>In addition, the State Government proposes to conduct an independent review into pricing of wood products generated from native forests during the 2000-01 financial year.</p>
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WATER INDUSTRY REFORM

<p><i>Ministerial Portfolios, May 1997, p. 171.</i></p>	<p>There was a prima facie case to suggest that the current levels of unaccounted water relating to the retail water companies was too high and could be economically reduced.</p>	<p>The retail water companies are reducing the impact of unaccounted water on their businesses through meter replacement and leakage reduction programs, and public education on water usage.</p>
<p><i>Ministerial Portfolios, May 1998, p. 175.</i></p>	<p>While the Water reform process envisaged the issue of licence agreements between the government and individual non-metropolitan water authorities by July 1995, and the establishment of an independent regulator, these aspects of the reform process have not been implemented.</p>	<p>The creation of licence agreements for non-metropolitan water authorities and the establishment of an independent regulator were objectives of the previous Government. The Department has indicated that the present Government will be considering these matters as part of the delivery of its policy commitment to protect consumer interests, enforce water quality and oversee and enforce a fair water pricing system through the proposed Essential Services Commission.</p>

SCHEDULE A - continued
STATUS OF MATTERS RAISED IN PREVIOUS REPORTS

<i>Report</i>	<i>Subject</i>	<i>Status at date of preparation of this Report</i>
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MATTERS RESOLVED OR ACTION COMMENCED - continued

WATER INDUSTRY REFORM - continued

<p><i>Ministerial Portfolios, May 1998, pp.177-9. May 1999, pp.227-33.</i></p>	<p>The May 1998 Report disclosed that only 57 per cent of the population supplied by non-metropolitan water authorities received water that met the guidelines for micro-biological quality. Of particular concern, was that one-third of water that was treated did not meet the guidelines.</p> <p>The May 1999 Report showed that 60 per cent of country Victorians were in receipt of water that met the guidelines for micro-biological quality, but with a higher percentage of treated water, now 38 per cent, not meeting the guidelines.</p>	<p>The corporate plans prepared by water authorities for 1998-99 projected an overall 14 per cent improvement in bacteriological compliance with World Health Organisation Guidelines. However, during this year, the overall level of compliance of authorities declined by 11 per cent to 49 per cent, principally as a consequence of the drought conditions experienced in Victoria, which affected the quality of source water.</p> <p>Infrastructure improvement works, designed to achieve authority compliance with water quality guidelines, are currently under way and are expected to be completed by the year 2002.</p>
<p><i>Ministerial Portfolios, May 1998 pp. 179-81 May 1999, pp.227-33.</i></p>	<p>The May 1998 Report disclosed that only 13 per cent of wastewater treatment plants operated by non-metropolitan water authorities fully met the Environment Protection Authority standards outlined in their licence agreements for the discharge of treated wastewater into waterways.</p> <p>The May 1999 Report showed that there was an improvement in compliance to 28 per cent.</p>	<p>An analysis by the Department of Natural Resources and Environment of data submitted indicated that around 33 per cent of wastewater treatment plants operated by the non-metropolitan water authorities fully met the Environment Protection Authority requirements set out in the licences for the 1998-99 financial year. This compares with 29 per cent reported for the 1997-98 financial year, and 13 per cent for the 1996-97 financial year.</p> <p>During the 1999-2000 financial year, a significant number of new treatment plants are planned to come into operation, which is expected to further increase the overall compliance rate of authorities.</p>

SCHEDULE A - continued
STATUS OF MATTERS RAISED IN PREVIOUS REPORTS

<i>Report</i>	<i>Subject</i>	<i>Status at date of preparation of this Report</i>
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MATTERS RESOLVED OR ACTION COMMENCED - continued

WATER INDUSTRY REFORM - continued

<p><i>Ministerial Portfolios, May 1996, p. 221.</i></p>	<p>In order to strengthen the Regulator-General's control over pricing policy, the Government should consider the introduction of a licence, monitored by the Regulator-General, to cover the provision of the Melbourne Water Corporation's services.</p>	<p>Since the tabling of the May 1996 Report, the Government has continued to be responsible for setting water prices and the regulatory framework for the metropolitan water industry has remained unchanged. The current system of regulation for the metropolitan water industry and the issue of an operating licence for Melbourne Water are likely to be considered in establishing the roles and responsibilities of the proposed Essential Services Commission.</p>
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<p><i>Ministerial Portfolios, May 1999, p. 234.</i></p>	<p>While Melbourne Water Corporation and the 3 metropolitan retail water companies have in place emergency management plans, in excess of half of the 15 non-metropolitan water authorities had not finalised their plans. Given the significance of this issue, a high priority needs to be given to the finalisation of appropriate emergency management plans for the water sector.</p>	<p>See comments on Water Storage Management by non-metropolitan urban and rural water authorities in this Part of the Report.</p>
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VICTORIAN DAIRY INDUSTRY AUTHORITY

<p><i>Ministerial Portfolios, May 1998, pp. 183-8.</i></p>	<p>The Victorian Dairy Industry Authority's share of the estimated accumulated losses in a joint venture in China to 30 June 1998 was expected to be \$564 000. In addition, the Authority has written-off \$530 000 of its initial investment on the venture of \$730 000, expended a further \$125 000 on the venture and incurred unquantified costs associated with its management. Accordingly, the joint venture has cost the Authority in excess of \$1.2 million.</p>	<p>The Victorian Dairy Industry Authority had expended a further \$210 000 during 1998-99 on the venture and incurred unquantified costs associated with its management. Accordingly, the joint venture has cost the Authority in excess of \$1.5 million to 30 June 1999.</p>
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SCHEDULE A
STATUS OF MATTERS RAISED IN PREVIOUS REPORTS - continued

<i>Report</i>	<i>Subject</i>	<i>Status at date of preparation of this Report</i>
NO ACTION TAKEN		
MELBOURNE WATER CORPORATION		
<p><i>Second Report, 1986-87, pp. 164-5. Ministerial Portfolios, May 1990, p. 343. May 1992, p. 432.</i></p>	<p>The enabling legislation does not confer on the Melbourne Water Corporation the authority to levy interest on arrears of rates and charges. In contrast, the legislation of other major rating bodies provides for the levying of interest on overdue amounts.</p>	<p>Melbourne Water Corporation has indicated that the rationale for the enabling legislation not providing the Corporation with the ability to charge interest on outstanding accounts lies in its ability to restrict water supply to individual properties. The Corporation contends that property restrictions are a more efficient method of encouraging customers to pay their bills on time and require less administration than that required of charging interest.</p> <p>In addition, if the Corporation's drainage rates are not paid they become a lien on the property and can be recouped when the property is sold.</p> <p>In contrast, local councils are not able to restrict supply and must resort to charging interest on unpaid bills to encourage payment on time. Nevertheless, councils do have the power to create liens on properties to recoup unpaid bills.</p>

**SCHEDULE B
COMPLETED/INCOMPLETE AUDITS**

<i>Entity</i>	<i>Financial year ended</i>	<i>Reporting to Parliament</i>	<i>Financial statements signed by entity</i>	<i>Auditor- General's report signed</i>
COMPLETED AUDITS				
Department of Natural Resources and Environment	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.46.</i>	21 Oct. 1999	29 Oct. 1999
AGRICULTURE				
Agriculture Victoria Services Pty Ltd	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.53A.</i>	27 Aug. 1999	24 Sept. 1999
Australian Food Industry Science Centre	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.46.</i>	8 Sept. 1999	16 Feb. 2000
Emu Industry Development Committee	30 June 1999	“ “	18 Jan. 2000	28 Jan. 2000 (b)
Food Quality Service Pty Ltd	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.53A.</i>	20 Aug. 1999	17 Sept. 1999 (b)
Food Science Australia	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.46.</i>	8 Sept. 1999	16 Feb. 2000
Melbourne Market Authority	30 June 1999	“ “	16 Aug. 1999	3 Sept. 1999
Murray Valley Citrus Marketing Board	30 June 1999	“ “	24 Sept. 1999	30 Sept. 1999
Murray Valley Wine Grape Industry Development Committee	Period 1 Aug. 1998 to 30 June 1999	“ “	8 Nov. 1999	15 Dec. 1999
Northern Victorian Fresh Tomato Industry Development Committee	30 June 1999	“ “	19 Jan. 2000	2 Feb. 2000
Veterinary Practitioners Registration Board of Victoria	31 Dec. 1998	30 Apr. <i>Financial Management Act 1994, s.46.</i>	4 Aug. 1999	16 Aug. 1999
Victorian Dairy Industry Authority	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.46.</i>	20 Aug. 1999	29 Sept. 1999 (b)
Victorian Meat Authority	30 June 1999	“ “	2 Sept. 1999	3 Sept. 1999
Victorian Strawberry Industry Development Committee	30 June 1999	“ “	14 Sept. 1999	23 Sept. 1999

SCHEDULE B
COMPLETED/INCOMPLETE AUDITS - continued

<i>Entity</i>	<i>Financial year ended</i>	<i>Reporting to Parliament</i>	<i>Financial statements signed by entity</i>	<i>Auditor-General's report signed</i>
COMPLETED AUDITS - continued				
ENERGY AND RESOURCES				
Renewable Energy Authority of Victoria	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.46.</i>	20 Sept. 1999	23 Sept. 1999
ENVIRONMENT AND CONSERVATION				
Alpine Resorts Co-ordinating Council	Period 30 Apr. 1998 to 30 June 1999	“ “	3 Sept. 1999	23 Sept. 1999
Barwon Regional Waste Management Group	30 June 1999	“ “	15 Dec. 1999	15 Dec. 1999
Barwon Regional Water Authority	30 June 1999	“ “	19 Aug. 1999	2 Sept. 1999
Calder Regional Waste Management Group	30 June 1999	“ “	17 Feb. 2000	24 Feb. 2000
Central Gippsland Region Water Authority	30 June 1999	“ “	13 Aug. 1999	31 Aug. 1999
Central Highlands Region Timber Pty Ltd	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.53A.</i>	10 Aug. 1999	26 Aug. 1999
Central Highlands Region Water Authority	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.46.</i>	19 Aug. 1999	26 Aug. 1999
Central Murray Regional Waste Management Group	30 June 1999	“ “	21 Oct. 1999	29 Oct. 1999
City West Water Ltd	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.53A.</i>	18 Aug. 1999	25 Aug. 1999
Coliban Region Water Authority	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.46.</i>	15 Sept. 1999	16 Sept. 1999
Corangamite Catchment Management Authority	30 June 1999	“ “	10 Sept. 1999	27 Sept. 1999
Desert Fringe Regional Waste Management Group	30 June 1999	“ “	15 May 2000	15 May 2000

SCHEDULE B
COMPLETED/INCOMPLETE AUDITS - *continued*

<i>Entity</i>	<i>Financial year ended</i>	<i>Reporting to Parliament</i>	<i>Financial statements signed by entity</i>	<i>Auditor-General's report signed</i>
COMPLETED AUDITS - <i>continued</i>				
<i>ENVIRONMENT AND CONSERVATION - continued</i>				
Eastern Regional Waste Management Group	30 June 1998	31 Oct. <i>Financial Management Act 1994, s.46.</i>	15 Mar. 1999	3 May. 1999
" "	30 June 1999	" "	29 Nov. 1999	27 Jan. 2000
East Gippsland Catchment Management Authority	30 June 1999	" "	30 Sept. 1999	30 Sept. 1999
East Gippsland Region Water Authority	30 June 1999	" "	17 Aug. 1999	22 Sept. 1999
Eco Recycle Victoria	30 June 1999	" "	11 Oct. 1999	13 Oct. 1999
Environment Protection Authority	30 June 1999	" "	27 Sept. 1999	25 Oct. 1999
Falls Creek Alpine Resort Management Board	Period 30 Apr. 1998 to 31 Oct. 1998	28 Feb. <i>Financial Management Act 1994, s.46.</i>	27 Aug. 1999	23 Sept. 1999
" "	31 Oct. 1999	" "	1 Feb. 2000	8 Feb. 2000
First Mildura Irrigation Trust	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.46.</i>	17 Aug. 1999	8 Sept. 1999
Gippsland and Southern Rural Water Authority	30 June 1999	" "	20 Aug. 1999	24 Aug. 1999
Gippsland Regional Waste Management Group	30 June 1999	" "	1 Nov. 1999	11 Nov. 1999
Glenelg Region Water Authority	30 June 1999	" "	23 Sept. 1999	29 Sept. 1999
Glenelg-Hopkins Catchment Management Authority	30 June 1999	" "	18 Aug. 1999	21 Sept. 1999
Goulburn Broken Catchment Management Authority	30 June 1999	" "	15 Sept. 1999	30 Sept. 1999

SCHEDULE B
COMPLETED/INCOMPLETE AUDITS - continued

<i>Entity</i>	<i>Financial year ended</i>	<i>Reporting to Parliament</i>	<i>Financial statements signed by entity</i>	<i>Auditor- General's report signed</i>
COMPLETED AUDITS - continued				
ENVIRONMENT AND CONSERVATION - continued				
Goulburn-Murray Rural Water Authority	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.46.</i>	12 Aug. 1999	25 Aug. 1999
Goulburn Valley Region Water Authority	30 June 1999	" "	18 Aug. 1999	2 Sept. 1999
Goulburn Valley Regional Waste Management Group	30 June 1999	" "	11 Feb. 2000	22 Feb. 2000
Grampians Region Water Authority	30 June 1999	" "	30 Sept. 1999	15 Oct. 1999
Grampians Regional Waste Management Group	Period 30 Oct. 1997 to 30 June 1998	" "	22 July. 1999	17 Dec. 1999
" "	30 June 1999	" "	17 Feb. 2000	31 Mar. 2000
Highland Regional Waste Management Group	Period 18 Dec. 1997 to 30 June 1998	" "	12 Jan. 1999	5 July. 1999
" "	30 June 1999	" "	17 Mar. 2000	12 Apr. 2000
Lake Mountain Alpine Resort Management Board	Period 30 Apr. 1998 to 31 Oct. 1998	28 Feb. <i>Financial Management Act 1994, s.46.</i>	30 June. 1999	6 July. 1999
" "	31 Oct. 1999	" "	1 Mar. 2000	28 Mar. 2000
Lower Murray Region Water Authority	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.46.</i>	1 Sept. 1999	15 Sept. 1999
Mallee Catchment Management Authority	30 June 1999	" "	7 Sept. 1999	23 Sept. 1999
Marine and Fresh Water Resources Institute	Period 1 July 1998 to 31 Dec. 1998	30 Apr. <i>Financial Management Act 1994, s.46.</i>	10 Aug. 1999	10 Aug. 1999 (a)

SCHEDULE B
COMPLETED/INCOMPLETE AUDITS - continued

<i>Entity</i>	<i>Financial year ended</i>	<i>Reporting to Parliament</i>	<i>Financial statements signed by entity</i>	<i>Auditor-General's report signed</i>
COMPLETED AUDITS - continued				
ENVIRONMENT AND CONSERVATION – continued				
Melbourne Parks and Waterways	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.46.</i>	29 Nov. 1999	14 Dec. 1999
Melbourne Water Corporation	30 June 1999	“ “	20 Aug. 1999	20 Aug. 1999
Mildura Regional Waste Management Group	30 June 1999	“ “	26 May. 2000	26 May. 2000
Mornington Peninsula Regional Waste Management Group	30 June 1999	“ “	26 Apr. 2000	2 May. 2000
Mount Baw Baw Alpine Resort Management Board	Period 30 Apr. 1998 to 31 Oct. 1998	28 Feb. <i>Financial Management Act 1994, s.46.</i>	25 June. 1999	22 July. 1999
“ “	31 Oct. 1999	“ “	28 Apr. 2000	3 May. 2000
Mount Buller Alpine Resort Management Board	Period 30 Apr. 1998 to 31 Oct. 1998	“ “	17 Nov. 1999	24 Nov. 1999
“ “	31 Oct. 1999	“ “	24 Mar. 2000	29 Mar. 2000
Mount Hotham Alpine Resort Management Board	Period 30 Apr. 1998 to 31 Oct. 1998	“ “	17 Sept. 1999	5 Oct. 1999
“ “	31 Oct. 1999	“ “	28 Jan. 2000	8 Feb. 2000
Mount Stirling Alpine Resort Management Board	Period 30 Apr. 1998 to 31 Oct. 1998	“ “	17 May. 1999	6 July. 1999
“ “	31 Oct. 1999	“ “	20 Dec. 1999	14 Feb. 2000
North Central Catchment Management Authority	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.46.</i>	28 Aug. 1999	1 Oct. 1999

SCHEDULE B
COMPLETED/INCOMPLETE AUDITS - continued

<i>Entity</i>	<i>Financial year ended</i>	<i>Reporting to Parliament</i>	<i>Financial statements signed by entity</i>	<i>Auditor-General's report signed</i>
COMPLETED AUDITS - continued				
ENVIRONMENT AND CONSERVATION – continued				
North East Catchment Management Authority	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.46.</i>	4 Aug. 1999	20 Sept. 1999
North East Region Water Authority	30 June 1999	“ “	18 Aug. 1999	27 Aug. 1999
North East Victorian Regional Waste Management Group	30 June 1999	“ “	16 Mar. 2000	27 Mar. 2000
Northern Regional Waste Management Group	30 June 1999	“ “	23 Sept. 1999	26 Sept. 1999
Parks Victoria	Period 3 July 1998 to 30 June 1999	“ “	17 Sept. 1999	21 Sept. 1999
Phillip Island Nature Park Board of Management	30 June 1999	“ “	27 Aug. 1999	10 Sept. 1999
Portland Coast Region Water Authority	30 June 1999	“ “	12 Aug. 1999	31 Aug. 1999
Royal Botanic Gardens Board	30 June 1999	“ “	17 Aug. 1999	13 Sept. 1999
Shrine of Remembrance Trustees	30 June 1999	No reporting requirements.	26 Aug. 1999	23 Sept. 1999
South East Water Limited	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.53A.</i>	23 Aug. 1999	23 Aug. 1999
South Eastern Regional Waste Management Group	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.46.</i>	28 Sept. 1999	30 Sept. 1999
South Gippsland Region Water Authority	30 June 1999	“ “	7 Sept. 1999	15 Sept. 1999
South West Water Authority	30 June 1999	“ “	25 Aug. 1999	20 Sept. 1999
South Western Regional Waste Management Group	30 June 1999	“ “	17 Dec. 1999	31 Dec. 1999
State Swimming Centre Committee of Management	30 June 1995	“ “	29 Aug. 1999	29 Aug. 1999
“ “	30 June 1996	“ “	29 Aug. 1999	29 Aug. 1999

SCHEDULE B
COMPLETED/INCOMPLETE AUDITS - *continued*

<i>Entity</i>	<i>Financial year ended</i>	<i>Reporting to Parliament</i>	<i>Financial statements signed by entity</i>	<i>Auditor-General's report signed</i>
COMPLETED AUDITS - <i>continued</i>				
ENVIRONMENT AND CONSERVATION – <i>continued</i>				
State Swimming Centre Committee of Management	30 June 1997	31 Oct. <i>Financial Management Act 1994, s.46.</i>	29 Aug. 1999	29 Aug. 1999
" "	Period 1 July 1997 to 31 Dec. 1997	30 Apr. <i>Financial Management Act 1994, s.46.</i>	29 Aug. 1999	29 Aug. 1999 (a)
Sunraysia Rural Water Authority	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.46.</i>	22 Sept. 1999	22 Sept. 1999
Surveyors Board of Victoria	30 June 1999	" "	15 Oct. 1999	22 Oct. 1999
Trust for Nature (Victoria)	30 June 1999	" "	31 Dec. 1999	31 Dec. 1999 (b)
Water Training Centre	30 June 1999	" "	8 Sept. 1999	23 Sept. 1999
West Gippsland Catchment Management Authority	30 June 1999	" "	29 Sept. 1999	30 Sept. 1999
Western Region Water Authority	30 June 1999	" "	18 Aug. 1999	27 Aug. 1999
Western Regional Waste Management Group	30 June 1999	" "	8 Feb. 2000	23 Feb. 2000
Westernport Region Water Authority	30 June 1999	" "	31 Aug. 1999	15 Sept. 1999
Wimmera Catchment Management Authority	30 June 1999	" "	23 Sept. 1999	13 Oct. 1999
Wimmera Mallee Rural Water Authority	30 June 1999	" "	2 Sept. 1999	2 Sept. 1999
Yarra Bend Park Trust	30 June 1999	" "	27 Oct. 1999	5 Nov. 1999
Yarra Valley Water Limited	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.53A.</i>	25 Aug. 1999	25 Aug. 1999
Zoological Parks and Gardens Board	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.46.</i>	27 Aug. 1999	10 Sept. 1999

SCHEDULE B
COMPLETED/INCOMPLETE AUDITS - *continued*

<i>Entity</i>	<i>Financial year ended</i>	<i>Reporting to Parliament</i>	<i>Financial statements signed by entity</i>	<i>Auditor- General's report signed</i>
INCOMPLETE AUDITS				
AGRICULTURE				
Veterinary Practitioners Registration Board of Victoria	31 Dec. 1999	30 Apr. <i>Financial Management Act 1994, s.46.</i>	Financial statements not received.	
ENVIRONMENT AND CONSERVATION				
Casey's Weir and Major Creek Rural Water Authority	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.46.</i>	Financial statements not received.	
Tungamah Shire Water Board	30 Sept. 1995	31 Jan. <i>Financial Management Act 1994, s.46.</i>	"	"
" "	Period 1 Oct. 1995 to 30 June 1996	31 Oct. <i>Financial Management Act 1994, s.46.</i>	"	"
" "	30 June 1997	" "	"	"
" "	30 June 1998	" "	"	"
Victorian Plantations Corporation	Period 1 July 1998 to 3 Dec. 1998	3 Apr. <i>Financial Management Act 1994, s.46.</i>	Audit substantially completed	
" "	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.46.</i>	"	"

(a) Final audit.

(b) Qualified audit report.

Part 3.6

Premier and Cabinet

KEY FINDINGS

Construction of the Melbourne Museum complex

- The final cost of completing the Museum was estimated as at February 2000 to be \$291.8 million – a \$4.2 million increase over the past 12 months. When compared with the original budget of \$250 million, the overall increase in costs is expected to be \$41.8 million.

Paras 3.6.4 to 3.6.15

- In February 2000, Museum Victoria decided that, due to the delays in the Museum's construction, it would be necessary to undertake a staged opening of the new facility, commencing in late 2000. The planned opening is almost 12 months later than originally scheduled and 3 months later than that projected in February 1999.

Paras 3.6.16 to 3.6.22

Sale of ticketing joint venture interests – Victorian Arts Centre Trust

- The result achieved from the sale of Victorian Arts Centre Trust's interest in 2 ticketing joint ventures was at the lower end of independent valuations obtained prior to the sale, and well below the recommended sale price advised to the Trust in August 1998.

Paras 3.6.51 to 3.6.58

- The net proceeds from the sale of the 2 joint ventures to the Trust, after taking into account the costs of sale of approximately \$511 000, were around \$3.4 million.

Para. 3.6.58

Development of Federation Square

- The Federation Square Project was launched in March 1996 as a joint venture initiative of the Government and the Melbourne City Council with a provisionally estimated construction cost of \$110 million.

Paras 3.6.59 to 3.6.66

KEY FINDINGS - *continued***Development of Federation Square** - *continued*

- During October 1997, and prior to the calling of tenders for construction of the Federation Square, the Project Manager's quantity surveyor estimated the cost of constructing the Square at \$249 million based on the winning design resulting from an international design competition, which was significantly above the then stated cost limit of \$128 million for the development of the Square.
Paras 3.6.75 to 3.6.83
- The tendering process for the construction of Federation Square was not subject to an independent probity audit and the construction of the Square proceeded ahead of the completion of design documentation.
Paras 3.6.84 to 3.6.119,
- Under the State's Agreement with the Managing Contractor, the risk of omissions, discrepancies and ambiguities existing in the design and documentation of the works was to be borne by the Contractor, but instead has been borne by the State without adjustment to the Contractor's fees in favour of the State.
Paras 3.6.98 to 3.6.102
- The latest cost estimate of \$262 million, prepared in August 1999, does not seek to capture the total cost of the Federation Square development and is partly unfunded as only \$212.6 million has been committed by the Government and the Council.
Paras 3.6.127 to 3.6.134
- In May 2000, the Government announced the appointment of a working party to consider part of the design of the Square, given its decision to remove one of the 2 Shards. The Square was originally intended to be completed by mid-2000, but prior to the removal of the Shard the estimated completion date had already been extended to May 2001.
Paras 3.6.82 to 3.6.83

3.6.1 The Premier, who is also the Minister for Multicultural Affairs, together with the Minister for the Arts and the Minister for Women's Affairs have responsibility for operations within the Premier and Cabinet sector. The Premier and these Ministers have collective responsibility for the Department of Premier and Cabinet.

3.6.2 Details of the specific ministerial responsibilities for public bodies within the Premier and Cabinet portfolio are listed in Table 3.6A. These public bodies, together with the Department of Premier and Cabinet, were subject to audit by the Auditor-General during the 1998-99 financial year.

**TABLE 3.6A
MINISTERIAL RESPONSIBILITY FOR
PUBLIC SECTOR AGENCIES WITHIN THE PREMIER AND CABINET PORTFOLIO**

<i>Ministerial portfolio</i>	<i>Agencies subject to audit</i>
Arts	Cinemedia Corporation Council of Trustees of the National Gallery of Victoria Geelong Performing Arts Centre Trust Library Board of Victoria Museums Board of Victoria National Gallery Society of Victoria State Library of Victoria Foundation Victorian Arts Centre Trust
Multicultural Affairs	Victorian Interpreting and Translating Service
Premier	Melbourne 2006 Commonwealth Games Pty Ltd Office of the Ombudsman The Office of Public Employment Victorian Relief Committee
Women's Affairs	-

3.6.3 Comment on matters of significance arising from the audit of entities within the Premier and Cabinet portfolio is provided below.

CONSTRUCTION OF THE MELBOURNE MUSEUM COMPLEX

3.6.4 As part of its Agenda 21 program of capital works, the Government agreed to construct a world class museum to be located at the Carlton Gardens, adjacent to the Royal Exhibition Building. In January 1994, following the announcement by Government of a national competition to design the new Melbourne Museum complex (the Museum), the successful design of the Museum was unveiled in May 1995.

3.6.5 The Museum will include a Gallery of Life, an Aboriginal Centre, a Children's Museum, a study centre, various education facilities, a storage facility for the Museum's collection, an IMAX theatre, which was opened to the public in May 1998, and a car park, which commenced operating in July 1998.

3.6.6 Construction of the project, which began in March 1997, is managed by the Office of Major Projects on behalf of the Museum Board of Victoria (Museum Victoria).

3.6.7 The May 1999 *Report on Ministerial Portfolios* included comments on the status of the construction of the Museum. In particular, the Report indicated that the cost of the new complex, which was initially estimated to be \$250 million had, as at February 1999, increased to \$287.6 million. The increase in cost was mainly attributable to a change in scope of the complex, lack of detailed costings relating to the public exhibition program, problems encountered with the treatment and removal of contaminated soil, and water seepage not envisaged prior to the commencement of the excavation works. In addition, it was found that project delays had required the opening of the complex to be deferred by 6 months, to July 2000.

3.6.8 This Report provides an update of the status of the construction of the Museum and identifies associated issues impacting on the cost of the project and the timeliness of its completion.



New Melbourne Museum complex, nearing completion.

Construction and fit-out of the Museum

3.6.9 The projected final cost of completing the Museum was estimated, as at February 2000, to be \$291.8 million – a \$4.2 million increase over the last 12 months. When compared with the original budget of \$250 million, the overall increase in costs is \$41.8 million.

3.6.10 Table 3.6B below illustrates that projected final cost of the Museum.

TABLE 3.6B
MUSEUM PROJECT BUDGET
((\$million))

<i>Cost component</i>	<i>Original budget (June 1995)</i>	<i>Projected final cost (February 1999)</i>	<i>Projected final cost (February 2000)</i>
Construction contracts and fees (a)	179.1	217.6	218.3
Off-site store construction and fit-out	7.4	6.7	6.7
Public exhibition program	30.0	48.0	52.2
Fittings, furniture and equipment	9.7	7.5	6.8
Project management and development costs of Museum Victoria	1.7	4.7	4.7
Collection relocation	3.1	3.1	3.1
Minister's discretionary fund (unallocated funds)	19.0	nil	nil
Total project cost	250.0	287.6	291.8

(a) Includes contingency amounts.

Funding of project

3.6.11 At February 2000, funding totalling \$283.1 million had been secured for the project, including sponsorship funding of \$3.4 million and \$1.1 million to be provided by Cinema Plus from funds held in trust. A further \$2.2 million is awaiting approval from the Government for funding relating to the fit-out of the Museum as a consequence of delays in the completion of the construction of the Museum. **This represents a shortfall of \$6.5 million compared with the project's projected final cost.** It is Museum Victoria's intention to obtain further sponsorship funding of \$3.4 million, however, even if this eventuates, a funding shortfall of \$3.1 million will still exist.

3.6.12 In November 1999, the Director of the Office of Major Projects advised the Minister for Major Projects and Tourism that additional funding would be required to complete the project, including the settlement of contractual variations lodged by the contractor. As at February 2000, contract variation claims totalling \$10.2 million had been approved by the Office of Major Projects and a further \$3.7 million of claims were awaiting negotiation.

3.6.13 In addition to these contract variation claims, the contractor had also lodged, further claims in excess of \$11 million and \$5.2 million for extensions of time and variations to the scope of construction, respectively. The Office of Major Projects advised that the claims will be considered in accordance with the terms of the contract and any further claims will be defended and may be subject to litigation.

Key factors contributing to increased projected final cost

3.6.14 The following key factors contributed to the increased projected final cost of the project since February 1999:

- settlement of the contractor's claim for delayed occupancy of the construction site and consequential loss of productivity (\$3.2 million);
- post-tender changes to the scope of construction and fit-out; and
- expansion of the public exhibition program.

3.6.15 The above additional costs have been partly offset by:

- deletion of roof louvres (\$1.2 million);
- changes to exhibition design incorporating a reduction in the scope of the Upper West Gallery (\$650 000) and deletion of a number of the Museum's multimedia components; and
- downgrading of the quality of the gallery parquetry.

Time delays

3.6.16 In February 2000, Museum Victoria decided that due to the delays in the Museum's construction, it would be necessary to undertake a staged opening of the Museum, commencing in late 2000. The planned opening is almost 12 months later than originally scheduled and 3 months later than that projected in February 1999. Table 3.6C indicates the initial timeframe and the actual or revised time frame for the project.

**TABLE 3.6C
INITIAL TIME FRAME COMPARED WITH ACTUAL/REVISED TIME FRAME FOR
MELBOURNE MUSEUM**

<i>Milestone</i>	<i>Initial timeframe</i>	<i>Actual/revised timeframe</i>
Handover of East exhibition for fit-out	February 1999	January 2000
Handover of West exhibition cluster for fit-out	April 1999	January 2000 (except Western superspace)
Handover of Gallery of Life for fit-out	April 1999	February 2000
Overall completion of primary construction works	June 1999	June 2000
Public opening of Museum	December 1999	Staged opening commencing late 2000

3.6.17 As reported in the May 1999 *Report on Ministerial Portfolios* the major reasons for delays in construction of the Museum which at that time would have delayed the opening by 7 months from December 1999 to July 2000 were as follows:

- impact of soil contamination and water seepage on excavation;
- later than expected occupation of the site by the contractor; and
- delays in the finalisation of the design of the extended car park.

3.6.18 Since the May 1999 Report there have been further delays of around 70 days in the completion of construction of the Museum, which have been predominantly due to Statewide industrial action.

3.6.19 In order to accommodate project delays, an alternative strategy was prepared in April 1999 for the fit-out of the Museum. This strategy involved the letting of separate tenders for works in the East and West exhibition clusters of the Museum, and most of the fabrication being undertaken off-site. The strategy proposed a staged opening of the Museum, with the East cluster (including the Gallery of Life, Aboriginal Centre and Touring Hall) being opened in July 2000, and the West cluster (including the Children's Museum and Study Centre) in October 2000. However, further delays in the Museum's construction have required the postponement of the staged opening of the Museum until late 2000, as mentioned earlier in this Report.

3.6.20 The construction contractor began handing over completed areas of the Museum in late 1999, however, the successful handover of a number of these areas was prevented by up to 3 months due to the need to rectify identified structural deficiencies. This included defective aluminium panels in the Gallery of Life roof, entrance canopy roof and lifts. Although this delayed the handover of the Gallery of Life by over 2 months, it did not preclude access to this area for the commencement of fit-out.

3.6.21 In addition to the delayed access to the site as a result of a later than expected completion of construction works, the commencement of fit-out works for the Museum was held up by:

- changes to exhibition designs by Museum Victoria during 1999 and delays of up to 14 weeks in the provision of the required design details, resulting in the late completion of tender documentation; and
- a delay of approximately 5 weeks in the letting of the construction contract for the secondary fit-out works for the East exhibition cluster, caused by the late approval of the recommended tenderer by the Office of Major Projects, predominantly as a result of the change in Government in October 1999.

3.6.22 We were advised by Museum Victoria that costs including salaries, contractor payments and consultant fees of \$2.2 million have resulted from the delay in the fit-out of the Museum and that approval for this additional funding requirement was anticipated to be obtained in the current budget cycle.

IMAX theatre

3.6.23 In March 1996, Museum Victoria announced an arrangement with Cinema Plus to develop the IMAX theatre as part of the new Museum Project, under which Cinema Plus would invest in, promote, manage and operate the IMAX theatre on behalf of Museum Victoria. In May 1998, the IMAX theatre, which cost \$23.6 million, opened 7 months later than originally planned, as a result of delays in both the construction and fit-out of the theatre. Although no damages were payable for the late completion of the theatre, due to the efforts of both parties seeking to accelerate the works to overcome time lost for reasons beyond the control of either party, the responsibility for certain costs associated with the construction and fit-out of the theatre was disputed by the parties.

Resolution of disputed costs

3.6.24 The May 1999 *Report on Ministerial Portfolios* indicated that an IMAX Construction Costs Deed, negotiated between Museum Victoria and Cinema Plus, was executed in June 1998 to resolve disputes over the payment of these costs.

3.6.25 The Deed required Cinema Plus and Museum Victoria to pay \$13.8 million and \$5.8 million, respectively, and Cinema Plus to lodge an additional \$4 million security in an escrow account pending the outcome of negotiations regarding the allocation of certain disputed costs between the 2 parties.

3.6.26 As at February 2000, Cinema Plus had agreed to meet \$1.1 million of the disputed costs, with \$1.4 million of these costs still subject to determination by an independent quantity surveyor.

Revenue earned from the IMAX theatre

3.6.27 Under the IMAX theatre lease, rental is payable by Cinema Plus to Museum Victoria at the base rate of \$250 000 per annum plus:

- 7 per cent of gross revenue above \$4 million and up to \$7.5 million per annum; and
- 10 per cent of gross revenue above \$7.5 million per annum.

3.6.28 In the first year of the lease, which commenced on 15 May 1998, Museum Victoria received from Cinema Plus \$604 000, based on gross revenue of \$8.6 million.

3.6.29 Although the attendance at the IMAX theatre totalled 568 000 during the first year of the lease, which was well in excess of the minimum patronage level of 250 000 patrons required by the lease, it was less than the budgeted attendance level of 684 000. Museum Victoria expects that IMAX theatre patronage will improve once the Museum is opened.

❑ **RESPONSE** provided by the Secretary, Department of Premier and Cabinet

In relation to the time delays in the opening of the Museum, an issue worth noting, but which is not mentioned, is that the postponement until late 2000 is not only related to the construction delays arising from contractual and industrial issues. A decision was taken to avoid opening the Museum at a time when national and international attention will be focused on Sydney for the 2000 Olympics in September.

**SALE OF TICKETING JOINT VENTURE INTERESTS -
VICTORIAN ARTS CENTRE TRUST**

3.6.30 The *Reports of the Auditor-General on the Statement of Financial Operations, 1994-95 and 1995-96* commented on the establishment of a joint venture between the Victorian Arts Centre Trust and Ticketmaster Corporation, a leading ticket provider in the United States of America, by the sale of 50 per cent of BASS Victoria - a former division of the Victorian Arts Centre Trust providing ticketing services to entertainment venues throughout Victoria.

3.6.31 The sale of 50 per cent of BASS Victoria was completed by March 1996 with the State receiving net sale proceeds of \$2.6 million. As part of the sale arrangements, responsibility for the management of the joint venture was allocated to the Ticketmaster Corporation, with management fees payable for the provision of this service. As part of the ongoing arrangements, the profits generated by the joint venture, together with future capital requirements, were to be provided on a 50:50 basis. In addition, in the event that one party wished to divest its interest, the parties agreed to offer the other party first option to purchase that interest in the joint venture at an independently assessed fair value.

3.6.32 The Victorian Arts Centre Trust held its 50 per cent interest in the unincorporated joint venture (known as Joint Venture 1) through its subsidiary, Bass Victoria Holdings Pty Ltd. The joint venture concentrated on the provision of ticketing services in Victoria, Tasmania and the Australian Capital Territory. The joint venture was managed by a management company, Ticketmaster Bass Pty Ltd, which was jointly owned by the Trust and Ticketmaster Corporation.

3.6.33 At the time of the sale, additional agreements were entered into between the Ticketmaster Corporation and the Trust, which established a second joint venture (known as Joint Venture 2) to be utilised for the expansion of ticketing services to the remaining Australian States and New Zealand. The Trust's 50 per cent interest in the second joint venture was held by its subsidiary, Bass Australasia Holdings Pty Ltd, and was managed by Ticketmaster Bass Australasia Pty Ltd, which was jointly owned by the Trust and Ticketmaster Corporation.

3.6.34 Joint Venture 2 proceeded to geographically expand the joint venture's activity. Early in 1997, it established a regional office in Queensland and subsequently in late 1997 moved into New South Wales with the purchase of a ticketing business known as FirstCall in October 1997. In 1998, Joint Venture 2 also entered into an agreement to sell tickets associated with events held at the Derwent Entertainment Centre located in Hobart, Tasmania.

3.6.35 In March 1999, Ticketmaster Corporation acquired the Trust's remaining interest in the 2 joint ventures giving it full ownership of the ticketing business and in September 1999 Ticketmaster Corporation sold 49.99 per cent of its interest to i7 Pty Ltd, a subsidiary of the Seven Network Ltd.

3.6.36 This Report comments on the activities of the joint ventures and provides an analysis of the sale of the Trust's 50 per cent interest in the 2 joint ventures.

Purchase of FirstCall

3.6.37 In October 1997, the Trust was notified by Ticketmaster Corporation that Joint Venture 2 and Ticketmaster Australasia Investments Pty Ltd had entered into a Heads of Agreement for the purchase of the assets and goodwill of a group of companies which were jointly referred to as FirstCall (Cameron Mackintosh Seats Pty Ltd, Tobeon Pty Ltd, Plusfore Pty Ltd and Bribosia Investments Pty Ltd) at a purchase price of \$4 million. FirstCall's main activity was the retail of tickets for various venues mainly based in Sydney together with certain venues in New Zealand. The proposal noted that the acquisition would support Joint Venture 2's bid to retail tickets for the Olympic Games to be held in Sydney in August 2000.

3.6.38 The Members of Trust were subsequently advised of the following key issues relating to the proposal:

- the Trust's contribution to the proposal to purchase FirstCall would be \$2.8 million;
- approval of the Minister for the Arts and the Treasurer of Victoria would be required, prior to the acquisition, due to the high level of financial commitment required including the possible need to borrow funds and the risks associated with the expansion of the business interest;
- it would be unlikely that the joint ventures would generate sufficient funds to meet any loan commitments arising from the acquisition of FirstCall; and
- the Trust's lack of adequate cash flows for operational needs would be a major factor in any consideration of the source of funding for the proposed acquisition.

3.6.39 Subsequently, Ticketmaster Corporation requested the Trust to confirm in writing discussions held with the Trust's former Chief Executive Officer regarding the Trust's approval for the acquisition of FirstCall as set out in the Heads of Agreement. In addition, Ticketmaster Corporation advised that if the Trust failed to agree to the provision of 50 per cent of the funds required for the acquisition, it expected that the Trust would agree to sell its interest in the 2 joint ventures.

3.6.40 The Trust subsequently advised Ticketmaster that it was unable to agree with the terms of the proposal as the Trust required additional information prior to it seeking any approval from the Minister for the Arts and the Treasurer of Victoria. The Trust also indicated that it may withdraw from Joint Venture 2 if Ticketmaster Corporation was prepared to renegotiate its agreement with the Trust in relation to the provision of ticketing services at venues controlled by the Trust.

3.6.41 In November 1997, following receipt of additional information regarding the acquisition of FirstCall, the Trust's former Chief Executive Officer formally advised Ticketmaster Australasia Investments Pty Ltd that, subject to the approval by the Treasurer of Victoria to enable the necessary raising of funds, it agreed to Joint Venture 2 acquiring FirstCall. However, the former Chief Executive Officer also advised the company that if the necessary approval to raise funds was not provided, the Trust would agree to the sale of the 2 joint ventures, or Joint Venture 2 to Ticketmaster Corporation.

3.6.42 In December 1997, the President of the Trust met with the Minister for the Arts to present a case for the acquisition of FirstCall and to seek support for the Trust's loan application.

3.6.43 Subsequently, Ticketmaster Corporation completed the purchase of FirstCall. At January 1998, however, the Trust had not received approval from the Treasurer of Victoria to borrow in order to finance its share of the acquisition costs. In addition, Ticketmaster Corporation withheld payment of a management incentive fee to the Trust which was due by 31 December 1997, as it argued that retention of the fee was justified to off-set the interest payments due to Ticketmaster for financing the Trust's portion of the acquisition costs associated with FirstCall.

3.6.44 Ticketmaster have advised us that the Trust consented to the Firstcall acquisition, and was aware at all times of progress towards the completion of the related transaction documents and that at no stage did the Trust advise Ticketmaster that the acquisition could not proceed until the Government determined the provision of funding. However, the Trust refutes these claims.

3.6.45 The Trust then sought and received legal advice that it should not concede to any claim that it was indebted to Ticketmaster in this matter.

3.6.46 Ticketmaster Corporation subsequently advised the Trust that the purchase price for FirstCall was funded partly by Joint Venture 1 through a contribution of \$670 000 and the balance through an advance provided by the Ticketmaster Corporation of \$2.68 million, with the Trust owing \$1.34 million for its portion of this advance which would accrue interest.

3.6.47 Ticketmaster Corporation also indicated that further delays would cause it to invoke the "deadlock provisions" under the agreement associated with Joint Venture 2, which allowed one of the parties to the joint venture to terminate the joint venture agreement and acquire the balance of the assets and goodwill in that joint venture in the event of a material disagreement between the parties to the agreement.

3.6.48 In February 1998, the Treasurer of Victoria advised the President of the Trust that its application to raise funding in connection with the acquisition of FirstCall by Joint Venture 2 was not approved.

3.6.49 The Members of the Trust resolved in March 1998 to divest the Trust's interest in both joint ventures. The rationale for the sale was that the returns from the joint ventures in the short-term were expected to be negligible, the Trust's ability to contribute additional capital was limited and the former Government's policy discouraged State-controlled agencies from engaging in business activities which could be provided by the private sector.

3.6.50 Subsequently, the Trust received legal advice indicating that Ticketmaster Corporation had committed the following possible breaches in relation to the joint venture arrangements:

Joint Venture 1

- A contribution of \$670 000 towards the acquisition of FirstCall without the knowledge and approval of the Trust or its representative;

- The submission of tenders with conditions to make significant up-front payments without the prior agreement of the Trust; and
- The withholding of management incentive payments to the Trust;

Joint Venture 2

- The acquisition of FirstCall and the entering into related financing arrangements; and
- The submission and negotiation of ticketing tenders relating to the Sydney 2000 Olympics without prior agreement of the Trust of the terms of the tender.

3.6.51 Ticketmaster advised us that it fully met its joint venture obligations such as the provision of draft tenders to the Trust prior to their formal submission to relevant parties. However, the Trust refutes these claims.

3.6.52 In April 1998, Ticketmaster Corporation agreed to buy the Trust's interest in the 2 joint ventures and requested the Trust to establish a price.

Sale process and key terms of the sale

3.6.53 Consistent with legal advice received by the Trust which indicated that opportunities for the disposal of the Trust's interest in the joint ventures to a party other than Ticketmaster Corporation would be limited, the Trust commenced direct negotiations with Ticketmaster Corporation.

3.6.54 In August 1998, the directors of Bass Victoria Holdings Pty Ltd and Bass Australasia Holdings Pty Ltd were advised that, based on indicative valuations received for the purpose of negotiating a sale, the valuation ranges for the Trust's interest in the two joint ventures were as follows:

- Joint Venture 1 - \$3.25 million to \$5.7 million; and
- Joint Venture 2 - \$0 to \$1.6 million.

3.6.55 Accordingly, the total indicative valuation range for the 2 joint ventures was \$3.25 million to \$7.3 million. The Trust's valuers recommended that for sale negotiation purposes the Trust should initially aim to achieve a sale price of between \$6.3 million to \$7.3 million.

3.6.56 Following extensive negotiations between the 2 parties, in March 1999, the Trust finalised arrangements for the sale of its interests in the business assets of the 2 joint ventures to Ticketmaster Corporation. The principle terms of the sale agreement were:

- a cash payment of \$3.9 million for the Trust's interest in the business assets of Joint Venture 1;
- a nominal consideration for the transfer of Bass Victoria Holdings Pty Ltd shareholding in Joint Venture 1, and Bass Australasia Holdings Pty Ltd shareholding in Joint Venture 2;
- forgiveness of a loan of \$1.45 million relating to the purchase of FirstCall; and
- payment of the outstanding management incentive fee of \$183 000.

3.6.57 In addition, under the sale agreement the Trust agreed to restrict its involvement in the provision of ticketing services for a period of 3 years in Victoria, Tasmania and the Australian Capital Territory, and to remain responsible for costs relating to third party claims regarding its joint venture activities occurring prior to March 1999.

3.6.58 The final sale agreement also included a new venue and box office ticketing agreement between the Trust and Ticketmaster Corporation. The key terms of this agreement included:

- an initial term of the agreement for 5 years, with an option for the Trust to extend the term for a further period of 3 years;
- the venues covered by the agreement include the Melbourne Concert Hall, the State Theatre, the George Fairfax Studio and the Playhouse which are situated at the Victorian Arts Centre, the Sydney Myer Music Bowl and any other facility controlled by the Trust, excluding car parking facilities;
- the Trust to receive a ticket royalty for each ticket sold by Ticketmaster at the above facilities controlled by the Trust; and
- the achievement of certain service standards in the provision of the Ticketmaster Corporation's ticketing services to the Trust.

3.6.59 The Trust's management have advised that the Trust will receive additional ticketing revenue during the initial term of the new venue and box office ticketing arrangement.

Assessment of sale result

3.6.60 Our analysis of the sale result of the Trust's interest in the 2 joint ventures indicated that:

- the total sale proceeds were at the lower end of the valuations obtained prior to the sale, and well below the recommended sale price advised to the Trust in August 1998;
- the sale price was \$3.19 million higher than the combined book value of the Trust's interest in the 2 joint ventures; and
- the net sale proceeds to the Trust, after taking into account the costs of sale of approximately \$511 000, were around \$3.4 million.

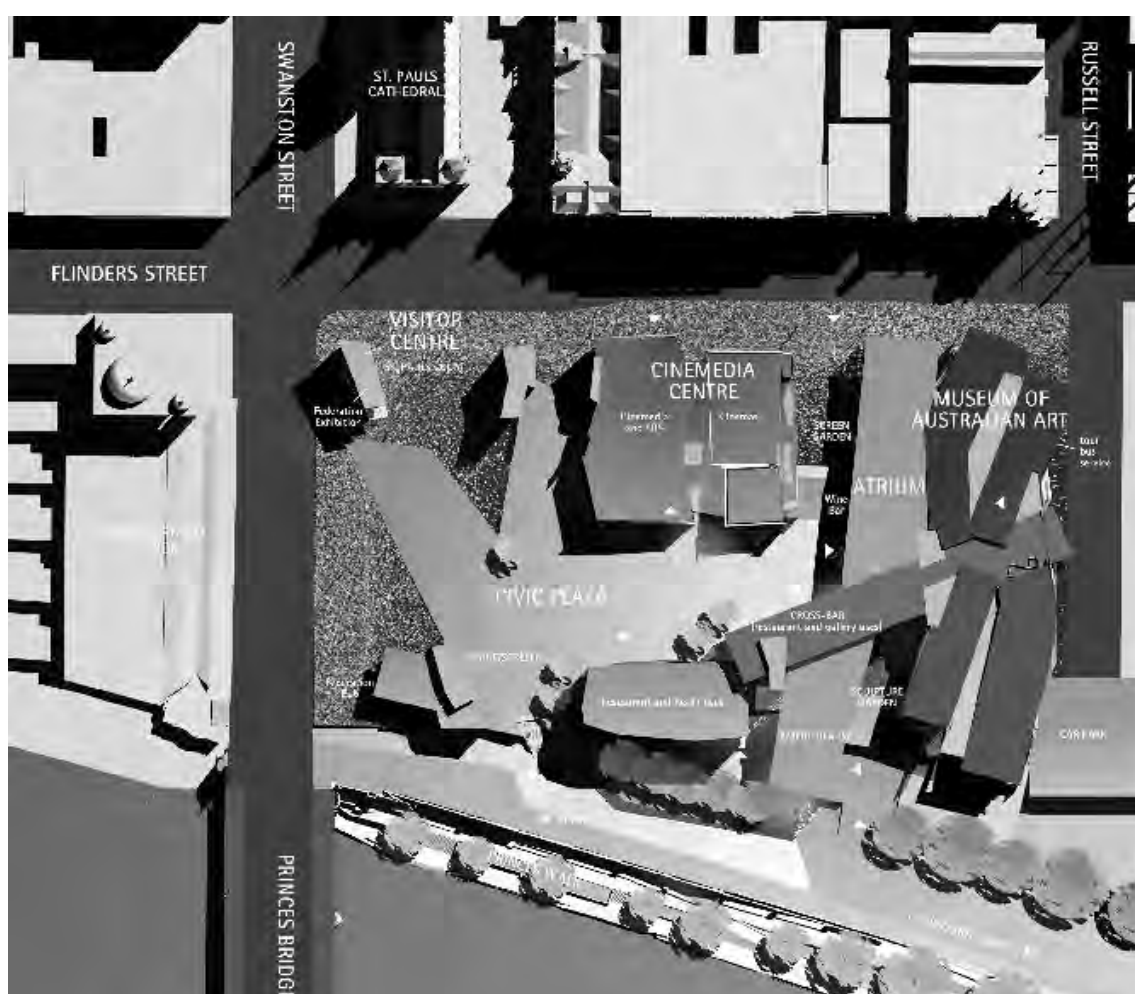
NO RESPONSE was provided by the Victorian Arts Centre Trust to the issues raised.

DEVELOPMENT OF FEDERATION SQUARE

3.6.61 The Federation Square Project (the Square) was launched in March 1996 as a joint venture initiative of the Government and the Melbourne City Council, involving the development of a 3 hectare site situated between Flinders Street and the Yarra River at the edge of the Melbourne central business district. The Square is being constructed over the Flinders Street railway lines.

3.6.62 Key design features of the Square are to include:

- a Civic Plaza and Atrium;
- the Museum of Australian Art, which is an extension of the National Gallery of Victoria;
- Cinemedia Centre, incorporating the Special Broadcasting Service (SBS);
- a mix of food and beverage outlets, including a boutique bar and hotel;
- a book and music superstore; and
- a tourist and visitor information centre.



Aerial view of Federation Square.

Note: Image courtesy of Lab & Bates Smart Architects and includes the Western Shard which has been removed from the design.

3.6.63 A Civic and Cultural Charter has been developed for the Square which recognises Melbourne's position as a centre for creativity and innovation, its diverse and successful arts and cultural festivals, its multi-cultural heritage, the popularity and beauty of its gardens and river and the need for a new focal point for contemporary cultural activities. The Charter requires that these themes are incorporated in the Square's management philosophy, marketing, programmed events and activities, and hiring and sub-leasing activities, including the presentation and market positioning of its commercial spaces. That is, all components of the Square are to be operated and managed in accordance with the Charter.

3.6.64 The Square, which is a project managed by the Office of Major Projects of the Department of State and Regional Development (the Project Manager), initially involved the demolition of the former Gas and Fuel Corporation towers and Princes Plaza. It is also part of a broader project encompassing the rationalisation of the Jolimont rail yards and the development of a new 8 hectare park next to the Yarra River designed to house major outdoor events as well as providing recreation areas east of Exhibition Street, provisionally known as Riverside Park.

Joint Venture Agreement and Trust

3.6.65 The terms of the joint venture arrangement between the Government and Melbourne City Council for the development of the Square are set out in an Agreement between the Premier and the Council dated March 1996 and include:

- The parties' common aim is to realise the Federation Square Project by 31 December 2000;
- The removal of the former Gas and Fuel Corporation towers and associated car park structure, Princes Plaza and the Metrol building in Batman Avenue;
- The parties acknowledged that significant alterations to the Public Transport Corporation's infrastructure in the area are required, and are a cost element of the Square;
- The Project Manager had provisionally estimated that the public sector capital expenditure required for the Square is approximately \$110 million;
- The parties will commit funds and consult each other on the expenditure of these funds and the further refinement of the Square's uses, design and procurement; and
- The parties acknowledge that the Government will have legal responsibility for taking decisions on the Square. The Government agrees, through the responsible Minister, to take advice from the Steering Committee established to oversee the development of the Square, before taking decisions on key implementation proposals in relation to the Square.

3.6.66 The Agreement was subsequently amended in June 1997. The amendment contained inclusions to acknowledge that:

- the scope of the Federation Square Project had been modified from that originally set out in the Agreement, whereby the Public Transport Corporation's works, open space works and major improvements in Batman Avenue and street improvement works in Flinders and Swanston Streets were to be excluded;
- the estimates of the public sector capital expenditure required for the Square had increased from \$110 million to \$128 million; and
- nothing in the 1997 Agreement would require the Council to make any further capital contribution to the Square, beyond \$64 million, even if there is further cost escalation.

3.6.67 Under the terms of the March 1996 Agreement, a principal sum of \$100 million, including a \$50 million contribution in the 1995-96 financial year from the Consolidated Fund together with an equivalent contribution provided by Council, was held in a specific purpose trust account with the State Trustees Limited, for use on the development of the Square. This contribution, together with anticipated interest earnings, was intended to fund the initial estimate of \$110 million.

3.6.68 In June 1997, capital contributions by the Government and Council for the development of the Square were increased by \$14 million each. In addition, Council committed a further \$15 million to upgrade and extend the gardens along and around Riverside Park, with a corresponding commitment by the Government to fund further Public Transport Corporation rationalisation of the Jolimont rail yards related to the Square at an estimated cost of \$35.5 million.

Management arrangements for the design, construction and operation of the Square

3.6.69 A Steering Committee was established in 1996 to oversee the development of the Square which consisted of a Project Manager and representatives from the Department of Premier and Cabinet, the Department of Treasury and Finance, and the Council.

3.6.70 A specific body to make financial decisions was also established at the beginning of 1997, called the Principal Expenditure Control Body (PECB). Its objective was to establish budgetary controls and accountability over the operations of the Trust Fund, and to agree on an expenditure approval process for adoption by the Steering Committee. The PECB consisted of representatives of the Department of Premier and Cabinet, the Department of Treasury and Finance, and the Council.

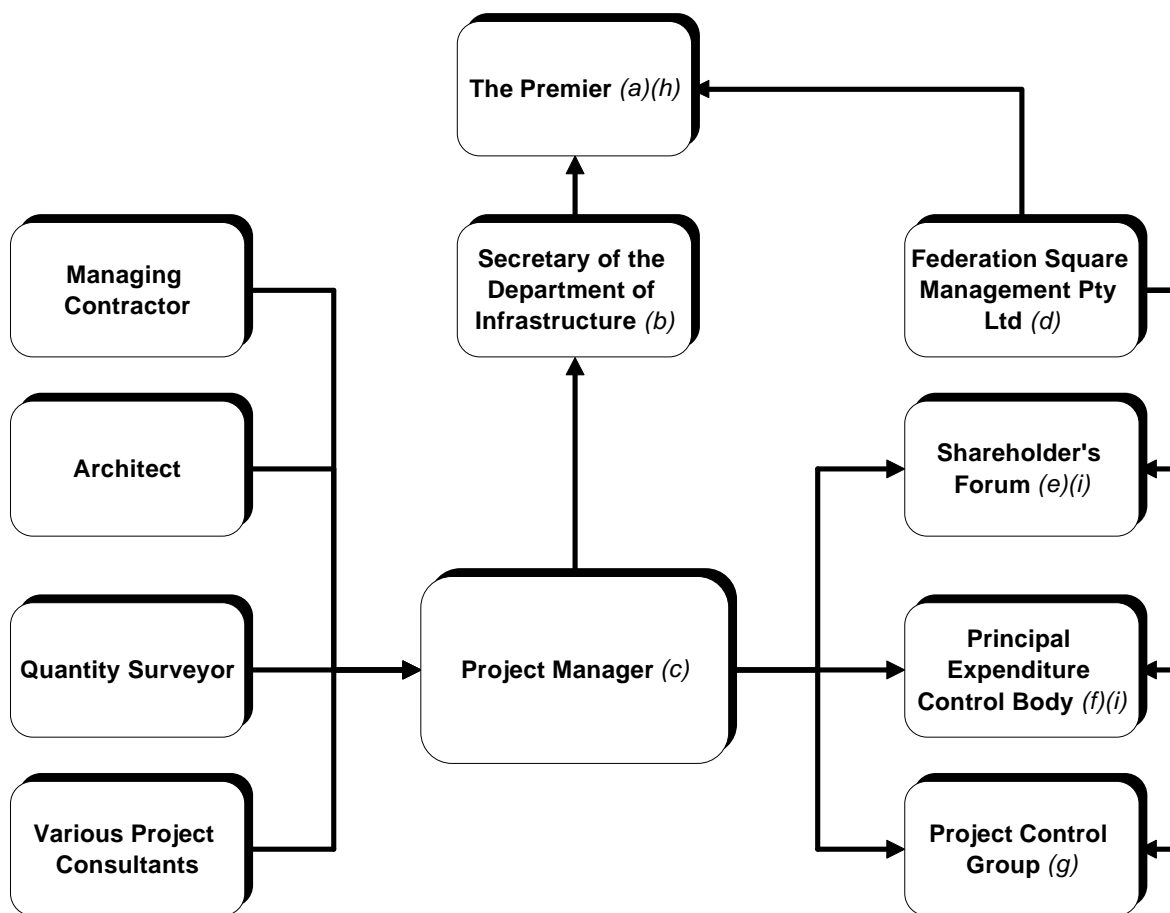
3.6.71 Based on the minutes of the meetings of the Steering Committee, the Project Manager has kept the Steering Committee apprised of key decisions taken in connection with the Square. However, based on these minutes, the Steering Committee has held concerns over the timeliness of information it has received from the Project Manager but has not played a formal role in certain key decisions relating to the Square, such as the decision to add a Museum of Australian Art to the Square, the appointment of the Managing Contractor and the adoption of a trade package contracting approach which is discussed later in this Report. This in part has arisen due to the direct relationship between the Premier, as the responsible Minister under the *Project Development and Construction Management Act 1994*, and the Project Manager. The Council representatives on the Steering Committee have also expressed concerns over the extent of information provided by the Project Manager.

3.6.72 The Steering Committee was replaced in late 1999 by a Shareholders' Forum and a Project Control Group was created. The Project Control Group focuses on operational issues so as to ensure the co-ordinated delivery of the Square, while the Shareholders' Forum aims to protect the shareholders' strategic interests.

3.6.73 Although the Project Manager was a member of the former Steering Committee and is a member of the Project Control Group, we are of the view that the objectivity of these groups would have been better served had the Project Manager not been a member of either of the groups, but should have been answerable to these groups.

3.6.74 The current management arrangements for the Square are depicted in Chart 3.6D.

**CHART 3.6D
FEDERATION SQUARE MANAGEMENT ARRANGEMENTS**



- (a) The Premier is responsible for the Square pursuant to the *Project Development and Construction Management Act* 1994.
- (b) The Secretary of the Department of Infrastructure's role included approving the appointment of the Managing Contractor under the Act and delegating power to the Project Manager to enter into a contract with the Managing Contractor for the Square. The Project Manager is now part of the Department of State and Regional Development.
- (c) The Project Manager, being the Office of Major Projects originally within the Department of Infrastructure but now within the Department of State and Regional Development, had responsibility for concept development and preparation of the brief for the international architectural design competition. It also has responsibility for the management of the architects, managing contractors, quantity surveyors, all tendering processes and various project consultants.
- (d) The Federation Square Management Pty Ltd was incorporated in 1999 and is responsible for facility management (tenancy and building issues) and cultural and civic programming. The Company will also be responsible for the management of the Square on its completion.
- (e) The Shareholders' Forum comprises representatives of the Department of Premier and Cabinet (Chair), Department of Treasury and Finance, and Council.
- (f) The Principal Expenditure Control Body comprises representatives of the Department of Premier and Cabinet (Chair), Department of Treasury and Finance, and Council.
- (g) The Project Control Group comprises representatives of the Federation Square Management Pty Ltd (Chair), Council, Arts Victoria (a division of the Department of Premier and Cabinet), Project Manager, Department of Premier and Cabinet, National Gallery of Victoria, Cinemedia and SBS.
- (h) The Department of Premier and Cabinet provides briefings to the Premier and liaises between the various bodies involved in the project and is also responsible for negotiations with the Commonwealth Government for seeking grants from the Federation Fund.
- (i) The Department of Treasury and Finance monitors financial matters associated with the Square through its representatives on the various committees.

3.6.75 A review of the management arrangements for the Square, which was jointly sponsored by the Secretaries of the Department of Premier and Cabinet, the Department of Treasury and Finance, and the Department of State and Regional Development, was undertaken in early 2000. The report outlining the results of that review, which was provided to my Office during April 2000, disclosed:

- It was essential that roles, responsibilities and accountabilities of the various parties involved in the Square are clearly defined and that a management structure be established so that all parties have the incentive to fulfil their responsibilities. It was evident that the management arrangements for the Square did not fulfil these 2 core criteria;
- There had not been a sufficient distinction between the client agency and sponsor department, with the sponsor department (the Department of Premier and Cabinet) taking on aspects of both roles, however, the interests of the 2 are not always identical. The sponsor department is responsible for ensuring that the Square is delivered in accordance with government policy and overall control of appropriated funds while the client agency (Federation Square Management Pty Ltd, National Galley of Victoria, Cinemedia and SBS), as end users of the facility, are responsible for the identification of what is required from the Square in order to meet program or service delivery obligations within the Government's policy framework;
- The Project Manager's responsibilities are wide-ranging under the Act and it has variously performed the role of client agency and project manager leading to potential conflicts of interest. Concerns over its level of accountability and relationship with the shareholders (which are taken to include the Council) were also identified in the context of the Project Manager's direct relationship to the former Premier as the responsible Minister under the Act for the Square;
- The administrative arrangements for managing the project are unusual where the Premier is the Minister responsible under the Act for the Square and the Minister for Major Projects has no substantive role. This is the only major project where the responsible Minister is not the Minister for Major Projects;
- There was a lack of clarity about scope and cost of the Square from the outset; and
- Issues relating to the cost, funding and budget of the project are yet to be reconciled (refer to related comments on these matters which appear later in this section of the Report).

3.6.76 At the date of preparation of this Report, the Government was considering the findings and the recommendations contained in the departmental report.

Federation Square architectural design competition

3.6.77 The design of the Square was based on the outcome of an international architectural design competition that was launched in November 1996. A panel comprising specialists in architecture, the arts and major projects judged the competition, which attracted 177 entries. Specified criteria were applied in assessing the entries and selecting the winning design.

3.6.78 The conduct of the competition was subject to review by a professional advisor. No concerns were raised in the reports of the advisor made available to my Office in connection with the fair and equitable conduct of the competition.

3.6.79 The rules of the competition stated that a design would be excluded from the competition if the judging panel determined that the probable cost of a proposed design exceeded the stated cost limit of \$128 million. However, all of the short-listed designs, including the winning design, exceeded this cost limit based on the estimates supplied by each competitor and preliminary estimates of those designs by the Project Manager's then quantity surveyor which varied from \$152 million to \$172 million. Accordingly, other competitors who submitted designs which may have complied with the cost limit were at a disadvantage.

3.6.80 In July 1997, the Premier and the Lord Mayor of Melbourne, publicly announced that *Lab Architecture Studio* of London in association with *Bates Smart Architects* of Melbourne, were the winners of the Federation Square architectural design competition.

3.6.81 During October 1997, and prior to the calling of tenders for construction of the Square, the Project Manager's quantity surveyor estimated the cost of constructing the winning design at \$249 million. The estimated cost was significantly above the stated cost limit of \$128 million for the development of the Square and, based on Steering Committee minutes, was not considered by the Steering Committee. Prior to the calling of tenders, changes were made to the winning design which on the one hand reduced the extent to which the cost limit had been exceeded but on the other also added further features.

3.6.82 The winning design included:

- a large irregularly shaped civic square;
- a plaza to be known as St Paul's Court, for alfresco dining, street theatre and music;
- a building complex along the Flinders Street frontage, which will provide space for a gallery, performing arts and cafes;
- a building complex for the Cinemedia Centre, multi-media facilities and offices;
- a glass wintergarden atrium that slices through the 2 major building complexes, complete with rainforest and desert greenhouses; and
- a free-standing restaurant and viewing tower.

3.6.83 A key change to the winning design, prior to the calling of tenders for construction, included the addition of a Museum of Australian Art.

3.6.84 The winning design for the Square also included 2 large glass shards in the St Paul's Court area of the Square. This design feature produced a mixed response, the main issue being the obstructed view of St Paul's Cathedral from Princes Bridge end of the Square. In February 2000, the Government commissioned an independent review of the impact of the Shards on the view of St Paul's Cathedral. The Government subsequently announced its decision during March 2000 to remove the Shard at the western end of the Square.

3.6.85 In May 2000, the Government announced the appointment of a working party to consider part of the design of the Square given the removal of the Shard. The Square was originally intended to be completed by mid June 2000 (excluding fitout works). Prior to the removal of the Shard the estimated completion date had already been extended to May 2001.



Façade of the Cinemedia Centre under construction at Federation Square.

Tendering processes for construction of the Square

3.6.86 In November and December 1997, a pre-qualification process was conducted to assess likely contractors to perform construction work on the Square. The pre-qualification process involved inviting potential contractors selected by the Project Manager to submit an expression of interest to undertake construction works on the Square. A public invitation for expressions of interest was not issued or required of the Project Manager under the prevailing legislative framework for the Square. **Nevertheless, it is our view that a public invitation for expressions of interest would have been desirable from the perspective of ensuring that the greatest possible range of potential tenderers were identified.**

3.6.87 The expressions of interest submitted by the selected contractors were assessed on the basis of established criteria including the financial position of the companies, level of bank guarantees, major contracts undertaken, discipline experience, project organisation, design manager experience, industry experience and quality assurance.

3.6.88 In March 1998, the Project Manager decided to issue invitations to tender to 6 contractors, as ranked by the evaluation team, for managing the design and construction and for carrying out works in relation to the Square. Specifically, tenderers were required to prepare submissions for:

- construction of a deck over the operating rail lines to support various civic, cultural and commercial buildings and spaces;

- construction of a Museum of Australian Art, Cinemedia Centre, Visitor Information Centre, public atrium spaces, a performance venue, food, beverage and retail outlets, and associated external works and landscaping including a civic plaza;
- a car park; and
- an adjoining commercial development on 2 sites comprising a function centre, boutique bar and space for other commercial/entertainment uses.

3.6.89 The background information prepared by the Project Manager, as part of the pre-qualification and tendering processes, indicated that:

- **construction of the deck by the successful contractor will proceed ahead of the completion of the schematic architectural design of the superstructure to be built on the deck**, such as the buildings, to achieve construction of the Square by the end of 2000;
- the successful contractor is expected to use their best endeavors to produce the most cost-effective deck structure and substructure works once the building designs and deck loadings are finalised; and
- during the tender period ongoing development of the Project's design concept and documentation may continue.

3.6.90 Under this approach, the conventional process of preparation of full design documentation and subsequent calling of a lump sum tender for the works was not applied. The Project Manager had instead proposed to appoint a managing contractor who would assume responsibility for undertaking certain key works, such as the construction of the deck, under a lump sum price arrangement, and manage the rest of the works through the conduct of a tendering process for superstructure works as design documentation for those works became available.

3.6.91 The superstructure works were proposed by the Project Manager to be tendered on the basis of trade packages, for example plastering works, rather than on the basis of an entire structure such as the Museum of Australian Art. The application of a trade package approach is considered later in this section of the Report.

Evaluation of tenders

3.6.92 In April 1998, 6 tenders were received and were assessed by the evaluation team comprising representatives from the Project Manager, an external project quantity surveyor, an external project programmer and construction adviser, and a project coordinator from the Department of Infrastructure.

3.6.93 Several discussions and meetings were held with each of the tenderers to clarify and resolve technical issues associated with their tenders. Once the evaluation team determined that all tenderers were capable of delivering the project and all technical issues had been resolved, the 2 lowest bid submissions were short-listed for further evaluation and interviews. Following this process the acceptance of the lowest tender, Multiplex Constructions (the Managing Contractor), was approved by the Secretary of the Department of Infrastructure in May 1998 on the recommendation of the Project Manager consistent with the conclusion reached by the evaluation team.

3.6.94 The Victorian Government Purchasing Board has developed guidelines to assist in the evaluation of tenders. The guidelines provide that the evaluation of bids using a weighted analysis technique, whereby each measurable criterion are assigned a weighting (in the form of points and/or percentages), is the preferred way of summarising information for the comparison of tenders and is usually used to support the final recommendation.

3.6.95 The guidelines further state that the tendered solution receiving the highest weighted score is prima-facie the most attractive offer. Consideration is then given to cost, which is not weighted. The guidelines provide that evaluators need to assess whether a higher point score justifies paying a higher price, where this situation occurs. This necessarily involves a value for money judgment.

3.6.96 Our review identified the following issues in respect of the assessment of tenders undertaken by the evaluation team:

- Unlike the pre-qualification process, where expressions of interest were assigned scores over many criteria and given an overall ranking based on their total score, **individual scores were not assigned to each of the evaluation criteria, including the related elements, or an overall score established for each tender;** and
- There was evidence that a number of discussions were conducted with each tenderer and a report was prepared setting out the evaluation team's assessment against only the financial criteria. **A consolidated report was not prepared which detailed how the successful tenderer offered the best value for money proposal by reference to the assessed overall score achieved for each of the evaluation criteria relative to the other tenderers and their respective tendered amounts.** Such an approach is of particular relevance to an undertaking such as the Square, which includes unique design and construction challenges, has substantial cultural and civic importance to the State, and involves significant outlays by taxpayers.

Probity of tendering processes

3.6.97 The Victorian Government Purchasing Board's guidelines also declare that the probity of the tendering and contracting process is the responsibility of all members of tender evaluation teams. In particular the guidelines support the need for a probity auditor where the transaction is of a high value, the matter is highly complex, unusual or contentious, or the nature of the marketplace makes grievances by tenderers more likely.

3.6.98 The role of a probity auditor is to provide an opinion as to whether the tendering and contracting process used is fair and that the tender selection process is conducted in accordance with that in the tender documents.

3.6.99 **The tendering process for the Square was not subject to an independent probity audit,** even though this was requested by members of the Steering Committee for other phases of the project and despite assurances given to the Steering Committee by the Project Manager in respect of the commercial tendering arrangements. As a consequence, best practice guidelines have not been applied and the benefits from a probity audit have not been realised, including attaining independent assurances over the fairness and equity of the tendering arrangements.

Managing Contractor Agreement

3.6.100 In July 1998 an Agreement was entered into between the Secretary of the Department of Infrastructure and the Managing Contractor to provide certain services, manage risks and construct certain works. The Agreement included:

- Element 1 – completion of the upper section of the crash wall, construction of other designated foundations not included in the early substructure works, construction of a deck over the underlying railway tracks on part of the site and associated minor demolition works;
- Element 2 – construction of certain buildings and installation of services for those buildings, undertake fitout works and installation of furniture, fittings and equipment not undertaken by tenants, and completion of external and landscaping works for the nominated areas using trade package contracting;
- Element 3 – construction of the public car park; and
- Element 4 – construction of the boutique bar and hotel, function centre and other commercial areas.

3.6.101 Element 4 relates to the commercial aspects of the Square which are intended to be privately financed. **At the date of preparation of this Report, private financing arrangements had not been finalised. Nevertheless, the Agreement provides for the construction of these parts of the Project without any qualification related to the dependencies of these works on private financing.** The Agreement does, however, reserve a right to the Secretary of the Department of Infrastructure not to proceed with nominated elements of the Square subject to the Managing Contractor being given reasonable notice and the overall programming of the works not being adversely affected. If the Secretary exercises this right, the Secretary must ensure that the Quantity Surveyor makes an allowance for the Managing Contractor's preliminaries and its fee in relation to the deleted element.

3.6.102 As at January 2000, \$1.5 million had been committed to the element 4 works. These works have an estimated total cost of \$15 million.

Allocation of risks to the State

3.6.103 Risks have generally been assigned to the Managing Contractor under the terms of the Agreement, however, the following risk exposures are to be borne by the State:

- omissions, discrepancies and ambiguities existing in the design and documentation of the works;
- design of any works not fit for the purposes for which it was intended;
- State or nationwide industrial disputes;
- variations initiated by the Secretary; and
- delays by tenants in carrying out their fit-out activities.

3.6.104 Under the Agreement the risk of omissions, discrepancies and ambiguities existing in the design and documentation of the works was to be borne by the Managing Contractor. In particular, the Agreement provided that following a review and adoption of a revised target cost plan at the completion of the schematic architectural design stage, the Managing Contractor would manage the design and construction works to ensure that the final cost of the works did not exceed that targeted. However, as the State did not novate the architects agreement to the Managing Contractor as provided for in the Managing Contractor's agreement, the design risk has remained with the State. In addition, corresponding adjustments to the Managing Contractor's fees have not been made to compensate for the acceptance of this risk by the State.

Variation of the deck structure

3.6.105 The contract was awarded to the Managing Contractor on the basis of their conforming tender, which was the lowest bid. The Secretary was advised, at the time of approving the appointment, that the Managing Contractor had offered a number of alternatives related to the construction of the deck, some with cost savings, which at the time were not considered preferable to that contained in their conforming tender. The tender documentation had required submission of conforming tenders on the basis of a concrete deck and allowed for submission of alternative options for the construction of the deck.

3.6.106 After the approval and acceptance of the tender, but prior to the actual execution of the contract, the Managing Contractor made representations to the Project Manager to change the deck construction from concrete to a steel alternative, which had been submitted with its conforming tender. The estimated costs submitted by the Managing Contractor for the construction of the steel alternative were lower than that of the concrete deck. The Project Manager subsequently accepted the proposed steel deck alternative. This is despite advice given to the Secretary at the time of approving the appointment of the Managing Contractor that the alternative options for the construction of the deck were then considered not preferable to the conforming tender.

3.6.107 The Project Manager entered into the contract with the Managing Contractor, under authority delegated by the Secretary, which provided for construction of a steel deck without any adjustment for the estimated cost reduction of approximately \$590 000.

3.6.108 Other short-listed tenderers were not given the opportunity to re-submit their tenders on the basis of a steel deck.

Trade contractors

3.6.109 As previously referred to in this section of the Report, a trade package approach was adopted for the construction of the superstructure to be built on the deck. This approach was preferred by the Project Manager due to the evolving nature of the Square, the absence of final designs and plans, and because it was envisaged that it would provide competitive outcomes and assist in the achievement of deadlines. However, a fixed lump sum contract approach was advocated by the Department of Treasury and Finance, as the fixed price trade package approach amounted to a cost plus arrangement which exposed the State to cost and timing risks that would be avoided under a lump sum approach, should it be possible to competitively secure fixed lump sum contracts in the absence of full design documentation.

3.6.110 Under the Agreement, the Managing Contractor is responsible for the management of trade package works and must undertake the following tasks in carrying out this function:

- define the scope and nature of trade packages;
- consult and agree with the quantity surveyor upon a pre-tender estimate for each trade package;
- prepare tender documents, manage the process of selecting pre-qualifying tenderers, call tenderers and co-ordinate the assessment of tenders in conjunction with the Secretary, design consultants and Project Manager's quantity surveyors;
- obtain the Secretary's approval before the engagement of any trade contractor;
- co-ordinate, control and supervise the execution of trade contracts;
- accept the risk of the performance of the trade contractor relating to timeliness, cost escalation and quality; and
- issue directions for variations to the trade contract work to be performed.

3.6.111 **Our review of the process followed for the tendering and awarding of a sample of trade contracts did not identify any key procedural deficiencies other than concerns recently raised by the Project Manager's quantity surveyor, which have implications for the completion and cost targets for the Square.** The concerns identified by the Project Manager's quantity surveyor include:

- design documentation details not in accordance with the limits outlined in the target cost plan;
- incomplete design documentation issued for measurement of trade packages;
- design and re-design continuing after trade packages were subject to tender; and
- significant design changes during the shop drawing process.

3.6.112 The Project Manager's quantity surveyor has attributed the above issues to the complexity of the design of the Square and pressures to achieve construction program milestones.

Variation claims

3.6.113 The Managing Contractor has submitted a number of claims for additional costs. Our Office was advised that claims totalling \$10.5 million had been agreed as at the date of preparation of this Report arising from the evolving design of the Square, changed loadings on the deck, costs associated with delays, industrial disputes, change proposals and variations, and increased fees. Further claims valued at \$6.1 million remained unresolved. These variations are additional to the original approved contract amount of \$34.5 million with the Managing Contractor.

Commercial tendering arrangements

3.6.114 A retail strategy was adopted during 1998 that defined the commercial theme, retail mix and projected financial outcomes of the commercial operations of the Square. The strategy determined 11 separate commercial opportunities, including the Federation NeoPub, a Book and Music Superstore, multi-media retail outlet, a function centre and 5 restaurants and cafes.

3.6.115 An expression of interest process commenced in December 1998 to secure tenants and operators for the commercial activities in the Square. Expressions of interest were evaluated by a review panel (comprising representatives of the Project Manager and consultants, and later involved representatives of Federation Square Management Pty Ltd) which led to invitations to short-listed parties to submit formal binding bids for tenancy. These submissions were assessed in terms of commercial viability, delivery capacity and leasing and/or purchase offers by the Commercial Planning Sub Committee comprising representatives from Council, Department of Premier and Cabinet, Department of Treasury and Finance, and the Project Manager.

3.6.116 It was envisaged that subject to a briefing, assessment, review and approval processes, commercial offers could be finalised between July 1999 and October 1999.

3.6.117 In November 1999, external consultants were engaged on a success fee basis by the Federation Square Management Pty Ltd to draft all legal documentation and secure tenants and finance, for the Book and Music Superstore and the NeoPub.

3.6.118 As at the end of February 2000, 10 of the 14 separate commercial operations were at various stages of the tender and evaluation process. In summary as at the date of preparation of this Report, 3 tenancies were agreed subject to agreement being reached on the terms of the leases, 5 tenancies were being negotiated and discussions were being held with potential tenants for 2 of the tenancies.

3.6.119 Also, at the date of preparation of this Report, title to the site had not been structured in accordance with the proposed basis of development and arrangements had not been put in place which would enable the company to sub-lease the respective segments of the site to commercial tenants. As a result, the finalisation of leasing arrangements by the company would be more difficult but, as indicated above, final agreement has not been reached on the terms of the leasing arrangements with any of the prospective commercial tenants.

Event programming strategy for the Square

3.6.120 Planning for activities and events commenced with the development in March 1998 of a programming strategy for the Square. The strategy paper emphasised that in addition to the number and type of ticketed and sponsored events to be programmed at Federation Square, of major importance to the Project's initial success would be the Federation Square Opening Ceremony and Federation celebrations.

3.6.121 A cultural programming review was undertaken in November 1998 to consider an appropriate strategy relating to the programming and production of events, performances and activities to be provided on an ongoing basis at Federation Square.

3.6.122 The Federation Square Management Pty Ltd has also commenced preparation of a public events program for the Square. In so doing, a number of meetings have been held with representatives from the major arts and event organisations to develop strategies to secure major festivals and events.

3.6.123 **As most local festivals and events are held in the November to April period, Federation Square Management Pty Ltd anticipates that programming of events at the Square, with the possible exception of one event, may not commence until 2002 given the expected completion date of the Square of May 2001.**

Federation Square management company

3.6.124 The Federation Square Management Pty Ltd was set up in June 1999 with responsibility for managing the Square after its completion. The current operations of the company include an extensive involvement in the commercial leasing program, preparing for the opening of the Square, and developing a program of cultural and civic activities to be held at the Square into the future.

3.6.125 For the 6 months period ended 31 December 1999, the company had incurred costs of \$164 000.

3.6.126 The company currently has one shareholder, the State, but it was intended that the Council would also take up a shareholding in the company, however, this depends on the resolution of a number of outstanding issues, including the satisfactory development of a sustainable business plan for the company.

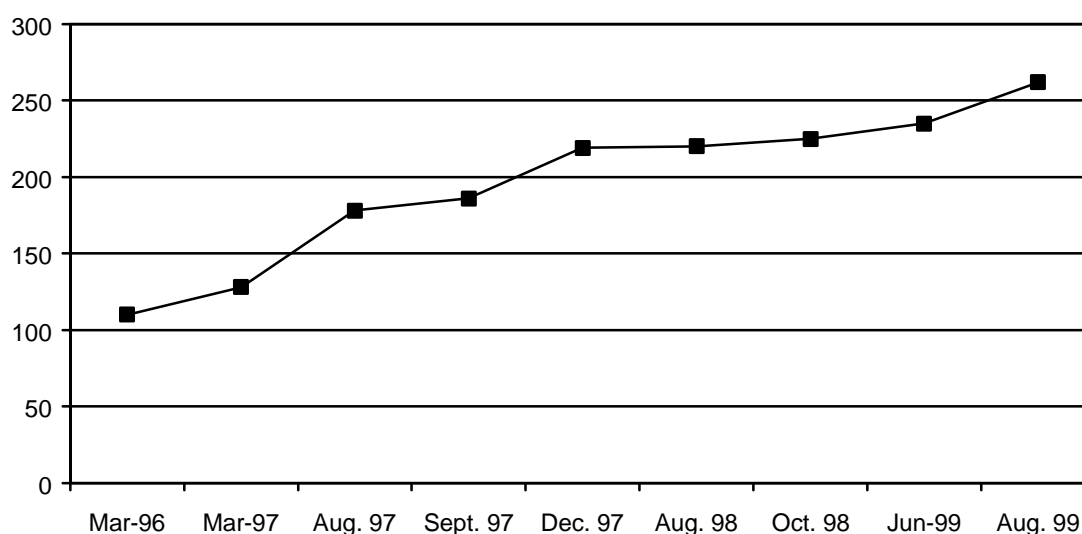
3.6.127 In 1996, consultants were commissioned to prepare a business plan for the operation of the Square. The original business plan was substantially modified in 1997 and 1998 to allow for changes in designated uses and concepts and to refine costings in relation to building outgoings, deletion of car parking revenue and the removal of a refurbishment sinking fund. Adjustments were also made to the business plan to reflect the impact of increased retail areas under proposed retail leases and the predicted average rental rates.

3.6.128 **The latest business plan prepared for the Square was finalised in August 1998. The company is currently in the process of developing an updated business plan, which should indicate the latest position concerning the ongoing financial viability of the Square.**

Estimated total cost of the Square

3.6.129 The Project Manager prepared an original cost estimate for the development of the Square of \$110 million in March 1996. Since that time, the estimated cost of the development of the Square has continued to escalate as detailed in Chart 3.6E. It should be noted that the revised cost estimates are not comparable with the original cost estimate given the changing and evolving nature of the Square, and the subsequent exclusion of certain related costs and inclusion of other costs.

CHART 3.6E
FEDERATION SQUARE –
ESTIMATED COST OF DEVELOPMENT
 (\$million)



3.6.130 The latest cost estimate of \$262 million prepared in August 1999, which was based on an expected completion date of May 2001, is now outdated given the recent change in the design of the Square including deletion of one of the Shards. In addition the latest cost estimate does not seek to capture the total cost of the Square. The following costs were not included in that estimate:

- Expenses incurred and to be incurred by the Federation Square Management Pty Ltd, associated with the opening ceremony for the Square and other associated costs - estimated at \$7.5 million;
- Any further variations in costs arising from the 40 per cent of trade package contracts yet to be committed;
- The costs associated with any further industrial disputation or any adverse changes in industrial terms and conditions which impact on the State;
- The cost of any further changes to the scope of the project;
- The impact of the introduction of the goods and services tax (GST);
- State-funded costs of demolition of the former Gas and Fuel Corporation Towers and Princes Plaza (which cost \$6.4 million to demolish, of which only \$1 million is included in the August 1999 estimate);
- State-funded street improvement works at Swanston and Flinders Streets;

- Council-funded works of upgrading and extending the gardens along and around the park provisionally known as Riverside Park (estimated at \$15 million in 1997). These works were not originally envisaged to be part of the Square but acted as an enhancement to the Square. Nevertheless, they were part of the commitments made by Council in connection with the changed funding arrangements in 1997; and
- The State-funded public transport corporation rationalisation works at Jolimont rail yards of which \$35.5 million was estimated in 1997 to be attributable to the development of the Square.

3.6.131 The Project Manager's cost estimate includes a net amount of \$5.1 million for contingencies which potentially could account for some of these additional costs.

3.6.132 The above cost estimates also do not include the net costs of maintaining the Square on an ongoing basis and are based on the cost of construction of the Book and Music Superstore, the NeoPub and the function centre not being borne by the Government.

3.6.133 Some of the above expenditure not included in the Project Manager's estimate of total costs will not require additional funding by the State.

3.6.134 The key causes of cost escalations from the March 1996 cost estimate of \$110 million to the August 1999 cost estimate of \$262 million are set out below:

- **The initial budget was established before the project brief and design concept was finalised.**

The Project Manager established the original cost estimate of \$110 million for the Square based on a broadly defined project scope while concept development had not been finalised, and only limited design work had been carried out. In particular, the estimate assumed a floor space limit of 26 000 square metres, however, the present design is about 39 000 square metres. Nevertheless, the present design size is consistent with the original joint venture agreement which provided for up to 40 000 square metres of floor space comprising generally low rise development. In addition, the original estimate included rail and other works which were subsequently excluded from the cost estimates for the Square under the 1997 amendment to the Joint Venture Agreement.

- **The international design competition was not adequately constrained by cost limits.**

A decision was taken by the City of Melbourne and the Government to hold an international design competition which provided the project with considerable publicity. One intended constraint of the competition was a cost limit of \$128 million for proposed designs, however, the Project Manager's quantity surveyor, during October 1997, estimated the cost of the winning design at \$249 million.

- **Additional unique design features.**

The winning design and the competition itself introduced further elements into the Square not anticipated in the original concept costings of the Project Manager, including unique design features such as environmental and sustainable development features, and secondary decking for a raised Civic Plaza. The Project Manager has estimated the increased cost of these features at approximately \$22 million.

- **The project brief was substantially expanded.**

Over the period of both concept development and the subsequent detailed design work, the scope of the project was expanded to include the following, increasing the cost by approximately \$72 million according to the Project Manager's cost estimates:

- a new Museum of Australian Art was introduced, which increased the floor space by 40 per cent;
- the closure and redevelopment of Batman Avenue;
- the raised standards for the deck's crash walls systems;
- the inclusion of a car park;
- increase in floor space requirements for Cinemedia and SBS; and
- increase in facilities associated with the principal buildings.

- **Suspension of work and industrial disputes, delaying the Square by several months.**

The site has experienced industrial unrest and the Government halted work on the site in early 1999, with work not resuming until a Federation Square Productivity Agreement was negotiated and executed in May 1999 between the Managing Contractor and union representatives. There have been further industrial stoppages since that time, mainly relating to industry-wide occupational health and safety issues. These delays were estimated by the Project Manager to have cost \$9 million.

- **Higher costs for trade package contracts when compared with that originally estimated by the Project Manager.**

A decision was made to procure the superstructure with trade package tendering, however, this tendering approach did not produce the competitive outcomes anticipated by the Project Manager. Difficulties have been experienced by the Project Manager in securing a fully competitive tendering market for key elements such as the concrete works, steel structures, and complex design features such as the facade and the atrium. These unfavourable conditions have been estimated by the Project Manager to increase costs by approximately \$8 million.

- **No provision for price movements.**

The original cost estimate did not take into account the impact of movements in prices until the completion of the Square. The Project Manager has estimated that this cost will amount to \$19 million.

- **Change from a private to public operator of the Square.**

The original brief for the Square developed in 1996 provided for the private sector to operate the Square on its completion. The subsequent change to utilise a public sector-owned company to manage the Square has, in the estimation of the Project Manager, added \$4 million to the cost in fit-out and management expenses of the Square.

Funding of expenditure on the Square

3.6.135 At the date of preparation of this Report, we understand that funding for the Square had not been finalised beyond the original \$128 million contributed by the State and Council and a further amount of \$84.6 million to be contributed by the State which was only approved by the Government during April 2000. We were advised that potential funding of \$50 million from the Commonwealth Government was yet to be finalised.

3.6.136 As a consequence, based on evidence made available to my Office at the time of preparation of this Report, the August 1999 estimated cost of completing the construction of the Square of \$262 million was partly unfunded as only \$212.6 million has been committed by the Government and Council.

- ❑ **RESPONSE** provided by the Secretary, Department of Premier and Cabinet

Management arrangements for the design construction and operation of the Square

The Steering Committee/Shareholders Forum recognises that in the past it was informed of a number of key decisions after they had been taken. The State's review of management arrangements was instituted partly in response to these concerns. The Government has accepted and has actioned key recommendations of the Report.

Federation Square architectural design competition

In September 1997 the Steering Committee was advised that the revised project budget was \$186 million but costs were subject to design review. In December 1997 the Steering Committee was advised that the cost was \$219 million but that cost savings were being sought. The revised cost plan was based on a floor area of 30 500 square metres, and included a contingency of \$9.5 million. We note that the Quantity Surveyor's estimate of \$249 million (which was not provided to the Steering Committee) was based on a floor area of 41 673 square metres and included a contingency of about \$19 million.

The working party announced by the Government in May 2000 is tasked with considering the parameters within which the design of the north-west corner should proceed following the decision not to construct the western shard. The working party will not be reconsidering the design of the Square

Tendering processes for construction of the Square

The Office of Major Projects advises that the total strategy for design and construction delivery was premised upon the shortest time frame for the delivery of the project and for occupation of Federation Square. Pre-qualification of potential contractors is a legitimate and widely used method of screening potential contractors. With respect to Federation Square, pre-qualification was the most cost and time-effective method of assessing potential contractors. While a greater range of potential contractors may have been identified through calling for expressions of interest, there is no evidence to suggest that a better result would have been achieved in terms of identifying the most appropriate contractor in a timely and efficient manner.

With respect to the appointment of a managing contractor, this decision was taken to address time pressures prior to achieving full design documentation of the Square. The appointment of a managing contractor allowed preliminary construction work to commence ahead of the completion of design documentation.

Evaluation of tenders

The Office of Major Projects performs its role in accordance with the Project Development and Construction Management Act 1994 and relevant Ministerial guidelines under the legislation. The Office of Major Projects' evaluation of tenders for Federation Square was conducted in accordance with Ministerial Guideline No. 1 – Tendering Provisions for Public Construction.

- ❑ **RESPONSE** provided by the Secretary, Department of Premier and Cabinet - continued

Probity of tendering processes

The Steering Committee/Shareholders Forum notes that the conduct of the architectural competition was overseen by Mr John Davidson. The Office of Major Projects advised the Committee that the Land Monitor oversees all property transactions involved. At the commercial leasing stage, the Steering Committee directed that a probity auditor be appointed for this process. The Office of Major Projects subsequently advised that it had done so. The Steering Committee was informed in early 2000 that this had not been implemented. Commercial leasing/tendering is now the responsibility of Federation Square Management Company (FSM). The Shareholders Forum will request FSM obtain probity sign-off on any subsequent transaction of this nature.

The Office of Major Projects advises it followed its established procedures for ensuring the probity of the tendering process for construction elements of the project.

With respect to commercial tendering, the Office of Major Projects raised its concerns about the appropriateness and benefits of a probity auditor for commercial leasing aspects of the project on a number of occasions following the initial decision.

Allocation of risks to the State

The Office of Major Projects advises that the State did not novate the architect's agreement to the managing contractor because the design of the Square was incomplete. Under these circumstances it was appropriate for the design risk to reside with the party best able to manage this risk. In this instance, the State was the party best able to manage design risk. The adjustments to the managing contractor's fee will form part of the negotiations on variation claims. The risk lies with the State rather than the Council since the Council has maintained a cap on its contribution to the project.

Variation of the deck structure and variation claims

The Office of Major Projects advises that the successful tender was the only tender to submit a steel deck alternative. A comprehensive value engineering process, post tender, supported the view that given the lack of definition of the superstructure a steel deck would provide a more certain outcome at a reduced cost.

Trade contractors

The Office of Major Projects notes that the Auditor-General's Report has highlighted the difficulties associated with securing fixed lump sum contracts in the absence of full design documentation. Without this documentation, a trade package tendering approach was adopted for Federation Square.

Commercial tendering arrangements

The Steering Committee/Shareholders Forum notes that the issue of a title to the Federation Square site enabling subleasing to commercial tenants has been acknowledged for some time, and is being addressed. Responsibility for resolving this matter now rests with the Chief Executive Officer of the Federation Square Management Company, and negotiations are progressing satisfactorily. In addition, there is no impediment to the Management Company entering into an agreement to lease as is regularly done in property transactions of this type.

- ❑ **RESPONSE** provided by the Secretary, Department of Premier and Cabinet - continued

Estimated total cost of the Square

The cost estimate does not include expenditure on items which are separate projects and funded from different sources to the Square. This is the case with the demolition of the Gas and Fuel Corporation Towers and Princes Plaza, the street improvements at Swanston and Flinders Streets, the Riverside Park and the rationalisation works at the Jolimont rail yards. These works are all part of a larger plan for the Jolimont rail precinct.

Funding of expenditure on the Square

With respect to the \$50 million in funding from the Commonwealth Government, this is a long-standing commitment backed up by a letter signed by the Prime Minister agreeing to this funding. While some minor conditions pertaining to the Deed of Grant are yet to be finalised, no issues of substance remain unresolved and a positive conclusion is anticipated before the end of the financial year.

SCHEDULE A
STATUS OF MATTERS RAISED IN PREVIOUS REPORTS

<i>Report</i>	<i>Subject</i>	<i>Status at date of preparation of this Report</i>
MATTERS RESOLVED OR ACTION COMMENCED		
VICTORIAN ARTS CENTRE TRUST		
<i>Ministerial Portfolios, May 1994, pp. 58-9.</i>	A long-standing policy of non-allocation of significant levels of indirect overhead expenses (almost \$10 million in 1992-93) to individual operating units has impaired decision-making and has impaired transparency and accountability to the Parliament.	As part of a new financial management information system, which became operational on 1 January 1999, the Trust has introduced a costing model which has facilitated the allocation of indirect overheads to operating units for financial reporting purposes.
MUSEUMS BOARD OF VICTORIA		
<i>Ministerial Portfolios, May 1999, pp. 278-86.</i>	The Melbourne Museum complex which was originally estimated to cost \$250 million was expected to cost \$287.6 million at completion. In addition, project delays resulted in deferment of the opening date of the Museum to July 2000.	Further comment in relation to the status of the construction of the Melbourne Museum complex is included in this Part of the Report.
<i>Ministerial Portfolios, May 1999, pp. 282-86.</i>	Audit was unable to determine whether revenue earned from the IMAX theatre had met expectations to date due to the management of Museum Victoria refusing to provide audit access to this information on account of commercial-in-confidence considerations.	Relevant data has now been provided to audit, enabling independent appraisal of the financial performance of the arrangements between Museum Victoria and the operators of the IMAX theatre.

**SCHEDULE B
COMPLETED/INCOMPLETE AUDITS**

<i>Entity</i>	<i>Financial year ended</i>	<i>Reporting to Parliament</i>	<i>Financial statements signed by entity</i>	<i>Auditor- General's report signed</i>
COMPLETED AUDITS				
Department of Premier and Cabinet	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.46.</i>	25 Oct. 1999	28 Oct. 1999
ARTS				
Cinemia Corporation	30 June 1999	“ “	24 Sept. 1999	30 Sept. 1999
Council of Trustees of the National Gallery of Victoria	30 June 1999	“ “	26 Aug. 1999	30 Sept. 1999
Geelong Performing Arts Centre Trust	30 June 1999	“ “	24 Sept. 1999	1 Oct. 1999
Library Board of Victoria	30 June 1999	“ “	22 Sept. 1999	28 Sept. 1999
Museums Board of Victoria	30 June 1999	“ “	30 Aug. 1999	4 Sept. 1999
National Gallery Society of Victoria	30 June 1999	“ “	26 Aug. 1999	22 Sept. 1999
State Library of Victoria Foundation	30 June 1999	“ “	22 Sept. 1999	28 Sept. 1999
Victorian Arts Centre Trust	30 June 1999	“ “	26 Nov. 1999	29 Nov. 1999
MULTICULTURAL AFFAIRS				
Victorian Interpreting and Translating Service	30 June 1999	“ “	13 Oct. 1999	27 Oct. 1999
PREMIER				
Office of the Ombudsman	30 June 1999	“ “	28 Oct. 1999	29 Oct. 1999
Office of Public Employment (a)	30 June 1999	“ “	27 Oct. 1999	28 Oct. 1999
Melbourne 2006 Commonwealth Games Bid Pty Ltd (b)	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.53A.</i>	15 Feb. 2000	18 Feb. 2000
Victorian Relief Committee	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.46.</i>	5 Oct. 1999	8 Oct. 1999

(a) Formerly known as the Office of the Public Service Commissioner.

(b) Final audit.

Part 3.7

State and Regional Development

KEY FINDINGS

Construction of the multi-purpose venue at Melbourne Park

- The contract for construction of the multi-purpose venue at Melbourne Park was executed in June 1999 some 11 months after the tenderer was advised of the success of its bid and with the works well advanced.

Paras 3.7.17 to 3

- The projected final cost of completing the construction of the multi-purpose venue, excluding the cycling training facility, was \$64.9 million - representing a \$500 000 saving on the original budget. This does not include a claim for damages of \$19.1 million submitted by the contractor.

Paras 3.7.22 to 3

- The construction of the multi-purpose venue was planned to be completed by November 1999. Project delays have resulted in a need for the opening of the facility to be postponed by 7 months, with the venue now expected to open in July 2000.

Paras 3.7.27 to 3

3.7.1 The Minister for State and Regional Development, the Minister for Manufacturing Industry and for Racing, the Minister for Major Projects and Tourism, the Minister for Small Business, the Minister for Sport and Recreation and the Minister for Industrial Relations have responsibility for operations within the State and Regional Development portfolio. These Ministers have collective responsibility for the Department of State and Regional Development.

3.7.2 Details of the specific ministerial responsibilities for public bodies within the State and Regional Development portfolio are listed in Table 3.7A. These public bodies, together with the former Department of State Development, were subject to audit by the Auditor-General during the 1998-99 financial year.

**TABLE 3.7A
MINISTERIAL RESPONSIBILITIES FOR
PUBLIC BODIES WITHIN THE STATE AND REGIONAL DEVELOPMENT PORTFOLIO**

<i>Ministerial portfolio</i>	<i>Entities subject to audit</i>
Industrial Relations	-
Manufacturing Industry	-
Major Projects and Tourism	Australian Grand Prix Corporation Docklands Authority Emerald Tourist Railway Board Melbourne Convention and Exhibition Trust Tourism Victoria
Racing	Greyhound Racing Control Board Harness Racing Board
Small Business	Liquor Licensing Commission <i>(a)</i>
Sport and Recreation	Melbourne and Olympic Parks Trust Melbourne Sports and Aquatic Centre Trust Melbourne 2002 World Masters Games Limited Victorian Institute of Sport Ltd Victorian Institute of Sport Trust
State and Regional Development	Overseas Projects Corporation of Victoria Ltd Victorian Medical Consortium Pty Ltd

(a) Entity incorporated into the former Department of State Development on 17 February 1999.

3.7.3 Comment on matters of significance arising from the audit of entities within the State and Regional Development portfolio is provided below.

CONSTRUCTION OF THE MULTI-PURPOSE VENUE AT MELBOURNE PARK

3.7.4 In May 1998 the Government, announced the construction of a new multi-purpose venue at Melbourne Park which was to be built at a cost of \$65.4 million with an additional \$5 million to be spent on the construction of a cycling training facility at Northcote.

3.7.5 The cost of the project was to be funded by a contribution of \$65 million from the Government, under the Agenda 21 program of which \$10 million would be repaid over an agreed timeframe by Tennis Australia and the Melbourne and Olympic Parks Trust, and a contribution of \$5.4 million from the Melbourne and Olympic Parks Trust from its own generated revenue.

3.7.6 The multi-purpose venue can be utilised as:

- 10 000 seat purpose built basketball venue;
- 6 000 seat international velodrome;
- 10 000 seat tennis court venue, to be used for the Australian Tennis Open;
- smaller entertainment venue for audience sizes ranging from 2 500 to 10 000; and
- corporate lounges, superboxes and club areas to promote events and generate revenue.

3.7.7 The project also involved ancillary works around the site and within Melbourne Park including the replacement of tennis courts, improvement of pedestrian walkways, rationalisation of roadworks and vehicle access arrangements, and an expansion of existing utilities within Melbourne Park.

3.7.8 The construction of the multi-purpose venue was planned to commence in August 1998 and be completed by November 1999 in time for the Australian Tennis Open Championship in January 2000.



Architectural model of multi-purpose venue at Melbourne Park.

Management arrangements

3.7.9 Under the established arrangements, the construction of the venue was to be managed by the Office of Major Projects, which is established under the *Project Development and Construction Management Act 1994*, on behalf of the Melbourne and Olympic Parks Trust. The Act provides the Office of Major Projects with the necessary powers to facilitate the delivery of the project.

3.7.10 The management of the construction of the venue by the Office of Major Projects, which forms part of the Department of State and Regional Development, brought together a project team comprising the contractor, consultants, architects, quantity surveyors, contract manager, the Trust and a project director from the Office of Major Projects.

3.7.11 The number of parties involved, coupled with the extensive financial resources required for such a project, made it imperative to establish adequate project management structures and processes that provide efficient and effective co-ordination of resources and allocation of tasks.

3.7.12 Our review of the project management structures and processes in respect of the construction of the multi-purpose venue found these to be satisfactory.

3.7.13 Project control groups comprising representatives from the contractor, the Trust and the Office of Major Projects were established to monitor project costs and the scheduling of works. In addition, a contract management consultant was engaged to assist with the monitoring of the progress of the project on behalf of Office of Major Projects, with the consultant required to provide:

- management services in respect of the project;
- direct administrative supervision of the construction contracts; and
- assistance to the project director from the Office of Major Projects to ensure that all obligations under the contract were fully satisfied.

Selection of contractor to construct venue

3.7.14 In May 1998, the Office of Major Projects, invited 6 of Australia's largest building contractors to submit tenders for the main construction of the multi-purpose venue. Following an assessment of the tenders received, in July 1998 the successful contractor was awarded the main construction contract for \$52.7 million.

3.7.15 The tender assessment process established by the Office of Major Projects included an evaluation team with relevant skills and expertise to evaluate the tenders submitted and appropriate selection criteria was developed to evaluate the tender proposals. Our review of the tendering process identified the following deficiencies:

- The selective tendering process undertaken by the Office of Major Projects followed established practices and procedures which have evolved over time but had not been documented by the Office in policies or manuals;
- Appropriate weightings were not developed in relation to the selection criteria used by the evaluation team and the major emphasis of the tender assessment process was on cost; and

- A probity auditor was not utilised to ensure that the tender process was undertaken in a manner which was fair and equitable to all tenderers. Although issues of probity in the evaluation process conducted by the Office of Major Projects were not raised by any of the unsuccessful contractors, ever increasing levels of outsourcing and contracting of government services has seen a commensurate increase in the level of public scrutiny applied to the tender processes.

3.7.16 The Office of Major Projects, which is responsible for the management of large and complex projects on behalf of the State, should ensure that its practices and procedures are formally documented, with those procedures requiring a suitably qualified independent probity auditor to be appointed to oversee all future major tendering processes.

Delay in the awarding of contract

3.7.17 While the Office of Major Projects was undertaking the tender process for the construction of the project, the Trust was simultaneously negotiating the project's funding arrangements with the Department of Treasury and Finance. At the time that the tenderer was verbally advised of the success of their tender for the construction of the venue in July 1998, the funding arrangements had not been finalised.

3.7.18 To avoid delays in the construction, approval was obtained by the Trust from the Department of Treasury and Finance for the initial funding of up to \$10 million to enable the contractor to commence works. Agreement was reached between the contractor and the Office of Major Projects to enable the contractor to take possession of the site and commence work in August 1998.

3.7.19 Following agreement of the arrangements to finance the construction of the venue, a formal letter of acceptance was finally issued to the contractor by the Office of Major Projects in October 1998. **The 11 week delay in providing the contractor with the formal letter of acceptance formed part of a claim for damages of \$19.1 million submitted by the contractor in February 2000 which is referred to later in this Report.**

3.7.20 However, it was not until June 1999, some 11 months after the tenderer was advised of the success of their tender for the construction of the venue, and with the works well advanced, that a formal contract was finally executed.

3.7.21 The Office of Major Project needs to liaise more closely with the agencies responsible for agreeing arrangements for the financing of major construction projects to avoid any potential delays in construction and financial exposure to the State.

Construction of the multi-purpose venue

Cost of construction

3.7.22 Our audit review revealed that as at February 2000, the projected final cost of completing the construction of the venue, excluding the cycling training facility, was \$64.9 million. This represented a \$500 000 saving on the original budget of \$65.4 million. Table 3.7B illustrates the budgeted, actual and projected final costs of the project.

TABLE 3.7B
MULTI-PURPOSE VENUE,
BUDGETED, ACTUAL AND PROJECTED FINAL COSTS
(\$million)

<i>Cost component</i>	<i>Original budget (June 1998)</i>	<i>Actual costs (February 2000)</i>	<i>Projected final cost (February 2000)</i>
Main contract	52.7	52.7	52.7
Sub-contracted works	2.2	0.7	2.2
Variations to main contract	1.0	0.5	1.1
Construction contingency	1.6	1.0	1.0
Western courts	1.3	1.3	1.3
Western courts contingency	0.4	0.4	0.4
Furniture, fittings and equipment	0.5	0.4	0.5
Base catering facilities	0.4	0.4	0.4
Professional fees	5.1	5.1	5.1
Stormwater outfall contribution	0.2	0.2	0.2
Total costs of venue	65.4	62.7	64.9
Construction of training velodrome	5.0	-	9.0
Total project cost	70.4	62.7	73.9

3.7.23 In addition, a further \$2.2 million has been expended on works outside the scope of the original project by Melbourne and Olympic Parks Trust.

3.7.24 As at February 2000, projected approved variations to the contract were estimated at \$1.1 million. However, the building contractor had lodged a formal statement of claim for \$19.1 million for estimated losses as a result of the alleged **failure by the Office of Major Projects to perform certain tasks in a proper manner**. The contractor has also indicated that the final claim amount may be further increased by the costs incurred in the preparation of the claim and for any claims that may be submitted by sub-contractors.

3.7.25 At the time of the preparation of this Report, the contractor's claim was being assessed and due to the magnitude of the claim and the potential complexity of the contractual arrangements, the Office of Major Projects has indicated that it is likely that the matter will be referred for negotiation, arbitration and possibly litigation.

3.7.26 As indicated previously, the Government also announced the construction of a cycling training facility at Northcote at a cost of \$5 million. In March 2000, the Department of State and Regional Development re-assessed the project, which incorporated an amended scope including seating and club facilities to enable minor events to be held at the facility, and revised the projected cost to \$9 million. The construction of the facility is planned to commence in March 2001 and to be completed by August 2002.

Delays in construction

3.7.27 The construction of the multi-purpose venue at Melbourne Park was planned to be completed by November 1999. However, project delays have resulted in a need for the opening of the venue being postponed by 7 months, with the venue not expected to open until July 2000.

3.7.28 Table 3.7C discloses the initial timeframe compared with the revised timeframe for the project.

**TABLE 3.7C
PROPOSED AND ACTUAL/REVISED TIME FRAMES FOR
MULTI - PURPOSE VENUE**

<i>Milestone</i>	<i>Initial timeframe</i>	<i>Revised timeframe</i>
Tender of construction contract	May 1998	May 1998
Formal signing of construction contract	August 1998	June 1999
Completion of construction (a)	November 1999	May 2000
Opening date	January 2000	July 2000

(a) Excludes construction of velodrome at the multi-purpose venue.

3.7.29 The major reasons for the delay in the project as outlined by the Office of Major Projects and Department of State and Regional Development are:

- significant industrial disputes due to Statewide industrial action;
- change in builder's management practices over the duration of the project; and
- inclement weather conditions.

3.7.30 The above delays have not only affected the expected completion date of the construction of the venue but have also impacted on the subsequent commencement of construction of the cycling velodrome track at the venue, which can only be constructed after the construction of the venue is completed. The scheduled commencement date for the construction of the velodrome was May 2000 with completion due in late June 2000.

3.7.31 Due to the delays associated with the project, the building contractor has submitted extension of time requests totalling 177.5 days. As at February 2000, extensions of time requests totalling 77 days had been approved by the Office of Major Projects, with 21 days rejected and 79.5 days awaiting further assessment in accordance with contract conditions. The rejection of the 21 days formed part of a claim for damages of \$19.1 million submitted by the contractor in February 2000, as discussed previously in this Report.

3.7.32 As the extensions of time for the completion of the venue had been approved, liquidated damages have not been imposed on the contractor at the date of preparation of this Report.

3.7.33 The delay in the construction has resulted in the multi-purpose venue not being ready for the January 2000 Australian Open Tennis Championships, the National Basketball League finals in April 2000, and may impact on an international cycling event proposed for August 2000 and pre-Olympic training commitments.

□ **RESPONSE** provided by the Secretary, Department of State and Regional Development

The content of the Report is generally consistent with discussions held between our 2 Offices, however, I feel I must respond to comments made regarding the tender process and use of a probity auditor.

I understand that our tendering processes were assessed by reference to the Government Outsourcing and Contract Management Guidelines. These guidelines are neither intended nor appropriate for procurement of construction works. The Office of Major Projects' tendering procedures comply with the Government's Code of Practice for the Building and Construction Industry. This code makes no reference to use of a probity auditor and to my knowledge the use of probity auditors in construction tendering is rare.

SCHEDULE A
STATUS OF MATTERS RAISED IN PREVIOUS REPORTS

<i>Report</i>	<i>Subject</i>	<i>Status at date of preparation of this Report</i>
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MATTERS RESOLVED OR ACTION COMMENCED

STATE AND REGIONAL DEVELOPMENT

Harness Racing Board

*Ministerial
Portfolios,
May 1999,
p. 293*

To ensure that the Board's procurement activities are conducted in a transparent and justifiable manner, the Board should develop formal purchasing policies and guidelines based on those promulgated by the Victorian Government Purchasing Board.

The Board has developed and implemented formal purchasing policies and guidelines.

**SCHEDULE B
COMPLETED/INCOMPLETE AUDITS**

<i>Entity</i>	<i>Financial year ended</i>	<i>Reporting to Parliament</i>	<i>Financial statements signed by entity</i>	<i>Auditor- General's report signed</i>
COMPLETED AUDITS				
Department of State Development (a)	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.46.</i>	26 Oct. 1999	28 Oct. 1999
MAJOR PROJECTS AND TOURISM				
Australian Grand Prix Corporation	30 June 1999	" "	27 July 1999	27 July 1999
Docklands Authority	30 June 1999	" "	29 Oct. 1999	29 Oct. 1999
Emerald Tourist Railway Board	30 June 1999	" "	19 Aug. 1999	14 Sept. 1999
Melbourne Convention and Exhibition Trust	30 June 1999	" "	1 Oct. 1999	6 Oct. 1999
Tourism Victoria	30 June 1999	" "	21 Oct. 1999	22 Oct. 1999
RACING				
Greyhound Racing Control Board	30 June 1999	" "	17 Sept. 1999	23 Sept. 1999
Harness Racing Board	30 June 1999	" "	27 Aug. 1999	6 Sept. 1999
SMALL BUSINESS				
Liquor Licensing Commission (b)	1 July 1998 to 17 Feb. 1999	17 June. <i>Financial Management Act 1994, s.46.</i>	1 June 1999	16 June 1999
SPORT AND RECREATION				
Melbourne and Olympic Parks Trust	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.46.</i>	6 Sept. 1999	7 Sept. 1999
Melbourne Sports and Aquatic Centre Trust	30 June 1999	" "	30 Sept. 1999	7 Oct. 1999
Melbourne 2002 World Masters Games Limited	10 June 1998 to 30 June 1999	31 Oct. <i>Financial Management Act 1994, s.53A.</i>	25 Aug. 1999	1 Sept. 1999
Victorian Institute of Sport Ltd	30 June 1999	" "	18 Aug. 1999	25 Aug. 1999
Victorian Institute of Sport Trust	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.46.</i>	18 Aug. 1999	25 Aug. 1999

SCHEDULE B
COMPLETED/INCOMPLETE AUDITS - continued

<i>Entity</i>	<i>Financial year ended</i>	<i>Reporting to Parliament</i>	<i>Financial statements signed by entity</i>	<i>Auditor- General's report signed</i>
COMPLETED AUDITS - continued				
STATE AND REGIONAL DEVELOPMENT				
Overseas Projects Corporation of Victoria Ltd	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.53A.</i>	21 Sept. 1999	30 Sept. 1999
Victorian Medical Consortium Pty Ltd	30 June 1999	" "	7 Oct. 1999	13 Oct. 1999

(a) Name changed to Department of State and Regional Development with effect from 29 October 1999.

(b) Entity incorporated into the former Department of State Development on 17 February 1999.

Part 3.8

Treasury and Finance

KEY FINDINGS

Financial condition of WorkCover

- The WorkCover scheme's continued funding deficiency [the proportion of the schemes' net assets in proportion to its outstanding claims liability – 95.5 per cent] has been mainly due to the growth in the level of outstanding claims liability without a matching or improving increase in available net assets.

Paras 3.8.4 to 3.8.8

- While the pursuit of an aggressive investment strategy by the Authority may increase the level of investment returns, it also increases the Authority's risk in relation to its investment returns and creates the potential for a mismatch of the availability of investment proceeds with the timing and value of claim payments. This represents an important issue for the Authority given its substantial investment holdings and the inherent risks associated with certain investments.

Paras 3.8.9 to 3.8.15

- The Authority decided to re-introduce the appointment of 2 independent external actuaries to assess the value of the outstanding claims liability every 6 months for the next 2 years due to the volatility of common law claims experience over the past 3 years and the likelihood that such volatility will intensify with the re-introduction of claimants' ability to recover common law damages for work-related injuries.

Paras 3.8.16 to 3.8.18

Victorian Channels Authority - Cost of channel operations

- The balance sheet of the Victorian Channels Authority does not reflect the value of its shipping channels. Accordingly, the true value of all assets available to the Authority are not reported and the true cost of services provided by these channels are not transparent because the channel assets have not been amortised over their useful economic life.

Paras 3.8.29 to 3.8.43

3.8.1 The Treasurer of Victoria, the Minister for Finance, the Minister for WorkCover, and the Minister for Gaming have responsibility for operations within the Treasury and Finance sector. These Ministers have collective responsibility for the Department of Treasury and Finance.

3.8.2 Details of the specific ministerial responsibilities for public bodies within the Treasury and Finance sector are listed in Table 3.8A. These public bodies, together with the Department of Treasury and Finance were subject to audit by the Auditor-General during the 1998-99 financial year.

**TABLE 3.8A
MINISTERIAL RESPONSIBILITY FOR
PUBLIC BODIES WITHIN THE TREASURY AND FINANCE SECTOR**

<i>Ministerial portfolio</i>	<i>Entities subject to audit</i>
Finance	Emergency Services Superannuation Scheme Government Superannuation Office State Superannuation Fund Parliamentary Contributory Superannuation Fund
Gaming	Regulator General, Office of the Tattersall's Club Keno Pty Ltd Tattersall's Gaming Pty Ltd Tattersall's Sweep Pty Ltd Victorian Casino and Gaming Authority
Treasurer	ACN 065 325 206 Ltd Chief Electrical Inspector, Office of the Gas Release Co. Pty Ltd Gas Safety, Office of Gas services business Pty Ltd Gas Transmission Corporation Gascor Pty Ltd Gascor Holdings No. 1 Pty Ltd and its 3 subsidiaries Gascor Holdings No. 2 Pty Ltd and its 3 subsidiaries Gascor Holdings No. 3 Pty Ltd and its 3 subsidiaries Gasmart (Vic) Pty Ltd Generation Victoria Hastings Port (Holding) Corporation Land Aggregation Program Trust Fund Loy Yang B Power Station Pty Ltd Melbourne Port Corporation Quiet Life Ltd Rural Finance Corporation State Electricity Commission of Victoria State Trustees Ltd and its 7 common funds STL Financial Services Ltd Terec Limited The Albury Gas Company Ltd Transmission Pipelines Australia (Holdings) Pty Ltd and its 2 subsidiaries Transport Accident Commission and its 3 subsidiaries

TABLE 3.8A
MINISTERIAL RESPONSIBILITY FOR
PUBLIC BODIES WITHIN THE TREASURY AND FINANCE SECTOR - *continued*

<i>Ministerial portfolio</i>	<i>Entities subject to audit</i>
Treasurer - cont	Treasury Corporation of Victoria Tricontinental Holdings Ltd and its 3 subsidiaries Vicfleet Pty Ltd Victorian Channels Authority Victorian Electricity Metering Pty Ltd Victorian Energy Networks Corporation Victorian Funds Management Corporation and its 5 trusts Victorian Managed Insurance Authority Victorian Power Exchange Pty Ltd Victorian Rail Track V/Line Passenger Corporation Western Underground Gas Storage Pty Ltd
WorkCover	Victorian WorkCover Authority

3.8.3 Comment on matters of significance arising from the audit of entities within the Treasury and Finance sector is provided below.

FINANCIAL CONDITION OF WORKCOVER

3.8.4 Previous Auditor-General's *Reports on Ministerial Portfolios* have provided extensive comment on the financial condition of the WorkCover scheme managed by the Victorian WorkCover Authority. Our May 1999 *Report on Ministerial Portfolios* highlighted that while the previous Government's key financial objective in relation to the scheme was to maintain a fully-funded position, since July 1997 this objective had not been achieved with the scheme not being fully funded.

3.8.5 Table 3.8B outlines the financial position of the scheme for the period 1 July 1997 to 31 December 1999 and shows that **the proportion of the scheme's net assets in relation to its outstanding claims liability has shifted from 96.1 per cent as at 30 June 1998 to 95.5 per cent as at 31 December 1999.**

TABLE 3.8B
FINANCIAL CONDITION OF THE WORKCOVER SCHEME,
1 JULY 1997 TO 31 DECEMBER 1999
((\$million))

	30 June 1998	31 Dec. 1998 (a)	30 June 1999	31 Dec. 1999 (a)
Premium revenue	960	580	1 185	603
Investment revenue	437	250	330	303
Claims expenditure	1 350	748	1 470	720
Operating profit before income tax and abnormal items	(123)	(14)	(176)	(97)
Outstanding claims liability (b) (c)	3 859	4 069	4 309	4 397
Net assets (b)	3 709	3 905	4 013	4 198
Surplus assets / (Deficiency)	(150)	(164)	(296)	(199)
Funding level (per cent) (d)	96.1	96.0	93.1	95.5
Return on investments (per cent)	12.9	6.4	8.5	(a) 7.3

(a) For the 6 month period ended 31 December 1998 and 1999.

(b) Amounts relate to the WorkCover Fund only and exclude other non-material funds, which comprise the Supplementation and Guarantee Funds.

(c) Represents net present value.

(d) Represents the percentage of the scheme's net assets in relation to its outstanding claims liability.

3.8.6 The scheme's continued funding deficiency has been mainly due to the growth in the level of outstanding claims liability without a matching or improving increase in available net assets. The key components of this liability are shown in Table 3.8C.

TABLE 3.8C
COMPONENTS OF THE OUTSTANDING CLAIMS LIABILITY,
30 JUNE 1998 TO 31 DECEMBER 1999
(\$million)

	30 June 1998 (a)	31 Dec. 1998 (a)	30 June 1999	31 Dec. 1999
Weekly compensation payments	-	-	1 838	1 954
Common law	-	-	954	810
Medical (b)	-	-	653	666
Maims, pain and suffering, and non-economic benefits	-	-	549	615
Other	-	-	343	354
Estimated tax package effect	-	-	29	42
Total gross liability	3 899	4 130	4 366	4 441
Total recoveries	(40)	(51)	(57)	(44)
Total net liability	3 859	4 069	4 309	4 397

(a) The value of components of the outstanding claims liability as at 30 June 1998 and 31 December 1998, as indicated in this table were not available.

(b) The liability for medical claims includes associated projected medico-legal costs.

3.8.7 The increase in the level of outstanding claims over the 6 month period ended 31 December 1999 was attributed to the following factors:

- increased duration of weekly benefit payments made to claimants;
- ongoing increase in the number of common law writs lodged prior to December 2000, the final date for lodgement of such claims under the current legislation, which to some extent was offset by a decline in the success rates for common law writs;
- increased average value of settlements for common law claims;
- increased claim costs, reflecting the impact of the legislative amendments in 1997 which extended the eligibility for impairment benefits to new types of injuries and diseases; and
- growth in rehabilitation, medical and other treatment type expenditures.

3.8.8 The growth in the level of outstanding claims liability was to some extent offset by an increase in the value of the Authority's investments during the 6 month period ended 31 December 1999. The major factors contributing to the improved investment return was the strong performance in both domestic and international equities held by the Authority. However, the Authority's actuary reported that the current investment profile was not consistent with the projected claim payments profile. According to the Authority, this position reflects the current long-term and aggressive investment strategy of the Authority.

3.8.9 While the pursuit of an aggressive investment strategy by the Authority may increase the level of investment returns, it also increases the Authority's risk in relation to its investment returns and creates the potential for a mismatch of the availability of investment proceeds with the timing and value of claim payments.

3.8.10 This represents an important issue for the Authority given its substantial investment holdings and the inherent risks associated with certain investments.

3.8.11 The Authority's actuary has estimated that the cost of the scheme for the 1999-2000 financial year would be equivalent to 1.69 per cent of wages, and therefore the current overall average premium rate of 1.90 per cent should be adequate to cover the cost of the scheme. In particular, the actuary projected that the scheme will be fully funded by March 2001. However, 12 months earlier the actuary estimated that the scheme would be fully funded by December 2000. The shift in this timeframe mainly reflects a deterioration in the scheme's claims experience.

Proposed legislative amendments

3.8.12 The under-funded position of the scheme has persisted in recent years despite legislated amendments in November 1997 which had the effect of eliminating the eligibility of common law damages in respect of work-related injuries that occurred on or after 12 November 1997. Table 3.8C, shows that despite the removal of access to common law damages and the high level of payments in relation to these claims in the past 2 years, the liability relating to common law claims still comprises a significant portion of the overall outstanding claims liability.

3.8.13 In April 2000, the Government announced that it proposed to change the legislation to retrospectively restore access to common law damages for work-related injuries, effective from 20 October 1999, where the degree of impairment suffered by an injured worker is assessed as 30 per cent or more, or it meets the test for serious injury under section 135A(2)(a) of the *Accident Compensation Act* 1985. The test under the legislation which requires the examination of the consequences of the injury, recognises that not all individuals suffer the same consequences from similar injuries and that workers who do not meet the 30 per cent impairment test may still have suffered serious consequences from their injuries. Those individuals who have sustained serious work-related injuries from 12 November 1997 to 20 October 1999 would be offered assistance through a new "Intensive Care Review Program" to be administered by the Authority.

3.8.14 Other legislative changes proposed by the Government include:

- an increase in the amount of compensation payable to injured workers for non-economic loss;
- the inclusion of regular payments for overtime and shift allowances in the calculation of an injured worker's weekly benefit payment for the first 26 weeks of payment; and
- a cap on legal and associated fees per claim.

3.8.15 As part of the announcement of the proposed legislative amendments, the Government also stated that the overall average premium will increase to 2.18 per cent of wages to overcome the scheme's funding deficiency, however, according to the Authority the average premium does not include the projected impact of the Commonwealth Government's goods and services tax.

Actuarial assessment of the level of outstanding claims

3.8.16 Our 1999 *Report on Ministerial Portfolios* identified that from the date of the scheme's commencement to 30 June 1998, an estimate of the outstanding claims liability was independently assessed every 6 months by 2 actuaries. The higher, more conservative of the 2 valuations as at 30 June of each financial year was then incorporated in the Authority's annual financial statements. **Our 1999 Report identified that although the extent of the variance between the actuarial estimates was generally not material in the context of the overall liability, as these variances ranged from \$24 million as at 30 June 1995 to \$100 million at 30 June 1998, they did have a material impact on the Authority's operating result.**

3.8.17 Effective from December 1998, the Authority's Board has decided to utilise only one actuarial firm to assess the level of the scheme's outstanding claims liability and to engage another firm to perform a peer review of the actuarial valuation. Given the magnitude of the outstanding claims liability and the sensitivity of the scheme to various economic and non-economic factors, my Office recommended that the Authority should have continued the assessment of the value of the outstanding claims liability every 6 months by 2 independent external actuaries.

3.8.18 It is pleasing to note that in February 2000 the Authority decided to re-introduce the appointment of 2 independent external actuaries to assess the value of the outstanding claims liability every 6 months for the next 2 years. The Authority has advised us that the change in policy was due to the volatility of common law claims experience over the past 3 years and the likelihood that such volatility will intensify with the re-introduction of claimants' ability to recover common law damages for work-related injuries.

□ **RESPONSE** provided by Chief Executive, Victorian WorkCover Authority

In setting our investment strategy, the Authority uses professional investment advice with an aim to optimise the balance between long-term and higher investment returns, minimising risk.

The Authority invests its funds through Victorian Funds Management Corporation (VFMC) and also engages Towers Perrin for policy and actuarial modelling confirmation. Investments are also made strictly in accordance with prudential guidelines as issued from the Department of Treasury and Finance.

The current strategy is based upon achieving a long-term return of 4 per cent above inflation. The last 5 years results have been:

	<u>1994-95</u>	<u>1995-96</u>	<u>1996-97</u>	<u>1997-98</u>	<u>1998-99</u>
Rate of Return	9.5%	10.2%	21.5%	12.9%	8.5%

The current asset portfolio allocation has a frequency of negative return of 4.7 years. This is factored into the investment strategy of balancing return and risk over the long-term.

□ **RESPONSE** provided by Chief Executive, Victorian WorkCover Authority - continued

In relation to the Authority's investment strategy leading to a mismatch of investment proceeds and the timing and value of claim payments, there is no real cashflow risk. The potential risk is with the actuarial valuation of the claims liability and the assets. The investment strategy is reviewed annually and this risk is taken into consideration.

The Authority's investment strategy is reviewed each year with recommendations from Towers Perrin and VFMC being made to the Authority's Board for consideration. The review for financial year 2000-01 will be presented to the June Board meeting.

SALE OF PROPERTY AT 40 MARKET STREET, MELBOURNE

3.8.19 In March 1988, the former Accident Compensation Commission, which managed the previous WorkCare compensation scheme, entered into an arrangement to acquire units, for \$53.5 million, in a property trust and the share capital of 2 trustee companies, which owned a commercial property located at 40 Market Street, Melbourne.

3.8.20 The Commission's successor-in-law, the Victorian WorkCover Authority, subsequently acquired direct ownership of the property in 1994. The property comprised a total lettable area of 11 900 square metres including ground floor retail tenancies, 9 upper levels of office space and 2 levels of basement car park.

3.8.21 The property has been subject to regular revaluations, undertaken by independent firms on behalf of the Authority, and as at June 1998 was recorded in the Authority's financial statements at \$17.1 million. The revaluations undertaken have taken into account the leasing arrangements associated with the property, which provided for regular rent reviews which enabled the rent payable to increase or reduce in line with movements in the overall Melbourne office rent market. The nature of the lease arrangements, in conjunction with an oversupply of office accommodation in the Melbourne central business district, contributed to the significant decline in the value of the property.

3.8.22 In September 1998, the Authority agreed to dispose of its interest in the property, in line with a shift in the Authority's investment strategy towards listed property trusts and following consideration of the ongoing costs associated with the maintenance of the building.

Sale process

3.8.23 In September 1998, the Land Monitoring Unit of the Department of Infrastructure was advised that the Authority was seeking to dispose of the property. Concurrently, the Authority appointed a firm of property consultants to act as project manager for the sale of the property. The first major task of the consultant entailed the appointment, following a selective tender process, of a legal adviser to the sale and a real estate agency to act as the selling agent for the property. In addition, other consultants were appointed to facilitate the sale process including the preparation of a due diligence report and a survey report.

3.8.24 In late October 1998, the property was advertised for sale by public tender, closing in late November 1998. The Valuer-General subsequently valued the building at \$18 million and accordingly, the Land Monitoring Unit granted approval to the Authority to set the reserve price at an equivalent amount.

3.8.25 The property was offered for sale. A total of 10 tenders for the purchase of the property were received, with bids ranging from \$14.75 million to \$18 million. However, only one tender was assessed as a conforming tender. In December 1998, the Authority concluded the sale of the property to the Retail Employees Superannuation Pty Ltd, as trustee of the Retail Employees Superannuation Trust, for a price of \$18 million.

Key terms of the sale

3.8.26 Under the terms of the sale agreement, a deposit of \$1.8 million was received in full in December 1998, with the balance of \$16.2 million paid in January 1999. Other key terms of the sale included:

- the purchaser acknowledged that the property was sold subject to the current tenancy arrangements and that the tenant had granted sub-leases in respect of the property;
- the Authority agreed that it was responsible for the cost of re-carpeting the building and would reimburse the tenant for such costs incurred by the tenant prior to settlement; and
- the Authority also agreed that it would pay to the tenant all costs for building works carried out by the tenant which were the responsibility of the Authority under the lease and which were incurred prior to settlement.

3.8.27 In accordance with the above provisions, in January 1999 the Authority paid \$273 000 to the tenant.

Assessment of the sale result

3.8.28 Our analysis of the sale result of the property located at 40 Market Street, Melbourne indicated that:

- the purchase price of \$18 million was consistent with the Valuer-General's valuation obtained in November 1998; and
- the purchase price was \$900 000 higher than the book value of the property but \$35.5 million below the initial cost of the investment in the property.

RESPONSE provided by Chief Executive, Victorian WorkCover Authority

The Report accurately reflects the historic facts associated with the property.

COST OF CHANNEL OPERATIONS – VICTORIAN CHANNELS AUTHORITY

3.8.29 Our previous Reports to the Parliament have commented on the port reform program of the previous Government which aimed to increase port efficiency and improve services. As part of the reform program, the Government in March 1996 established the Victorian Channels Authority and assigned to it certain functions previously performed by the former Port of Melbourne Authority and the former Port of Geelong Authority.

3.8.30 The Victorian Channels Authority's main activity is the management of shipping channels and the provision of navigational aids at the ports at Melbourne, Geelong, Portland and Hastings. The Authority is also responsible for harbour control within Port Phillip Bay and the ports at Melbourne and Geelong.

3.8.31 The Authority has around 70 port users and in 1997-98 a total of 3 340 commercial ships visited the ports of Melbourne and Geelong.

3.8.32 During 1995-96, responsibility for the shipping channels of the former Port of Melbourne Authority and the former Port of Geelong Authority was transferred to the Victorian Channels Authority. At that time, these channels had a book value of \$86.3 million. However, these channel assets have not been reported in the balance sheet of the Authority and, as a result, we have issued qualified short-form reports on the Authority's financial statements since that date.

3.8.33 In September 1999, the Treasurer of Victoria advised the Authority that, while he appreciated its concerns regarding the audit qualification of the Authority's financial statements, it was the Government's view that the channels did not have an economic value. This view was taken despite the substantial value (service potential) of these assets to the Authority, Victorian taxpayers and the key stakeholders in the shipping industry.

3.8.34 In September 1999, the Regulator-General launched a public inquiry into the pricing of port services for the purpose of formalising a new price order with effect from 1 July 2000 to 30 June 2005. The Regulator-General is required under the *Port Services Act* 1995 to regulate port charges, including those levied by the Authority.

3.8.35 The current pricing order which was issued by the Regulator-General in November 1996, was designed to deliver an annual 12 per cent real reduction in channel user charges until its expiry on 30 June 2000.

3.8.36 This Report highlights a number of matters, the impact of which needs to be taken into account by users of the Authority's financial statements when assessing channel operations and related services.



Inspection of mains-powered navigational aid.

Cost of operating shipping channels

3.8.37 The 1998-99 financial statements of the Authority disclose total operating expenses of \$11 million. These expenses include an amount of \$2.1 million associated with the depreciation of its assets, of which \$1 million relates to the depreciation of the recently deepened Geelong shipping channel. However, the Authority's financial statements do not recognise the value of shipping channel assets transferred to the Authority on its creation. It is estimated that the annual depreciation charge associated with the assets not recognised totals around \$2.6 million and accordingly, the Authority's total operating expenses are understated by an equivalent amount.

3.8.38 In assessing the Authority's total operating expenses and operating result in any one financial year, it is also important to recognise that the Authority has adopted a policy whereby major maintenance of its shipping channels to their normal depth is not undertaken on an annual basis but is programmed on a cyclical basis of up to 6 years. Accordingly, channel expenditures will increase in the year in which cyclical works are undertaken. The next major maintenance dredging works are scheduled for 2001-02.

3.8.39 Since inception, the following capital works have been brought to account by the Authority:

- \$33.3 million – deepening of the Geelong shipping channel; and
- \$3.6 million – construction of a new shipping control centre.

3.8.40 Both of these works were funded by the State and have been capitalised in the balance sheet of the Authority, with both assets being amortised over their useful economic life.

3.8.41 In the light of these treatments it is difficult to understand the rationale for the decision not to recognise the fair value of channel assets vested in the Authority at inception. Some consistency in accounting treatment for the Authority's major assets is required.

3.8.42 So long as the balance sheet of the Authority fails to reflect the value of its channels, the true value of all assets available to the Authority will not be reported and the true cost of services provided by these channels will not be transparent because the channel assets will not have been amortised over their useful economic life.

3.8.43 The Authority has advised that in order for the port at Melbourne to compete with other major Australian ports and to service ships with deeper draughts, the depth of the existing channels may need to increase from the current depth of 13.1 metres within the next 5 to 10 years. A report on the future of the Victorian ports was recently commissioned by the Department of Infrastructure for the purpose of assessing the future requirements of ports in Victoria, including the need for any proposed deepening of the channels. **The preparation of the departmental report also provides an opportunity for the review of the long-term financial requirements of the shipping channels with a view to ensuring that the full cost of operating the channels is determined and transparently reported.**

□ **RESPONSE** provided by Chief Executive, Victorian Channels Authority (VCA)

The VCA does not disagree in substance with the Report.

**SCHEDULE A
STATUS OF MATTERS RAISED IN PREVIOUS REPORTS**

<i>Report</i>	<i>Subject</i>	<i>Status at date of preparation of this Report</i>
MATTERS RESOLVED OR ACTION COMMENCED		
VICTORIAN CASINO AND GAMING AUTHORITY		
<i>Ministerial Portfolios, May 1999, pp. 339-43</i>	The Government, in consultation with the Authority, should establish a firm timeframe for addressing player fairness issues in the gaming industry and for taking of action to better meet the needs of players.	The <i>Casino Control Act 1991</i> and the <i>Gaming Machine Control Act 1991</i> have been amended to provide for players of gaming machines to be given information relevant to gaming on these machines.
VICTORIAN WORKCOVER AUTHORITY		
<i>Ministerial Portfolios, May 1999, pp. 333-38</i>	Due to the magnitude of the outstanding claims liability and the sensitivity of the WorkCover scheme, the Authority should continue to have the outstanding claims liability valued each half-year by 2 independent external actuaries and recognise the higher assessed value in the body of its financial statements.	Further comment in relation to the status of this matter is included in this Part of the Report.
DEPARTMENT OF TREASURY AND FINANCE		
<i>Ministerial Portfolios, May 1996, p. 335.</i>	There is a need for clarification within the Government's supply guidelines of the classification of consultancy and contractor services, in order to improve the disclosure of consultancy payments in annual reports to the Parliament.	The Department advised that although these guidelines remain unchanged, the issue has been referred to the Department's advisers who are currently conducting a review of procurement on behalf of the Minister for Finance.

**SCHEDULE B
COMPLETED/INCOMPLETE AUDITS**

<i>Entity</i>	<i>Financial year ended</i>	<i>Reporting to Parliament</i>	<i>Financial statements signed by entity</i>	<i>Auditor- General's report signed</i>
COMPLETED AUDITS				
Department of Treasury and Finance	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.46.</i>	5 Nov. 1999	8 Nov. 1999
FINANCE				
Audit Victoria	30 June 1999	" "	13 Sept. 1999	13 Sept. 1999
Audit Victoria (a)	Period 1 July 1999 to 31 Dec. 1999	" "	31 Mar. 2000	6 April. 2000
Emergency Services Superannuation Scheme	30 June 1999	" "	21 Sept. 1999	23 Sept. 1999
Parliamentary Contributory Superannuation Fund	30 June 1999	" "	18 Oct. 1999	18 Oct. 1999
Regulator-General, Office of the	30 June 1999	" "	8 Oct. 1999	1 Nov. 1999
State Superannuation Fund	30 June 1999	" "	4 Nov. 1999	5 Nov. 1999
Victorian Superannuation Board (b)	30 June 1999	" "	4 Nov. 1999	5 Nov. 1999
Victorian Superannuation Fund (c)	30 June 1999	" "	29 Oct. 1999	29 Oct. 1999 (d)
Victorian WorkCover Authority	30 June 1999	" "	27 Aug. 1999	27 Aug. 1999
Water Industry Superannuation Fund (c)	30 June 1999	" "	31 Aug. 1999	31 Aug. 1999
Water Industry Superannuation Fund Pty Ltd (b)	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.53A.</i>	31 Aug. 1999	31 Aug. 1999
GAMING				
Tattersall's Club Keno Pty Ltd	30 June 1999	31 Oct. <i>Club Keno Act 1993, s.10.</i>	16 Nov. 1999	1 Dec. 1999
Tattersall's Gaming Pty Ltd	30 June 1999	31 Oct. <i>Gaming Machine Control Act 1991, s.132.</i>	16 Nov. 1999	1 Dec. 1999
Tattersall's Sweeps Pty Ltd	30 June 1999	31 Oct. <i>Tattersall Consultations Act 1958, s.8C.</i>	16 Nov. 1999	1 Dec. 1999

SCHEDULE B
COMPLETED/INCOMPLETE AUDITS - continued

<i>Entity</i>	<i>Financial year ended</i>	<i>Reporting to Parliament</i>	<i>Financial statements signed by entity</i>	<i>Auditor-General's report signed</i>
COMPLETED AUDITS - continued				
GAMING				
Totalizator Agency Board	1 Aug. 1994 to 2 June 1995	2 Oct. <i>Financial Management Act 1994, s.46.</i>	24 Aug. 1999	31 Aug. 1999
Victorian Casino and Gaming Authority	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.46.</i>	28 Sept. 1999	28 Sept. 1999
TREASURER				
ACN 065 325 206 Ltd (e)	Period 1 July 1998 to 29 June 1999	29 Oct. <i>Financial Management Act 1994, s.53A.</i>	16 Aug. 1998	16 Aug. 1998
Aluminium Smelters of Victoria Pty Ltd (f)	Period 1 July 1998 to 21 Aug. 1998	21 Dec. <i>Financial Management Act 1994, s.53A.</i>	18 June. 1999	30 June. 1999
Aluvic Metal Sales Pty Ltd (f)	Period 1 July 1998 to 21 Aug. 1998	" "	18 June. 1999	30 June. 1999
Chief Electrical Inspector, Office of the	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.46.</i>	10 Aug. 1999	12 Aug. 1999
Energy 21 Pty Ltd (g)	Period 1 July 1998 to 31 Mar. 1999	31 July. <i>Financial Management Act 1994, s.53A.</i>	24 Feb. 2000	24 Feb. 2000
Gas Release Co. Pty Ltd	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.53A.</i>	30 Sept. 1999	1 Oct. 1999
Gas Safety, Office of	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.46.</i>	28 July. 1999	20 Aug. 1999
Gas services business Pty Ltd	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.53A.</i>	24 Sept. 1999	24 Sept. 1999
Gas Transmission Corporation	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.46.</i>	24 Sept. 1999	29 Sept. 1999
Gascor Holdings No. 1 Pty Ltd (g)	Period 1 July 1998 to 30 Mar. 1999	30 July. <i>Financial Management Act 1994, s.53A.</i>	20 Sept. 1999	29 Sept. 1999
" "	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.53A.</i>	22 Dec. 1999	24 Dec. 1999

SCHEDULE B
COMPLETED/INCOMPLETE AUDITS - continued

<i>Entity</i>	<i>Financial year ended</i>	<i>Reporting to Parliament</i>	<i>Financial statements signed by entity</i>	<i>Auditor-General's report signed</i>
COMPLETED AUDITS - continued				
TREASURER - continued				
Gascor Holdings No. 2 Pty Ltd (g)	Period 1 July 1998 to 24 Feb. 1999	24 June. <i>Financial Management Act 1994, s.53A.</i>	22 Oct. 1999	26 Oct. 1999
“ “	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.53A.</i>	22 Dec. 1999	24 Dec. 1999
Gascor Holdings No. 3 Pty Ltd (g)	Period 1 July 1998 to 31 Mar. 1999	31 July. <i>Financial Management Act 1994, s.53A.</i>	24 Feb. 2000	28 Feb. 2000
“ “	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.53A.</i>	12 Apr. 2000	14 Apr. 2000
Gascor EPL Pty Ltd (h)	30 June 1999	“ “	12 Apr. 2000	14 Apr. 2000
Gascor IEPL Pty Ltd (g) (i)	Period 1 July 1998 to 30 Mar. 1999	30 July. <i>Financial Management Act 1994, s.53A.</i>	20 Sept. 1999	24 Sept. 1999
“ “	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.53A.</i>	22 Dec. 1999	24 Dec. 1999
Gascor KEPL Pty Ltd (j)	30 June 1999	“ “	22 Dec. 1999	24 Dec. 1999
Gascor MAPL Pty Ltd (g) (k)	Period 1 July 1998 to 30 Mar. 1999	30 July. <i>Financial Management Act 1994, s.53A.</i>	20 Sept. 1999	24 Sept. 1999
“ “	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.53A.</i>	22 Dec. 1999	24 Dec. 1999
Gascor MGPL Pty Ltd (g) (l)	Period 1 July 1998 to 30 Mar. 1999	30 July. <i>Financial Management Act 1994, s.53A.</i>	20 Sept. 1999	24 Sept. 1999
“ “	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.53A.</i>	22 Dec. 1999	24 Dec. 1999

Gascor Pty Ltd	30 June 1999	"	"	19 Oct. 1999	21 Oct. 1999
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SCHEDULE B
COMPLETED/INCOMPLETE AUDITS - continued

<i>Entity</i>	<i>Financial year ended</i>	<i>Reporting to Parliament</i>	<i>Financial statements signed by entity</i>	<i>Auditor- General's report signed</i>
COMPLETED AUDITS - continued				
TREASURER - continued				
Gascor SAPL Pty Ltd (m)	30 June 1999	31 Oct. <i>Financial Management Act 1994,</i> s.53A.	12 Apr. 2000	14 Apr. 2000
Gascor SNPL Pty Ltd (n)	30 June 1999	" "	12 Apr. 2000	14 Apr. 2000
Gascor (T No.1) Pty Ltd (g)(o)	Period 1 July 1998 to 2 June 1999	2 Oct. <i>Financial Management Act 1994, s.53A.</i>	9 Feb. 2000	9 Feb. 2000
" "	30 June 1999	31 Oct. <i>Financial Management Act 1994,</i> s.53A.	9 Feb. 2000	10 Mar. 2000
Gascor (TH) Pty Ltd (g) (p)	Period 1 July 1998 to 2 June 1999	2 Oct. <i>Financial Management Act 1994, s.53A.</i>	9 Feb. 2000	9 Feb. 2000
" "	30 June 1999	31 Oct. <i>Financial Management Act 1994,</i> s.53A.	9 Feb. 2000	10 Mar. 2000
Gascor WAPL Pty Ltd (q)	30 June 1999	" "	22 Dec. 1999	24 Dec. 1999
Gascor WPL Pty Ltd (r)	30 June 1999	" "	22 Dec. 1999	24 Dec. 1999
Gasmart (Vic) Pty Ltd (s)	Period 1 July 1998 to 31 Mar. 1999	31 July. <i>Financial Management Act 1994,</i> s.53A.	21 June 1999	29 June 1999
Generation Victoria (g)	Period 1 July 1998 to 17 Feb. 1999	17 June. <i>Financial Management Act 1994, s.46.</i>	28 June. 1999	29 June. 1999
Generation Victoria (t)	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.46.</i>	30 June. 1999	30 June. 1999
Hastings Port (Holding) Corporation	30 June 1999	" "	10 Sept. 1999	23 Sept. 1999
Kinetik Energy Pty Ltd (g)	Period 1 July 1998 to 24 Feb. 1999	24 June. <i>Financial Management Act 1994,</i> s.53A.	22 Oct. 1999	26 Oct. 1999

SCHEDULE B
COMPLETED/INCOMPLETE AUDITS - continued

<i>Entity</i>	<i>Financial year ended</i>	<i>Reporting to Parliament</i>	<i>Financial statements signed by entity</i>	<i>Auditor-General's report signed</i>
COMPLETED AUDITS - continued				
TREASURER - continued				
Land Aggregation Program Trust Fund	Period 27 Oct. 1998 to 30 June 1999	31 Oct. <i>Financial Management Act 1994, s.46.</i>	4 Aug. 1999	4 Aug. 1999
Loy Yang B Power Station Pty Ltd (<i>u</i>)	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.53A.</i>	16 Aug. 1999	16 Aug. 1999
Met Train 1 (trading as Bayside Trains)	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.46.</i>	27 Aug. 1999	3 Nov. 1999
Met Train 2 (trading as Hillside Trains)	30 June 1999	" "	19 Aug. 1999	26 Aug. 1999
Met Tram 1 (trading as Swanston Trams)	30 June 1999	" "	22 Sept. 1999	29 Sept. 1999
Met Tram 2 (trading as Yarra Trams)	30 June 1999	" "	27 Aug. 1999	30 Sept. 1999
Melbourne Port Corporation	30 June 1999	" "	25 Aug. 1999	27 Aug. 1999
Opalwood Pty Ltd	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.53A.</i>	27 Aug. 1999	27 Aug. 1999
Quiet Life Limited (<i>u</i>)	30 June 1999	" "	16 Aug. 1999	16 Aug. 1999
Rural Finance Corporation	30 June 1999	" "	4 Aug. 1999	4 Aug. 1999
Securities Finance Corporation Ltd	31 Dec. 1999	30 April. <i>Financial Management Act 1994, s.53A.</i>	8 Mar. 2000	8 Mar. 2000
Southgate Trust	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.46.</i>	27 Aug. 1999	27 Aug. 1999
State Electricity Commission of Victoria	30 June 1999	" "	17 Sept. 1999	17 Sept. 1999
State Trustees Limited	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.53A.</i>	13 Oct. 1999	13 Oct. 1999
STL Financial Services Limited	30 June 1999	" "	30 Sept. 1999	30 Sept. 1999

SCHEDULE B
COMPLETED/INCOMPLETE AUDITS - continued

<i>Entity</i>	<i>Financial year ended</i>	<i>Reporting to Parliament</i>	<i>Financial statements signed by entity</i>	<i>Auditor-General's report signed</i>
COMPLETED AUDITS - continued				
TREASURER - continued				
Stratus Networks Pty Ltd (g)	Period 1 July 1998 to 31 Mar. 1999	31 July. <i>Financial Management Act 1994, s.53A</i>	24 Feb. 2000	28 Feb. 2000
Stratus Networks (Assets) Pty Ltd (g)	Period 1 July 1998 to 31 Mar. 1999	" "	24 Feb. 2000	28 Feb. 2000
TAC Law Pty Ltd	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.53A.</i>	30 Aug. 1999	30 Aug. 1999
Terec Limited (u)	30 June 1999	" "	6 Sept. 1999	6 Sept. 1999
The Albury Gas Company Ltd (s)	Period 1 July 1998 to 31 Mar. 1999	31 July. <i>Financial Management Act 1994, s.53A.</i>	18 Feb. 2000	28 Feb. 2000
Transmission Pipelines Australia (Assets) Pty Ltd (v)	Period 1 July 1998 to 2 June 1999	2 Oct. <i>Financial Management Act 1994, s.53A.</i>	9 Feb. 2000	9 Feb. 2000
Transport Accident Commission	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.46.</i>	30 Aug. 1999	30 Aug. 1999
Treasury Corporation of Victoria	30 June 1999	" "	25 Aug. 1999	25 Aug. 1999
Tricontinental Corporation Ltd	31 Dec. 1999	30 April. <i>Financial Management Act 1994, s.53A.</i>	8 Mar. 2000	8 Mar. 2000
Tricontinental Holdings Ltd	31 Dec. 1999	" "	8 Mar. 2000	8 Mar. 2000
Twin Waters Resort Pty Limited	31 Dec. 1999	" "	8 Mar. 2000	8 Mar. 2000
Vicfleet Pty Ltd	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.53A.</i>	5 Nov. 1999	11 Nov. 1999
Victorian Channels Authority	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.46.</i>	20 Sept. 1999	21 Sept. 1999 (d)

SCHEDULE B
COMPLETED/INCOMPLETE AUDITS - continued

<i>Entity</i>	<i>Financial year ended</i>	<i>Reporting to Parliament</i>	<i>Financial statements signed by entity</i>	<i>Auditor-General's report signed</i>
COMPLETED AUDITS - continued				
TREASURER - continued				
Victorian Electricity Metering Pty Ltd (u)	30 June 1999	31 Oct. <i>Financial Management Act 1994</i> , s.53A.	16 Aug. 1999	16 Aug. 1999
Victorian Energy Networks Corporation	30 June 1999	31 Oct. <i>Financial Management Act 1994</i> , s.46.	20 Sept. 1999	20 Sept. 1999
Victorian Funds Management Corporation	30 June 1999	" "	26 Aug. 1999	7 Sept. 1999
VFM Australian Equities Trust	Period 1 Sept. 1998 to 30 June 1999	" "	7 Sept. 1999	7 Sept. 1999
VFM Australian Fixed Interest Trust	30 June 1999	" "	7 Sept. 1999	7 Sept. 1999
VFM Indexed Bonds Trust	Period 1 Sept. 1998 to 30 June 1999	" "	7 Sept. 1999	7 Sept. 1999
VFM International Equities Trust	Period 1 Oct. 1998 to 30 June 1999	" "	7 Sept. 1999	7 Sept. 1999
VFM Short Term Money Market Trust	30 June 1999	" "	7 Sept. 1999	7 Sept. 1999
Victorian Managed Insurance Authority	30 June 1999	" "	31 Aug. 1999	30 Sept. 1999
Victorian Power Exchange Pty Ltd	30 June 1999	31 Oct. <i>Financial Management Act 1994</i> , s.53A.	20 Sept. 1999	20 Sept. 1999
Victorian Rail Track	30 June 1999	31 Oct. <i>Financial Management Act 1994</i> , s.46.	4 Oct. 1999	5 Oct. 1999
V/Line Freight Corporation (g)	Period 1 July 1998 to 30 April 1999	30 Aug. <i>Financial Management Act 1994</i> , s.46.	14 Oct. 1999	15 Oct. 1999

SCHEDULE B
COMPLETED/INCOMPLETE AUDITS - continued

<i>Entity</i>	<i>Financial year ended</i>	<i>Reporting to Parliament</i>	<i>Financial statements signed by entity</i>	<i>Auditor-General's report signed</i>
COMPLETED AUDITS - continued				
TREASURER - continued				
V/Line Freight Corporation (w)	30 June 1999	31 Oct. <i>Financial Management Act 1994, s.46.</i>	14 Oct. 1999	15 Oct. 1999
V/Line Passenger Corporation	30 June 1999	" "	25 Oct. 1999	29 Oct. 1999
Westar Pty Ltd (g)	Period 1 July 1998 to 24 Feb. 1999	24 June. <i>Financial Management Act 1994, s.53A.</i>	22 Oct. 1999	26 Oct. 1999
Westar (Assets) Pty Ltd (g)	Period 1 July 1998 to 24 Feb. 1999	" "	22 Oct. 1999	26 Oct. 1999
INCOMPLETE AUDITS				
Western Underground Gas Storage Pty Ltd	Period 1 July 1998 to 27 Nov. 1998	27 Mar. <i>Financial Management Act 1994, s.53A.</i>	Audit substantially completed.	

- (a) Final audit performed by a firm of private auditors appointed by the Parliament. Entity abolished on 31 December 1999.
- (b) Final audit.
- (c) Final audits. Entity now subject to the *Superannuation Industry (Supervision) Act 1993* of the Commonwealth Government.
- (d) Qualified audit report issued.
- (e) Formerly known as Ecogen Energy Ltd. Entity sold to private sector on 29 June 1999.
- (f) Final audit. Entity sold to private sector on 21 August 1998.
- (g) Audit requested by the Treasurer of Victoria as at the date of sale of the entity's net assets to the private sector.
- (h) Formerly known as Energy 21 Pty Ltd.
- (i) Formerly known as Ikon Energy Pty Ltd.
- (j) Formerly known as Kinetik Energy Pty Ltd.
- (k) Formerly known as Multinet (Assets) Pty Ltd.
- (l) Formerly known as Multinet (Gas) Pty Ltd.
- (m) Formerly known as Stratus Networks (Assets) Pty Ltd.
- (n) Formerly known as Stratus Networks Pty Ltd.
- (o) Formerly known as Transmission Pipelines Australia Pty Ltd.
- (p) Formerly known as Transmission Pipelines Australia (Holdings) Pty Ltd.
- (q) Formerly known as Westar (Assets) Pty Ltd.
- (r) Formerly known as Westar Pty Ltd.
- (s) Final audit. Entity sold to private sector on 31 March 1999.
- (t) Final audit. Entity abolished 1 July 1999.
- (u) Company deregistered in July 1999.
- (v) Final audit. Entity sold to private sector on 2 June 1999.
- (w) Final audit. Entity abolished on 1 July 1999.

Part 4

Broad Scope Issues

Part 4

Broad scope issues

KEY FINDINGS

Implementation of the GST in the Victorian public sector

- Government agencies are currently preparing for the introduction of the new tax regime and there are substantial operating and financial ramifications for those agencies if they are not prepared in time.
Paras 4.1.1 to 4.1.5
- The arrangements established by the Department of Treasury and Finance for the introduction of GST throughout the public sector were comprehensive. However, certain problems associated with the monitoring arrangements have adversely impacted on the implementation process. In addition, other factors largely outside the control of the State Government, relating to delays in enacting amendments to the Commonwealth's GST legislation and delays experienced with the Australian Tax Office in providing interpretation and treatment rulings have also adversely impacted on the implementation of the GST throughout the public sector.
Paras 4.1.10 to 4.1.11
- As at 2 May 2000, only 30 per cent of selected public sector agencies were on target to achieve readiness for the implementation of the GST by 30 June 2000.
Paras 4.1.16 to 4.1.19
- Although the Government's target date for the completion of the ABN registration process was the end of May 2000, given the logistics involved in the registration process, a substantial number of government agencies may not be registered prior to the commencement of the GST on 1 July 2000.
Paras 4.1.27 to 4.1.33
- It is important that embedded tax savings are identified and secured by agencies through timely negotiation with suppliers to ensure that the State budget position is not eroded.
Paras 4.1.34 to 4.1.39
- In light of the extent of work yet to be performed, and the fast approaching deadline of 30 June 2000, there is a need for agencies to re-assess the criticality of all identified business processes and to prioritise outstanding tasks to be performed.
Para. 4.1.42

KEY FINDINGS – *continued*

Outsourcing in the Victorian public sector

- Because of a number of factors, including the long-term nature of many of the major outsourcing arrangements currently in place, effective management of outsourced services is likely to remain an important responsibility of government agencies for some time.
Paras 4.2.16 to 4.2.20
- Based on departmental experiences with outsourcing, several key issues will warrant attention in the formulation of policies for the future delivery of government services.
Paras 4.2.27 to 4.2.53
- All 5 departments examined during this audit had taken positive action aimed at strengthening their overall management approach to outsourcing.
Paras 4.2.54 to 4.2.106

Part 4.1

Implementation of the GST in the Victorian public sector

4.1.1 The Commonwealth Government's recently introduced changes to the Australian taxation system, including the implementation of a goods and services tax (GST) that is to apply from 1 July 2000, which impact on both the public as well as the private sectors.

4.1.2 The GST is a broad based tax (10 per cent) levied on the supply of most goods and services consumed in Australia, whereby the consumer will bear the cost of the GST rather than the entity producing the goods and services. However, the liability to pay GST to the Australian Taxation Office (ATO) rests on the supplier rather than the consumer.

4.1.3 The GST will apply to government services in substantially the same way as to the private sector. The Government will collect the GST on the non-exempt services it provides and will claim input tax credits for the GST paid on its purchases of goods and services. Even where a government agency supplies GST-free goods or services, it can still claim input tax credits from the ATO for the GST paid on most of its purchases.

4.1.4 Government agencies are currently preparing for the introduction of the new tax regime and there are substantial operating and financial ramifications for those agencies if they are not prepared in time.

4.1.5 In recognition of the substantial impacts that the GST will have on all 540 public sector organisations, and in light of the fast approaching deadline, we conducted a review of the level of preparedness of public bodies for the implementation of the GST. Our examination included a review of central agency leadership and monitoring arrangements.



Information booklets on the new GST tax system.

Key government initiatives to address the implementation of the GST

4.1.6 While the GST was first proposed by the Commonwealth Government in 1998, it was not until legislation was passed in June 1999 that action in the Victorian public sector could be taken to address its implementation. One of the key actions taken by the Victorian Government in July 1999 was the establishment of a GST Implementation Unit within the Department of Treasury and Finance to co-ordinate and monitor the progress of each department and agency in achieving preparedness for the commencement of the GST.

4.1.7 At the same time, the following key stakeholders were assigned responsibility for the implementation of the GST:

- the Minister for Finance for implementation standards across all public sector agencies and for monitoring compliance;
- relevant Ministers to be accountable for the implementation of the GST in all entities within their portfolio;
- departmental Secretaries and the Chief Executive Officers (CEOs) of each agency for managing the implementation of the GST at an entity level and ensuring compliance with ATO tax obligations; and
- portfolio co-ordinators to provide relevant information on the GST to entity CEOs within the portfolio, including decisions of the Government Steering Committee, and guiding the implementation of the GST throughout their respective portfolios.

4.1.8 Other key actions taken by the Government since July 1999 included:

- a number of high level committees and working parties were established to oversee the implementation of the GST throughout the public sector;

- Victoria joined the Interstate GST Working Group to assist in overcoming implementation difficulties through the sharing of information and experiences, and enable a united approach to the resolution of issues with the Commonwealth Government and the ATO;
- consultants were appointed by the Minister of Finance to support the implementation of the GST and related activities at a public sector agency level; and
- an *Accounting and Financial Reporting Bulletin* was recently issued providing guidance on the accounting conventions to be utilised for the implementation of the GST.

4.1.9 In addition to the action taken by the Victorian Government, considerable resources have been allocated by the Commonwealth Government to increase awareness of the GST and assist with its implementation. Although the Commonwealth Government initiatives are mainly directed at the private sector, the public sector has also benefited from the increased awareness and training provided to suppliers, service providers and the community generally.

GST Implementation Unit

4.1.10 The GST Implementation Unit established within the Department of Treasury and Finance has responsibility to drive and co-ordinate the implementation of the GST in the Victorian public sector. The Unit works in co-operation with departments and agencies across portfolios to ensure that there is a co-ordinated approach to the implementation of the new tax system. Consistent with this role, the Unit has:

- raised the level of awareness of the many issues surrounding the implementation of the GST, through regular meetings, forums and seminars, and provided other information and advice to agencies on an ad-hoc basis;
- engaged consultants to develop a GST implementation methodology for the public sector, design a quality assurance and monitoring process, and assist individual agencies with their implementation requirements;
- created a public sector GST website to allow agencies to have ready access to the implementation methodology as well as informative articles, including ATO rulings and promotional material relevant to the implementation and administration of the GST;
- established a quality assurance and progressive reporting database on the Department of Treasury and Finance website to assist senior management of agencies to appreciate the issues requiring attention, enable the monitoring of the implementation of GST across all public sector agencies, and recommend action where required;
- facilitated inter-agency co-operation where appropriate; and
- co-ordinated GST issues impacting on the Victorian Government with other State Governments for resolution with the ATO or Commonwealth Government.

4.1.11 We have concluded that the arrangements established by the Department of Treasury and Finance for the introduction of GST throughout the public sector were comprehensive. As detailed in later sections of this Report, certain problems associated with the monitoring arrangements have adversely impacted on the implementation process. In addition, other factors largely outside the control of the State Government, relating to delays in enacting amendments to the Commonwealth's GST legislation and delays experienced with the ATO in providing interpretation and treatment rulings have also adversely impacted on the implementation of the GST throughout the public sector.

Project framework for the implementation of the GST in public sector agencies

4.1.12 One of the GST Implementation Unit's key responsibilities included establishing an implementation methodology, developed in conjunction with consultants, to enable public sector agencies to follow an appropriate and systematic process for the implementation of the GST. The following 5 phases of the implementation process outline the critical tasks that should have been undertaken by each agency at the completion of each phase, by the dates indicated.

Phase 1: Scoping and Analysis - 15 January 2000:

- identified all significant issues which arise from GST implementation;
- identified the most appropriate structure to minimise tax procedures;
- drafted an implementation plan to address the issues identified; and
- assessed the resources required to implement the required processes and systems.

Phase 2: Preparation and Design - 31 January 2000:

- developed a capability transfer framework;
- assessed pre-GST business structure and prioritise post-GST restructure opportunities;
- developed new system process requirements;
- developed new business processes;
- defined financial benchmarks and developed cost models; and
- developed a communication strategy.

Phase 3: Modification and Change - 14 April 2000:

- conducted changes at the organisational level;
- completed supplier management and negotiations;
- re-negotiated contracts and service agreements as appropriate;
- implemented the required business process re-engineering so they are operational on 1 July 2000; and
- implemented changes to information systems so they are operational on 1 July 2000.

Phase 4: Testing and Implementation - 9 June 2000:

- monitored and reviewed the key milestones and performance against benchmarks;
- simulated the new transaction environment for GST compliance;
- analysed and reviewed the overall tax effect on the agency as a result of the GST;
- tested and piloted new processes;
- delivered leadership education programs and received feedback; and
- carried out test planning, integration testing and assessed system and software conversion.

Phase 5: Compliance Review - 6 October 2000:

- evaluated the capability transfer framework and reviewed key milestones;
- evaluated the live transaction environment;
- reviewed and refined processes after the cut-over to live operations;
- reviewed pricing and costing models; and
- conducted end-user training and continued internal and external communications about the impact of the GST.

4.1.13 It is important to recognise that failure to appropriately modify systems and business processes in line with the above project phases may result in an agency's inability to accurately calculate the GST liability payable to the ATO or to claim input tax credits on a timely basis. While the potential exists for tax penalties to be applied, a more significant issue would be a loss of revenue to the State from failing to claim input tax credits. In addition, any delays in claiming input tax credits from the ATO will have an adverse impact on an agency's cash flow position.

4.1.14 It is pleasing to note that appropriate recognition has been given to the considerable monitoring and review efforts that will be required. This will assist the Government in ensuring that agencies are complying with the requirements of the GST legislation and enable necessary assistance to be directed at areas encountering difficulties.

4.1.15 **The GST Implementation Unit has revised, on a number of occasions, the completion dates shown for each phase due to implementation difficulties being experienced across the public sector. The revised dates leave agencies with little scope for any further delay in the implementation process.**

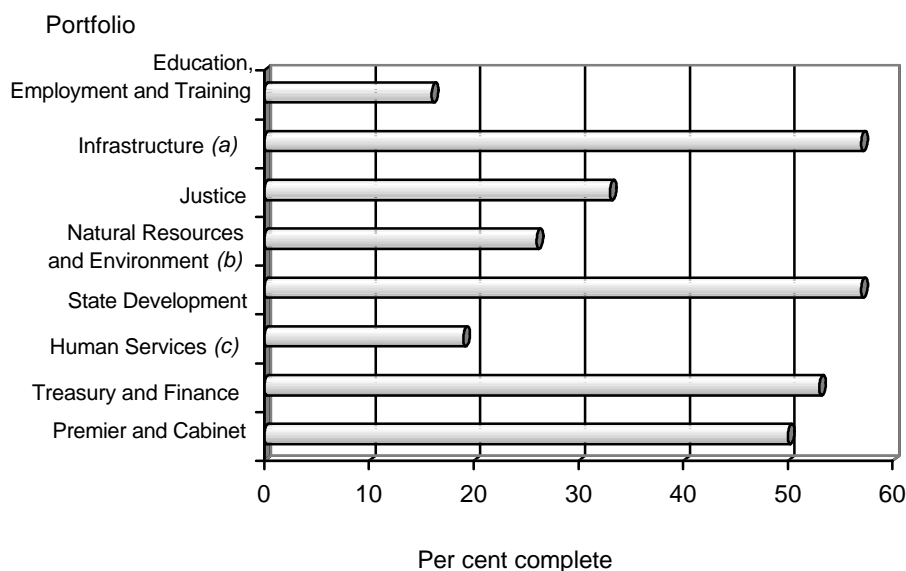
Preparedness of the State for the implementation of the GST

4.1.16 The GST Implementation Unit monitors the progress of individual public sector agencies in achieving GST readiness from information supplied by portfolio coordinators who are responsible for the completion of computerised surveys on the website. These surveys detail the agency's assessment of the percentage of work completed for each of the 5 phases of the implementation methodology outlined above.

4.1.17 The percentage of work completed for each phase is then averaged through a benchmarking process, developed by the Unit, which is automatically applied to an individual agency's survey data. Based on this information, reports are prepared by the GST Implementation Unit, which provide summary details of the average GST preparedness across selected agencies within a ministerial portfolio.

4.1.18 An analysis of these reports indicates that, as at 2 May 2000, only 30 per cent of these selected public sector agencies were on target to achieve readiness for the implementation of the GST by 30 June 2000. Chart 4.1A indicates that, in terms of phase 3 of the implementation process, the majority of public sector agencies that were monitored are considered not to be on schedule to achieve compliance with the GST requirements as planned.

CHART 4.1A
PERCENTAGE OF PUBLIC SECTOR AGENCIES ON TARGET WITH
PHASE 3 OF THE GST IMPLEMENTATION REQUIREMENTS, AS AT 2 MAY 2000



- (a) Infrastructure excludes municipal councils.
- (b) Natural Resources and Environment includes water bodies, alpine resorts and various agricultural authorities.
- (c) Human Services includes larger public hospitals, but excludes cemeteries.

4.1.19 Although most entities had identified project completion deadlines in line with the Government's implementation timetable, given their progress at the date of preparation of this Report, it appears unlikely that all agencies will achieve this goal. This is of particular concern, given that the GST legislation will take effect from the 1 July 2000.

GST implementation monitoring deficiencies

4.1.20 Apart from the implementation delays highlighted in the above chart, we identified a number of issues which impacted on the usefulness, reliability and accuracy of the survey data collected by the GST Implementation Unit from the monitoring system. These issues included:

- **The reporting system and monitoring arrangements established by the GST Implementation Unit do not include any risk assessment of the critical business transactions and processes to identify those that represent the greatest risk to the State as a result of failure to comply with the GST legislative requirements.** For example, such an assessment could be based on the size and type of transactions or potential impact of disruptions to services as a result of dealings with non-compliant suppliers and service providers;
- An analysis of the survey data revealed that the majority of agencies had not submitted any responses to the first 2 phases of the implementation process with a large number also not responding to the third implementation phase. This is of particular concern given that the objective of the reporting process is to gain assurance that agencies are undertaking the key tasks and achieving major milestones required to enable the timely implementation of GST;
- Significant differences were identified in the percentage completion calculated by the monitoring system compared with the actual level of preparedness that existed within certain portfolios and individual agencies. For example, while a number of lead agencies were reported as being on target for the implementation, we found that certain issues were still to be resolved with the Commonwealth Government and the ATO; and
- The GST Implementation Unit had, on several occasions, reduced the number of agencies required to respond to the survey. In this regard, the latest survey data collated by the Unit was for only 216 agencies compared with the 310 that were identified by us when the database was first established. The low number currently being monitored by the Unit will make it difficult for the Government to obtain an accurate picture of the implementation status of the State's 540 public sector agencies.

4.1.21 Given the survey difficulties, there has been some concern that the information reported on the State's GST readiness may not be the most reliable and accurate. Under these circumstances, the GST Implementation Unit has expended considerable effort in revamping the questionnaire and developing a new simplified and shorter version, which by mid-March 2000 was available for use by smaller agencies. The latest survey results for phase 3 of the implementation process indicate that these steps have resulted in a significant improvement in the number of agencies responding to the survey data.

Cost of implementing the GST in the public sector

4.1.22 The original aim of the Government was for departments to fund their internal costs of implementing the GST by the re-arrangement of development priorities and to reduce implementation costs by adopting common methodologies and tools. Accordingly, the total budget allocation for the implementation of the GST across the budget sector for the 2 year period ending June 2001 was restricted to \$15 million. In line with the Government's funding strategy, the majority of this amount was to be expended on consultancies engaged by central agencies for the development of implementation methodologies, monitoring tools, policy advice, training and guidelines, with only a small proportion of the funding available to individual departments and agencies.

4.1.23 Subsequently, the implementation effort was further devolved and additional budgeted funds were re-directed to individual departments and agencies. Table 4.1B details the budgeted funds provided and the funds expended by DTF in co-ordinating and supporting budget sector agencies in implementing the GST, based on information provided by the GST Implementation Unit.

TABLE 4.1B
VICTORIAN BUDGET SECTOR, GST IMPLEMENTATION COSTS, MET FROM
SPECIFIC BUDGET ALLOCATION, AS AT 30 APRIL 2000
 (\$million)

<i>Funding source</i>	<i>Actual expenditure (a)</i>	<i>Funds yet to be expended</i>	<i>Total estimated cost</i>
1999-2000 Budget	3	7	10
2000-2001 Budget	Nil	5	5
Total	3	12	15

(a) Does not include the costs incurred by self-funded or non-budget sector agencies or the salaries of staff involved in implementation. In addition, "actual expenditure" shown in the table does not include amounts committed.

4.1.24 The table highlights that only \$3 million or 30 per cent, of the funds provided for the GST implementation program had been spent on GST implementation activities to the end of April 2000. We were advised that, at that time, additional expenditure commitments had been entered into totalling \$4.9 million.

4.1.25 The above table does not include any costs associated with self-funded agencies, government business enterprises or local government agencies, nor does it include any salary costs associated with project teams involved in the implementation of the GST. Based on information provided by certain agencies and the GST Implementation Unit, we estimate that the total implementation costs across the entire public sector to be in excess of \$40 million. In addition, the costs involved in the ongoing administration of the GST is also expected to be substantial across the public sector.

4.1.26 From a cost-control perspective, it is important that the Government monitors the total funds expended throughout the public sector on the implementation and the ongoing administration of the GST. Given the current absence of this information there is a need for the GST Implementation Unit to develop a mechanism to collect costing information from individual agencies.

Australian Business Number registration process

4.1.27 One of the main administrative changes introduced by the Commonwealth Government's tax reform package is the requirement for entities to register with the ATO and receive an Australian Business Number (ABN). Individual entities are required to obtain an ABN number so that their correct status can be recognised when purchasing or selling goods and services, and to assist them in fulfilling their administrative obligations under the new tax system.

4.1.28 Under the agreed implementation arrangements, the Minister for Finance provides the ATO with "proof of identity" for each public sector entity applying for registration. The Minister provides this advice in phases, in line with an approved list of public sector organisations that are considered to require ABN registration. In accordance with the agreed arrangements, the ATO forwards the registration information to the nominated entities and the entities are then required to independently apply to the ATO for their ABN registration. The cut-off date for each phase is set out in Table 4.1C below.

**TABLE 4.1C
STATUS OF EACH PHASE, AS AT 2 MAY 2000**

<i>Phase and cut-off date</i>	<i>No. of entities (to be) included in the list sent to ATO</i>	<i>No. of entities with ABN registration processed by ATO</i>
Phase 1 - December 31	190	107
Phase 2 - February 28	200	40
Phase 3 - March 31	(a) 5 000	(b)
Total	5 390	147

(a) Includes kindergartens, cemeteries, committees of management, schools etc.

(b) The list of entities forming phase 3 has not been finalised by Department of Treasury and Finance as at 2 May 2000

4.1.29 Following the receipt and processing of applications lodged, the ATO provides advice to the Department of Treasury and Finance on the number of Victorian public sector agencies that have been issued their ABN. The table highlights that 52 per cent of the larger public sector agencies, that were included in the phase 1 and phase 2 lists, have not received their ABN registration. However, due to delays in finalising the phase 3 list, less than 10 per cent of all public sector entities have received their ABN registration.

4.1.30 Our review identified that the GST Implementation Unit initially had difficulty agreeing on the requirements for registration with the ATO, in terms of the level at which ABN registration was to apply. This resulted in the late submission to the ATO of the “proof of identity” for entities on the phase 1 and phase 2 lists. As indicated in the above table, the majority of entities requiring registration form part of phase 3 for which ‘proof of identity’ had not been forwarded to the ATO. We were advised that the phase 3 list had not been submitted as related threshold issues were only resolved with the ATO in early April 2000.

4.1.31 Concerns have been raised in the wider community about the expectation of delays resulting from the many late applications which are expected to be received by the ATO prior to the commencement of the GST. While the registration process is now relatively straight forward, there is concern that the late submission of the phase 3 list of public sector entities to the ATO may result in delays in processing ABN registration.

4.1.32 Under *A New Tax System (Goods & Services) Act 1999*, where proof of an ABN registration cannot be provided by entities, the purchaser will be required to withhold 48.5 per cent of any payments to that entity. In addition, agencies without an ABN registration will not be able to claim the applicable 10 per cent input tax credits. As the ABN registration will also facilitate the administration of other taxes such as group tax and fringe benefits tax (FBT) the non-registration could result in higher administration costs and delays in dealing with the ATO.

4.1.33 **Although the Government’s target date for the completion of the ABN registration process was the end of May 2000, given the logistics involved in phase 3 of the registration process, a substantial number of government agencies may not be registered prior to the commencement of the GST on 1 July 2000.**

Ensuring embedded tax savings are realised

4.1.34 As part of the national tax reform package a number of existing taxes will be abolished. These include the wholesale sales tax, currently levied at up to 22 per cent, and a range of State taxes which will be eliminated in stages, the first being financial institutions duty and stamp duty on marketable securities which will be eliminated on 1 July 2001. The elimination of these taxes and the introduction of the new diesel fuel rebate scheme should result in significant reductions in business costs in the private sector.

4.1.35 Given that most State Government agencies and many of their service providers were exempt from sales tax, the potential for direct cost savings for public bodies from the elimination of these taxes is significantly reduced. However, as many suppliers to the Government were previously liable for sales tax on their inputs there is potential for reduced costs of supply by the extraction of these taxes. The extraction of these taxes, which is known as “embedded tax savings”, will assist in lowering input costs.

4.1.36 These embedded tax savings have been factored into the level of Commonwealth Government funding, with the Victorian Government required to extract at least \$100 million of these savings to maintain its budget position in the 2000-2001 financial year. As a consequence, the Victorian Government has reduced the level of funding provided to budget sector agencies based on the estimated amount of cost reductions expected to result from the new tax system.

4.1.37 Under the *Trade Practices Act 1974*, suppliers are required to pass on the embedded tax savings to the purchaser. To enable compliance with that Act, all agencies are required to determine the level of potential embedded tax savings from their suppliers and ensure they re-negotiate contracts to obtain those identified savings prior to 30 June 2000.

4.1.38 To assist agencies with the task of identifying embedded tax savings, the Victorian Government has provided an economic modeling tool and appropriate training to departments and individual agencies. However, given the diverse nature of the goods and services, the various suppliers and the many contracts involved, it will be challenging for agencies to realise this level of potential savings. In addition, the significant implementation delays commented on previously could also impact on an agency's ability to identify the embedded tax savings that are required to be found from the suppliers and service providers.

4.1.39 **To ensure that the State budget position is not eroded, it is important that embedded tax savings are identified and secured by agencies through timely negotiation with suppliers.**

Factors impacting on GST implementation in the public sector

4.1.40 While the public sector is exposed to the same issues and difficulties that need to be addressed in the implementation of the GST across the private sector, there are a number of features that create additional challenges for the public sector. Some of the major issues causing the delays experienced by agencies and identified during the review, include:

- Most public sector agencies have not had to deal with taxation matters in the past as they have been exempt from sales tax and income tax. Therefore, many officers in the public sector are currently dealing with taxation concepts without any prior tax experience as well as the many complexities surrounding the implementation of the GST;
- Certain amendments to the GST legislation have only recently been enacted and, therefore, their impact on the public sector has only recently been clarified;
- The applicability of GST to appropriations, grants and various other transactions are unique to individual agencies with no other private or public sector precedents established which has required ATO rulings and informal advice on the GST treatment of these transactions;

- The GST legislation is only one part of the Commonwealth Government's overall changes to the tax system. Other changes that are also being implemented as part of the National Tax Reform include changes to the fringe benefits tax (FBT) and the new Pay-As-You-Go system, which encompasses the reconciliation and settlement of all tax obligations such as FBT, group tax and GST through the one process. These changes, particularly FBT, have significant consequences in the public sector and to some extent have led to a diversion of some resources and focus away from the implementation of the GST;
- The determination of GST exemptions appears to be more complex in the public sector due to the many grey areas associated with making some goods and services taxable and some goods and services GST-free. For example, some education services like school fees are to be GST-free, but at the date of preparation of this Report it had not been determined whether certain other education services such as private tutoring, vocational seminars and courses would be subject to GST. The resolution of these issues will involve negotiations with the Commonwealth, State and local government agencies that deliver the various educational services in conjunction with the ATO;
- Transitional arrangements requiring the re-negotiation of existing supply and service contracts will be very difficult in most portfolios due to the number and complexity of the agreements involved. For example, the Department of Human Services has around 2 700 service agreements with various non-government organisations and local government bodies that need to be examined and re-negotiated for GST impacts before 1 July 2000; and
- The number of entities within each ministerial portfolio that need to be registered and comply with the GST legislation creates substantial logistical difficulties. For example, the Department of Human Services currently only monitors the progress of implementation of around 150 public bodies. However, there are approximately 2 400 other entities that come within the portfolio that will also need to prepare for the implementation of the GST. The ministerial portfolios of Education, Employment and Training, and Natural Resources and Environment are also facing similar difficulties.

4.1.41 While public sector agencies have gained a good understanding of the key issues involved in implementing the GST, due to the issues outlined above, it will be difficult for all agencies to be fully prepared for the implementation of the GST by 30 June 2000.

Completion of the implementation process

4.1.42 In light of the extent of work yet to be performed, and the fast approaching deadline of 30 June 2000, there is a need for agencies to re-assess the criticality of all identified business processes and to prioritise outstanding tasks to be performed. In this regard it is important that agencies ensure the following actions, if not already completed, are instituted as a matter of priority:

- the risk of non-compliance on core business processes is evaluated;
- specific additional monetary and human resources required to achieve GST compliance are identified and provided as soon as possible;

- any delays in the ABN registration process for individual agencies be identified and resolved;
- ensuring systems and processes are in place to enable completion of necessary GST documentation and enable all available input tax credits to be claimed;
- agencies to assess the impact of GST and reset their fees and charges in accordance with government policy;
- external service providers and suppliers be contacted to obtain assurances in regard to their ABN registration to ensure that problems will not arise through their non-compliance with GST requirements; and
- potential embedded tax savings be identified and realised from appropriate external suppliers through timely contract re-negotiation.

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

The Department of Treasury and Finance (DTF) notes audit acknowledgment that comprehensive arrangements were established for the introduction of the GST throughout the Victorian Public Sector (VPS).

DTF agrees with the overall findings of the audit report in terms of GST implementation progress:

- *as at mid-April, only 30 per cent of public sector agencies were on target against the benchmark timetable for GST implementation, but most entities have established timetables that will enable them to achieve GST readiness by 1 July 2000;*
- *it is likely that some VPS agencies will not be fully “GST ready” by 1 July 2000, (contingency mechanisms are in place at portfolio level); and*
- *GST implementation has been severely impacted by significant delays in resolution of key issues by the Federal Government and the Australian Taxation Office.*

In terms of the detail of the audit report, clarification of some of the findings may assist readers:

Monitoring system

The audit report draws heavily on data derived from the DTF Quality Assurance and Monitoring system, which was put in place to allow DTF to audit its own performance and that of the VPS.

DTF does not agree with the review’s assessment of deficiencies in the monitoring system. Systems of this type are a strategic monitoring tool, rather than a comprehensive risk management system. Risk management is separately undertaken through other means.

- *The difficulties attributed to the monitoring system relate principally to significant delays in resolution of key issues by the Federal Government and the Australian Taxation Office. As a consequence of the frequency of changes and clarifications, the Victorian implementation program has involved many adjustments at agency, portfolio and whole-of-government levels:*

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

- Benchmark timetables have had to be periodically adjusted to take into account continuous “external” delays in (Federal Government/ATO) caused by the Federal Government and the ATO in resolving emerging policy issues; and
- Smaller agencies were grouped not simply for monitoring purposes (the reason for the reduction in number of reporting entities), but to reflect the fact that implementation programs for certain types of small agencies were very minor or best planned and supported at a portfolio level (e.g. Committees of Management, small hospitals, schools, DNRE regional activities, etc.).
- The review highlights the fact that as at 2 May only 30 per cent of agencies were on target to achieve readiness according to the QA and Monitoring system. Also relevant, however, is the fact that at that time only 11 per cent of agencies were significantly behind schedule.
- On the available evidence GST preparations in the VPS compare favourably against other jurisdictions and the private sector.
- The majority of VPS entities face similar issues to small/medium enterprises in the private sector, in terms of limited financial preparedness, capabilities and skills for dealing with a complex new taxation compliance environment.

Cost of implementing GST in the Public Sector

The DTF GST budget was set in April 1999 before the Federal Government finalised its tax package in June 1999. The accountability framework and implementation approach had not been determined at the time the budget was set.

- The subsequent decision to adopt a devolved accountability framework meant that DTF was able to set up a small co-ordination and support function rather than a large centralised project team.
- The majority of the DTF expenditure has been applied to providing support mechanisms for portfolio co-ordinators and agencies. In addition, \$2.5million of the commitments referred to in the audit report relate to an intention to make a contribution to partial reimbursement of costs incurred in portfolio departments.

Collection of costing information is not considered an immediate priority in terms of achieving GST compliance within the tight timeframes. Costs are already being minimised through the adoption of a shared approach to common issues and tasks, and the focus on reallocation of internal resources. Consideration will be given to estimating the total “absorbed” costs, as part of the post implementation review process.

Australian Business Number registration progress

The audit report concludes that a substantial number of government agencies may not be registered prior to the commencement of the GST on 1 July 2000. This risk will only materialise if the ATO is unable to meet its ABN processing commitments. There is no major risk attributable to the actions of the State.

- Registration of government entities (across all jurisdictions) has been significantly delayed by the Federal Government and the ATO.

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

- Anomalies existed in the Federal Government's new tax legislation with different criteria being required for ABN, GST, PAYG and FBT registration. The Federal Government and the ATO have taken 4 to 5 months to standardise the registration arrangements for government entities.
- Clarification of the application of registration threshold criteria for government entities was only recently provided (delaying the registration process for the 5 000 small government entities).
- A rigorous program has been developed (involving close liaison between the ATO, DTF and portfolio co-ordinators) to ensure registration details for all Victorian Government entities are provided to the ATO by 31 May 2000.
- DTF is confident that virtually all VPS entity details for ABN registration will be lodged by 31 May.
- The ATO is publicly committed to ensure ABNs are issued for all entities whose registration details are lodged by 31 May 2000.

Embedded tax savings

A communication and education program has been conducted to ensure all VPS agencies are aware of the importance of pursuing embedded tax savings.

- Significant guidelines and support materials have been made available through the Victorian Government Purchasing Board to assist agencies in dealing with suppliers on this issue.
- A risk to the State budget exists because VPS extraction of cost savings is dependent upon each supplier extracting embedded tax savings from their suppliers. The private sector generally is expressing significant doubts as to the level of savings potential compared with the estimates developed by the Federal Government for economy-wide savings. These estimates were used to adjust the level of Commonwealth "guarantee" funding to the States.
- The Expenditure Review Committee of Cabinet was aware of the risk at the time the 2000-2001 State budget was framed, and has requested that a review of the economy-wide experience of embedded tax savings be conducted by March 2001.

Risk Management

The audit report confirms that the delays in resolution of key issues by the Federal Government and the ATO have created a significant risk to the VPS (and all jurisdictions) achievement of GST compliance capability by 1 July 2000.

The VPS implementation program has been adapted as far as possible to minimise the risk factors. All the of the key actions identified by the audit review as being required to complete the implementation process have been highlighted to agencies.

In addition, a variety of major/common risks have been identified in regard to the post-1 July 2000 environment. These risks will be monitored as part of the post-implementation review program:

- Extraction of embedded tax savings will require an ongoing focus, as many of the savings are progressively available after 1 July.
- The need to ensure all input tax credits are captured and claimed as soon as they are available.

- ❑ **RESPONSE** provided by Secretary, Department of Treasury and Finance - continued
- *Lack of awareness of the requirements of the new PAYG system and delayed education programs by the ATO.*
 - *Cash flow impacts associated with the complex interaction of GST and PAYG under the new Business Activity Statement environment.*
 - *Non-registration of government suppliers and grant recipients for ABN and GST.*
 - *Delays in ATO resolution of emergent issues and requests for private rulings.*

Part 4.2

Outsourcing in the Victorian public sector

OVERALL SUMMARY

4.2.1 Under public sector reforms pursued by the former Government between 1992 and 1999, outsourcing became a distinctive feature of resource management strategies within the State.

4.2.2 Because of the prominence directed to outsourcing, my Office determined to extend past audit coverage of this topic to examine the strategic approach to outsourcing and the management of individual outsourcing arrangements within 5 government departments. An assessment was also undertaken of the central agency role of the Department of Treasury and Finance in guiding the implementation of outsourcing across the public sector.

4.2.3 The current Government, since its election in October 1999, has questioned the emphasis placed on outsourcing throughout the 1990s and has signalled its intention to utilise alternative means of involving the private sector, such as through business partnerships, in the delivery of government services. Notwithstanding this approach, the level of outsourcing within the public sector may not change significantly for some time due to the long-term nature of many existing contractual arrangements and difficulties likely to be faced by agencies in readily re-establishing in-house resources as a viable alternative to the use of private sector service providers.

4.2.4 Effective management of outsourcing and other arrangements with the private sector will, therefore, remain a key responsibility of government agencies.

4.2.5 This audit examination identified several positive features of the strategic approach to outsourcing followed by each of the 5 departments. It also established that management procedures in agencies need to be strengthened in particular areas and that central action by government is necessary to upgrade the overall statewide management framework for service delivery.

OVERALL SUMMARY - *continued*

4.2.6 Based on my Office's assessment of departmental experiences with outsourcing, the key issues warranting attention in the formulation of policies for the future delivery of government services include:

- a need for a specific Statewide policy framework to guide agencies in their implementation of new approaches to service delivery;
- strengthening of decision-making within agencies, including establishment of a requirement for preparation of business cases for all arrangements with the private sector, to facilitate selection of the optimum means of service delivery;
- a strategic focus on identification and measurement of the extent of achievement of outcomes expected from outsourcing or other service delivery strategies;
- enhancement of both qualitative and quantitative performance standards incorporated in contracts entered into with the private sector;
- substantial improvement to the processes used by agencies for the ongoing management and monitoring of contractors' performance in meeting contractual obligations and delivering services; and
- the importance of a structured management approach within agencies when assessing, at the expiration of current contracts, whether outsourcing remains the most appropriate means of delivering relevant services.

4.2.7 Action in the above areas would serve to complement the initiatives taken to date by departments and help to ensure that the State's interests are adequately protected in major contractual arrangements with the private sector.

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

The Department of Treasury and Finance welcomes the Auditor-General's comments on outsourcing in the Victorian public sector. The general thrust of the audit findings and improvements proposed are supported.

INTRODUCTION

4.2.8 A prime responsibility of government agencies is the efficient and effective delivery of services to the community.

4.2.9 Historically, public sector agencies in Victoria have predominantly relied on in-house resources for the delivery of services. However, under the economic and public sector reforms pursued between October 1992 and October 1999 by the former Government, outsourcing became a distinctive feature of resource management strategies within the State.

4.2.10 Outsourcing involves a process whereby an agency engages an external party to provide core or non-core services under the terms of a contract or agreement. Outsourced arrangements generally extend over at least one year (and often more in the case of key services) and may involve services previously supplied internally or services associated with a new policy direction of government.

4.2.11 As part of its purchasing reform agenda, the former Government expected each department to critically analyse the appropriateness of all service delivery structures. To complement this expectation, the Department of Treasury and Finance encouraged departments to consider service delivery strategies such as outsourcing which had the potential for introducing market competition. Under this approach, each department was responsible for determining the most suitable means of delivering services, and for planning and managing the implementation of outsourcing.

4.2.12 The use of outsourcing, while transferring various risks and responsibilities to an external party, does not relieve the relevant government agency from its fundamental responsibility for service delivery, particularly in terms of accountability for the cost and quality of outsourced services.

REPORT ON OUTSOURCING BY THE PUBLIC ACCOUNTS AND ESTIMATES COMMITTEE

4.2.13 In March 2000, the Public Accounts and Estimates Committee tabled its thirty-fourth report to the Parliament titled *Report of the Inquiry into Outsourcing of Government Services in the Victorian Public Sector*.

4.2.14 The Committee's Report outlines findings and recommendations on a wide range of strategic and operational issues associated with outsourcing arrangements.

4.2.15 These findings and recommendations should be very useful to the Government in its consideration of future directions with the contracting-out of projects and services.

GOVERNMENT'S INITIAL VIEWS ON OUTSOURCING

4.2.16 Since assuming office in October 1999, the Government has questioned the past emphasis on outsourcing and, as an initial action, commissioned an *Audit Review of Contracts* headed by a 3 person external panel. This review was nearing completion at the time of preparation of this Report.

4.2.17 The Government has also expressed a stated preference for the pursuit of “business partnerships” with the private sector, where deemed appropriate, and an intention to be more selective in the application of outsourcing strategies for the delivery of public services.

4.2.18 An early sign of the likelihood of a change in policy direction in this area was given by the Government in November 1999 when it formally disbanded the Outsourcing and Contract Management Unit within the Department of Treasury and Finance. This Unit was previously responsible for providing central guidance on the implementation of outsourcing by agencies.

4.2.19 Notwithstanding the Government's likely future approach, the level of outsourcing within the public sector may not change significantly for some time due to:

- the long-term nature of many of the major outsourcing arrangements currently in place;
- difficulties faced by agencies in readily re-establishing in-house resources in circumstances where internal service delivery is considered to be a viable alternative to the use of current private sector service providers; and
- the likelihood that external contractors will continue to provide certain types of services more cost-effectively.

4.2.20 Because of these factors, it is probable that effective management of outsourced services will remain a key responsibility of government agencies.

EXAMINATION OF THE MANAGEMENT OF OUTSOURCING WITHIN 5 DEPARTMENTS

4.2.21 In view of the prominence directed to outsourcing throughout the term of the former Government, my Office has presented a number of Reports to the Parliament dealing with major outsourcing arrangements including:

- *Metropolitan Ambulance Services: Contractual and outsourcing practices (April 1997);*
- *Victoria's multi-agency approach to emergency services: A focus on public safety (December 1997);*
- *Automating fare collection – A major initiative in public transport (November 1998);*
- *Victoria's prison system – Community protection and prisoner welfare (May 1999);* and
- *Test calls made to non-emergency ambulance telephone lines (April 2000).*

4.2.22 A decision was made by my predecessor to extend the past audit coverage on this important topic to encompass an analysis of the strategic approach to the management of outsourcing within the following 5 departments:

- Education, Employment and Training;
- Human Services;
- Infrastructure;
- Natural Resources and Environment; and
- Treasury and Finance.

4.2.23 In addition to assessing strategic issues, the scope of the exercise included specific examination of one outsourcing contract in each department, as outlined in Table 4.2A.

**TABLE 4.2A
SAMPLE OF DEPARTMENTAL OUTSOURCING CONTRACTS**

<i>Department</i>	<i>Details of the selected outsourcing arrangement</i>	<i>Aggregate contract value and term of contract</i>
Education, Employment and Training	Interpreting and translation services to government schools	\$1.75 million over the period from July 1997 to December 2000
Human Services	Aged care services component of the Victorian Strategy for Carers (Loddon-Mallee region)	\$1.4 million over 3 years from July 1997 to June 2000
Infrastructure	Privatisation of government metropolitan bus operations	\$27 million over 10 years from April 1998
Natural Resources and Environment	Digital mapping services	\$1.2 million over 2 years from July 1995 to June 1997
Treasury and Finance	Project management services for energy sector reform	\$30.5 million over 3 years from July 1996 to June 1999

4.2.24 In examining these contracts, attention was directed to 4 key areas, namely:

- justification of the decision to outsource;
- fairness and equity of the tender evaluation and selection of supplier processes;
- approach adopted for management of key contractual risks; and
- framework established for the monitoring of contractual performance.

4.2.25 The examination also encompassed an assessment of the nature of actions initiated by the Department of Treasury and Finance in its central agency role of guiding the implementation of outsourcing across the public sector.

4.2.26 The audit traversed the period of a change of government in the State in October 1999. Accordingly, the observations and findings presented in the following paragraphs have been adapted to complement the existing environment and the likelihood of substantial changes in the Government's policy direction concerning outsourcing and contractual practices.

IMPLICATIONS OF DEPARTMENTAL EXPERIENCES TO THE FORMULATION OF FUTURE POLICIES

4.2.27 The audit examination of departmental approaches to outsourcing and the management of individual arrangements identified a number of matters that have implications for the formulation of policies for the future delivery of government services.

Central agency role of the Department of Treasury and Finance

4.2.28 Throughout the 1990s, the Department of Treasury and Finance had a leadership role in assisting agencies in the implementation of outsourcing. The Department met this role mainly through the establishment, in 1994, of the Outsourcing and Contract Management Unit. As previously mentioned, this Unit was disbanded in November 1999 in line with the Government's revised approach to outsourcing.

4.2.29 While the current Government has identified that a reduced emphasis will be placed on outsourcing, it is likely that some level of central agency guidance will still be required given the large volume and value of existing outsourcing arrangements.

4.2.30 Key tasks for the Department of Treasury and Finance will be to establish the need within agencies for ongoing guidance on outsourcing and to determine the most appropriate methods of meeting this need. The Department should seek and consider the views of relevant agencies when developing strategies for future management of outsourcing and other contractual arrangements with the private sector.

4.2.31 Later paragraphs indicate that each of the 5 departments examined during this exercise adopted a range of strategies during the 1990s to review existing methods of service delivery and, where deemed necessary, implemented alternative methods including outsourcing.

4.2.32 While management responsibility was rightly delegated to departments, an explicit policy framework did not exist to guide the agencies in their high-level evaluation of options available in reviewing service delivery strategies. The Department of Treasury and Finance advised that a draft policy framework had been developed in July 1996 but was not formally adopted by the former Government.

4.2.33 A high-level management framework for deciding methods of service delivery should encompass:

- a whole-of-government approach that ensures consistency across government while concurrently providing flexibility to agencies in determining the best means of service delivery;
- a clear link between the mission and objectives of government and the method by which agencies deliver their services;
- assistance to agencies in gaining an understanding of the expectations and intended outcomes of government; and
- appropriate benchmarks to compare the progress of Departments against planned goals.

4.2.34 Notwithstanding the likelihood of a changed policy environment, the development of a Statewide framework would constitute an important mechanism to guide agencies in their assessment of new approaches to service delivery. A sound central framework would also provide some assurance to the Government that its strategies underlying provision of services to the community are implemented by agencies in the intended manner.

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

The Department agrees that it is important to clarify the policy framework for consideration of delivery options such as outsourced arrangements for the provision of the Government's core and non-core services. This is particularly important following the election of the new Government in October 1999 which saw a distinct shift in government policy.

The current Government commitments in this area include a statement that outsourcing is to occur only after proper consultation and subject to rigorous employment impact, social and economic benefit tests. Furthermore, the rights and employment standards of contract employees in an outsourcing arrangement are to be protected.

As reported by audit, the Department closed its Outsourcing and Contract Management Unit in November 1999 in response to the new, more restricted approach to future consideration of outsourcing. The Unit was a part of the Procurement Branch within the Department of Treasury and Finance and the Procurement Branch now has residual responsibility for policy development in this area. The policy framework, once approved by the Minister for Finance and the Victorian Government Purchasing Board, is then mandatory for government departments.

In finalising a policy statement on outsourcing, the Department will take account of findings and recommendations in a number of reviews and reports which are either directly applicable or relevant:

- *the Public Accounts and Estimates Committee "Report of the Enquiry into Outsourcing of Government Service in the Victorian Public Sector";*
- *Audit Report of Government Contracts (Professor Russell); and*
- *Review of Government Report No. 34 of Purchasing Arrangements (KPMG).*

In addition, it is expected that the Government will make a major statement on its Public Private Partnerships approach to the provision of major government infrastructure. This will also contribute to key aspects of a new policy framework for outsourcing and contract management in the public sector.

Requirements for justifying decisions on methods of service delivery

4.2.35 In respect of the 5 contracts examined by audit, no formal evaluations to support outsourcing decisions were undertaken by any of the departments immediately before implementation of their outsourcing arrangements.

4.2.36 This situation increased the possibility that departments would not fully consider all aspects of proposed outsourcing, including:

- available alternatives, for example, utilising a mix of internal and private sector involvement in service provision;

- potential risks associated with subsequent contractual arrangements;
- levels of services required and any likely changes to these requirements in the future; and
- standards for the quality and costs of services to be used as guidance in subsequent tendering and contract management.

4.2.37 Accordingly, it is felt that action will be required at a central level to ensure that a sound business case is established to substantiate all service delivery arrangements entered into by government agencies with the private sector.

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

The Department agrees that the preparation of an appropriate and up-to-date business case is a crucial requirement for consideration of service delivery options with the private sector before they are entered into by government agencies. The business case should incorporate fully costed in-house and external delivery options. In the case of options which consider external delivery, the Department agrees that full costings of all staff implications and the tendering and planning process should be incorporated in the business case.

The Victorian Government Purchasing Board will incorporate in its policy statement the full requirements of a business case and the policy commitments of the Government, i.e. proper consultation, protection of staff rights and rigorous employment impact, social and economic benefit tests.

Assessing the outcomes of Statewide service delivery initiatives

4.2.38 With the intention of measuring the impact of outsourcing in the public sector, the former Outsourcing and Contract Management Unit within the Department of Treasury and Finance surveyed the level of outsourcing activity for the 1995-96, 1996-97 and 1997-98 financial years

4.2.39 While this action represented a positive initiative by the Unit, the value of the surveys was limited by a number of factors including:

- significant delays in the finalisation of surveys with results covering the 1995-96 and 1996-97 financial years not finalised until December 1997 and November 1998 respectively, while the 1997-98 survey remains in draft form;
- inadequate measurement of the impact of outsourcing on service quality through compilation of information such as the views of the end users of services;
- major concerns over the accuracy of cost savings achieved from outsourcing as calculated from the surveys including;
- a calculated saving of 28 per cent in average costs reported in the 1997-98 Victorian draft survey which appeared unusually high compared with the 6 per cent average cost savings in Australia and 8 per cent worldwide as identified in independent surveys of outsourcing;
- inconsistencies in the reporting methods adopted by individual departments and, in many cases, an inability to accurately identify the cost of delivering services prior to outsourcing; and

- the exclusion from savings calculations of general costs of outsourcing such as those associated with the planning and implementation of individual outsourcing arrangements and redundancy payments to public sector staff.

4.2.40 The Department of Treasury and Finance should consider the means of measuring the ongoing impact of outsourcing or any future reforms to service delivery. As part of these considerations, attention should be directed towards:

- the preparation of relevant information on a timely basis but no later than a specified period (say 6 months) after the period subject to measurement;
- establishment of a costing framework encompassing Statewide standards and promoting consistency in the compilation of data;
- incorporation of all costs associated with implementation of reforms including the management and administrative costs incurred within individual agencies; and
- appropriately measuring the impact on the quality of services.

❑ **RESPONSE** provided by Secretary, Department of Treasury and Finance

The Department accepts audit criticism of previous surveys of outsourcing activity in the public sector. The different subject matter of departments, combined with varying approaches to data collection, make this an activity of limited value. The Department considers that the aggregation of public sector-wide data on outsourcing in a way which would be up-to-date and useful poses too many difficulties. The effort required in terms of costs and resources would outweigh the benefits.

The Department, therefore, proposes to no longer proceed with public sector-wide surveys of outsourcing activity. This will be confirmed with the Government when it considers its response to Report No. 34 of the Public Accounts and Estimates Committee.

The Department considers that more cost-effective and useful results would be obtained from studies of service delivery in particular subject matter areas, e.g. Human Resources or Information Technology, which would be done as once-off studies to answer particular concerns or monitor implementation in a specific service delivery field.

Improving the quality of contractual performance standards

4.2.41 Weaknesses existed in several of the outsourcing arrangements examined in terms of both the adequacy of contractual performance standards and the effectiveness of monitoring processes employed by departments. These issues have been recurring themes in a number of Auditor-General's Reports over the last decade.

4.2.42 Clearly, there is still scope for substantial improvement in this key area of resource management within the State. As this need for improvement prevails generally across the public sector, it is important that, at a central level, action be taken to:

- develop appropriate guidelines concerning the extent and content of qualitative and quantitative performance standards to be included in contracts with the private sector and the procedures that should be employed to monitor contractor performance; and

- continue to implement appropriate professional development activities to ensure that all contract management personnel have the necessary capabilities to implement performance monitoring processes.

4.2.43 In addition, the adequacy of performance standards in current contracts should be evaluated by departments and, where necessary, appropriate amendments be pursued when renegotiating renewal of contractual arrangements.

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

The Department agrees with the Auditor-General that contract performance standards have not been fully satisfactory as established in some contracts. The case studies analysed by audit demonstrate some of the weaknesses. The Department agrees that both qualitative and quantitative performance standards should be included in contracts with private sector providers and contract performance by the private sector should then be closely monitored and managed.

The Department also agrees that training and professional development activities are important to lift the capabilities of public sector contract managers in implementing performance monitoring. Training will be addressed through PACCER, the Procurement and Contracting Centre of Education and Research, which provides training programs for public sector managers and staff involved in procurement and contract management.

Measuring and reporting on outcomes of outsourcing

4.2.44 The results of this audit have indicated that departments directed minimal attention to implementing mechanisms to enable assessment of expected outcomes from outsourcing.

4.2.45 Discussions with staff of the various departments also indicated that, in the majority of instances, outsourcing had been assessed primarily on whether the required quantum of services had been provided under the contract. Far less emphasis was placed on assessing outcomes of outsourcing in terms of the quality of services or whether benefits initially envisaged from outsourcing had been achieved.

4.2.46 There are currently no accountability requirements in place for Departments to publicly report the details and outcomes of major outsourcing arrangements.

4.2.47 Given the need to address the current deficiencies in the assessment and reporting of outcomes, all Departments should consider:

- the development of suitable frameworks for the measurement of outsourcing outcomes in terms of assessment against the benefits identified in the original justification to outsource and against specific deliverables as stated in contractual arrangements; and
- implementation of appropriate management information systems to enable consistent compilation and reporting of information concerning outcomes of individual outsourcing arrangements.

4.2.48 Mandatory requirements should also be developed for all agencies to incorporate in annual reports presented to the Parliament relevant details of major outsourcing arrangements, such as the cost and terms of contractual agreements, the extent to which envisaged benefits have been achieved and the consequential impact on the quality of services.

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

The Department will consider individual departments making publicly available the details and outcomes of major outsourcing arrangements. An appropriate reporting regime will be considered in consultation with departments.

The Department does not agree that these details should be provided in Annual Reports presented to the Parliament as the volume of material would be overwhelming. A preferable approach may be to publish contractual details on the Victorian Government Purchasing Board's existing website. A database known as the Contracts Publishing System was recently established on this website which could be expanded for further reporting of the details and outcomes of major outsourcing contracts.

Issues relevant for future renegotiations of outsourcing arrangements

4.2.49 As outlined in earlier paragraphs, the emphasis on outsourcing throughout the 1990s has led to a situation where a large number of contracts for the delivery of government services, involving a high value of contract payments, remain in force throughout the Victorian public sector.

4.2.50 The current Government's decision to review the previous emphasis on outsourcing and to pursue alternative arrangements with the private sector, such as business partnerships, creates the need for each department to review the ongoing appropriateness of outsourcing at the expiration of existing contracts.

4.2.51 A fundamental decision facing departments will be to determine whether outsourcing remains the most appropriate method to deliver relevant services or whether alternative methods should be implemented such as the use of internal departmental resources, a mix of internal and external resources or some other form of arrangement with the private sector.

4.2.52 Agencies will also need to carefully assess their experience with the management of contracts. If a decision is reached to renew contractual arrangements, all existing contractual provisions should be examined to identify if any amendments are necessary to better protect the State's interests.

4.2.53 Overall, departments should undertake detailed evaluation of all outsourcing arrangements to determine the most cost-effective and appropriate method of service delivery into the future.

PAST ROLE OF GOVERNMENT DEPARTMENTS IN MANAGING OUTSOURCING

Department of Education, Employment and Training

Strategic management of outsourcing

Extent of past involvement in outsourcing

4.2.54 The Department pursued the outsourcing of a range of activities throughout the 1990s for a variety of reasons which included making use of specialist skills and expertise, managing fluctuations in demand for services and accessing developments in information technology. Examples of activities contracted-out during this period included interpreting and translation services, cleaning of schools, information technology, WorkCover claims administration, human resources management, legal services, marketing of educational materials, insurance and risk management, and vocational educational training programs.

Positive features of strategic approach to outsourcing

4.2.55 It was pleasing to identify that, at a strategic level, the Department of Education, Employment and Training had embarked upon a range of actions aimed at identifying improvement opportunities and facilitating the implementation of outsourcing, including:

- establishment of a steering committee to oversee and monitor matters related to outsourcing;
- development of a strategic sourcing plan in 1997 which considered outsourcing and other potential delivery mechanisms;
- preparation of an outsourcing strategic plan in 1998 to identify potential opportunities for further outsourcing of corporate functions;
- implementation of departmental purchasing guidelines; and
- specific training of management and staff in outsourcing and contract management.

4.2.56 The actions taken by the Department were positive initiatives to identify service delivery options and to develop the skills necessary in an outsourcing environment. However, delays occurred in implementing the outsourcing strategic plan as the Department continued to undertake high-level reviews that either directly or indirectly affected proposed outsourcing activity. These delays meant that the plan had not been fully implemented at the time of the change in government.

Areas requiring improvement

4.2.57 Within the Department, responsibility for assessing outcomes for individual outsourcing arrangements rested with relevant divisional management. Generally, any assessments were based on the extent to which program objectives had been achieved while little attention was devoted to establishing whether benefits initially envisaged from outsourcing had ultimately occurred.

4.2.58 The Department did not have in place processes for assessing and reporting on outcomes on a departmental-wide basis. In this respect, reliance was placed on information from Statewide surveys of outsourcing compiled by the Department of Treasury and Finance.

Case study - Interpreting and translation services

Outline of the contractual framework

4.2.59 Since the mid-1970s, government primary and secondary schools have received interpreting and translation services to enable students and their families from non-English language backgrounds to access information on school programs, services and other issues relating to education. Over the years, demand for these services increased as schools and parents became more aware of their availability.

4.2.60 Whereas the Department had previously provided services to government schools through an internal interpreting division, from 1992, it ceased to have this capability and utilised services available elsewhere in the public sector.



Interpreting and translating services are required in schools to keep parents informed of students' progress.

4.2.61 The Department ultimately sought tenders outside the public sector for the provision of interpreting and translation services for the 1996-97 financial year. Subsequently, with the service requirements remaining basically unchanged, tenders were called for the 1997-98 financial year and the 1999 and 2000 calendar years. The original tenderer was successful on each occasion.

Results of audit examination

Justification of the decision to outsource

- The Department relied on a business case developed in the early 1990s that could no longer be located for audit review. It did not prepare an updated business case at the time of the 1996-97 tendering process as outsourcing was considered to be the only option available, given the lack of internal capability in this area.

Evaluation and selection processes

- The Department had adopted transparent and equitable tender evaluation and selection processes for the outsourcing arrangement. Specific action taken by the Department included establishment of an evaluation panel, implementation of evaluative criteria to access tender bids, and processes to ensure that all prospective service suppliers were dealt with equally.

Management of key contractual risks

- The contract was based on a standard departmental contract used for all arrangements with the private sector. Overall, the contract adequately addressed key areas of risk to the Department and the Government.
- The standard contract of the Department does not incorporate dispute resolution mechanisms thereby increasing the risks of additional costs or the suspension of service provision in the event of a dispute with the contractor.
- The contract did not provide for access by the Department to the records of the contractor to enable verification of performance information to support the quantity of services provided by the contractor.

Monitoring of contractor performance

- Performance criteria were only included in guidelines to schools and the contractor and not formally incorporated within the contract. The Department's ability to legally enforce these criteria was therefore placed in doubt.
- The performance criteria did not address certain key issues such as the ability of the contractor to meet the quantity and timeliness of services demanded by schools.
- The Department has not undertaken any analysis of performance issues such as the level of service provided, the responsiveness of the contractor and the overall quality of performance. The Department advised that, as the contract was primarily output-based, little emphasis had been given to an assessment of outcomes. The Department also considered that its close contact with schools, in the normal course of operations, provided the basis for continuing oversight of the quality of services.
- In the absence of departmental monitoring of service quality, audit conducted a survey of a selection of schools to ascertain their views on the quality of the contractor's performance. This survey indicated a high level of satisfaction with the services provided.

Overall assessment and recommendations

4.2.62 This outsourcing arrangement has resulted in the provision of high quality interpreting and translation services to government schools.

4.2.63 The Department has the opportunity to further improve its future management of this contract through:

- the preparation of a business case following expiry of the current contract to ensure that outsourcing remains the most appropriate option for delivery of these services;
- amendment of contractual terms and conditions to incorporate performance standards, dispute resolution processes and the right of access by the Department to contractor records; and
- enhancement of management processes by ensuring that both quantitative and qualitative aspects of contractual performance are monitored on an ongoing basis.

4.2.64 Such action would build on the earlier important initiatives already taken by the Department.

□ **RESPONSE** provided by Secretary, Department of Education, Employment and Training

The Department acknowledges the positive comments made in the Report in respect of the strategic approach taken towards outsourcing, the implementation of training programs in outsourcing and contract management and the transparent and equitable tender selection processes in the contract under review.

However, the Report does not correctly reflect current Departmental practice in respect of the management of contractual arrangements, including outsourced activities.

The Department through its Accredited Purchasing Unit, has established guidelines in its Purchasing Manual for the purchase of goods and services. Departmental purchasing procedures require all submissions to the Accredited Purchasing Unit to be documented according to a systemised proforma to ensure the adoption of high standards of probity and best practice. This includes the development of a business case where significant contracts including those for outsourced services, are being considered.

The proforma also requires an indication of the relevant contract management framework to be implemented. Senior managers are responsible for monitoring and assessing contract performance in accordance with the approved framework.

❑ **RESPONSE** provided by Secretary, Department of Education, Employment and Training

In terms of the monitoring of outsourcing across the Department, prior to the Statewide surveys conducted by the Department of Treasury and Finance, the Department maintained a database on outsourcing through the Outsourcing Steering Committee. With the inception of the Statewide surveys, the database was discontinued because of the extent of duplication involved in the collection of information and because of the level of priority attached to the new surveys. In 1998 the Department did, however, embark on a major project to identify and describe in great detail all outsourcing activity as a preliminary step to the development of a strategic plan for outsourcing across the organisation. At the time of the audit review, the Department had yet to develop an integrated mechanism for assessing and reporting on outsourcing beyond that provided through the Statewide surveys.

In relation to the sample contract considered in the review, the Department has had no direct role in the provision of interpreting and translation services since early 1992 when staff were transferred to the then Ministry of Ethnic, Municipal and Community Affairs (MEMCA). The Department purchased these services initially from MEMCA and subsequently from a government-funded agency - the Victorian Interpreting and Translation Service - between June 1992 and June 1996. The matter of a business case was not relevant in this instance as the Department no longer had the appropriate internal resources, and the establishment of a contract with an external service provider was the only option available to ensure that schools received the necessary services.

The contract for interpreting and translation services mandates the use of appropriately qualified staff and provides for appropriate reporting. The daily involvement of a senior officer in contract implementation and contact with schools together with other management systems, enable the timeliness and quality of services to be monitored. This year these arrangements will be supplemented by other quality assurance mechanisms including client satisfaction surveys and spot checks in schools.

The Department will re-examine its standard contract to minimise key contractual risks.

Department of Human Services

Strategic management of outsourcing

Extent of past involvement in outsourcing

4.2.65 The Department of Human Services has traditionally purchased the majority of its services (currently consuming around 89 per cent of its recurrent budget) from community-based or non-government organisations. Accordingly, the Department's focus under the former Government was not necessarily to further pursue outsourcing but to continually improve its processes for purchasing services and monitoring the effectiveness of service delivery by external providers.

4.2.66 Arrangements with many of the Department's service providers, including public hospitals, nursing homes and healthcare networks, are in the form of annual *Health Service Agreements*. These agreements incorporate the conditions under which a range of services is to be delivered on behalf of the Department including the level of funding to be provided by the Department and the performance and reporting requirements expected of the service supplier.

Positive features of strategic approach to outsourcing

4.2.67 In line with its focus on improving purchasing and monitoring processes, the Department had initiated a number of actions including:

- preparation of a purchasing guide for the health services sector;
- development of a charter of best practice for tendering;
- appointment of contracting and tendering co-ordinators to advise staff, distribute tender policy information, co-ordinate reporting and monitor compliance with guidelines and policies;
- staff training in probity, purchasing practices, tendering procedures and risk management;
- recruitment of contract management expertise; and
- redevelopment of certain key services reflecting a desire to extend the level of contestability and private sector involvement.

Areas requiring improvement

4.2.68 The Department had directed little attention to assessing outsourcing outcomes, on a departmental basis, or evaluating the extent to which anticipated benefits of outsourcing arrangements had ultimately been realised.

Case study - Aged care services

Outline of the contractual framework

4.2.69 The *Victorian Strategy for Carers*, a Statewide initiative, was launched by the former Government in October 1996 in recognition of the critical role that carers play in supporting people who require care to remain living in a community-based setting. Funding of around \$100 million was approved for implementation of the Strategy over 4 years, commencing in 1997-98.

4.2.70 For the contract selected for audit examination, the Department, in May 1997 following a selective tendering process, appointed the successful tenderer to provide services associated with aged care in the Department's Loddon Mallee region for a period of 3 years.

*Results of audit examination**Justification of the decision to outsource*

- The Department did not prepare a formal business case to justify outsourcing on the basis that:
 - the Carers' Strategy, a new initiative of government, was established following evaluation of community needs;
 - a desire existed to implement the strategy as soon as possible; and
 - outsourcing was considered the only feasible option, given a lack of in-house resources to provide these services.

Evaluation and selection processes

- Overall, the selection and engagement of the successful tenderer was found to be appropriate. However, a number of issues were identified in selection processes, as outlined below, that arose primarily due to the inexperience of relevant staff at the time of this outsourcing arrangement.
- In the early stages of the tendering process, the Department identified a potential conflict of interest for a member of the evaluation panel. The Department stated that any subsequent involvement of this person was restricted to advising on administrative processes associated with outsourcing, given the inexperience of other staff.
While recognising the action taken by the Department to manage the potential conflict, additional processes, such as the engagement of a probity auditor, would have provided further assurance on the integrity of the tender process.
- Documentation maintained in relation to the selection and evaluation process was inadequate in certain respects such as a lack of records of interviews held with prospective and unsuccessful tenderers.
- The Department's Accredited Purchasing Unit did not review and endorse processes related to the evaluation of bids and the selection of the provider, which was contrary to delegations to the Unit from the Victorian Government Purchasing Board.

Management of key contractual risks

- The successful tenderer is a non-government organisation which provides a range of services on behalf of the Department. Given this status, contractual arrangements with the tenderer comprise annual *Health Service Agreements*. While this agreement did not constitute a fully commercial arrangement, it provided an appropriate basis for formalising the contract with the supplier.

Monitoring of contractor performance

- Performance standards included in the service agreement were solely quantitative in nature and did not reflect the qualitative aims of the care initiative such as the increased availability of services or the effectiveness of care provided. In addition, the agreement did not address the key areas of contractor efficiency or the timeliness of service delivery.
- Certain quantitative targets were understated as provider performance compared with individual targets varied substantially and, in one case, recorded performance for just one month exceeded the quantitative target for the entire year by 24 per cent without any evidence of query by the Department.
- The Department had not monitored provider performance in relation to the measures and targets stipulated in the agreement. Staff appeared unclear on the allocation of responsibility within the Department for this important task.
- The Department had not independently verified the monthly statistical information provided by the contractor which is used as a basis for contract payments.

Overall assessment and recommendations

4.2.71 While a number of deficiencies were identified during the examination of this contract, selection processes implemented for the arrangement were found to have resulted in an appropriate decision on an external service provider. The Department has also taken action to improve the expertise of personnel engaged in tendering processes of this nature.

4.2.72 Substantial improvement is required in the ongoing monitoring of this particular arrangement. Specific actions necessary include:

- the development of appropriate contractual standards addressing qualitative aspects of services to be delivered by the contractor;
- re-assessment of current quantitative targets in line with the level of service to be provided; and
- implementation of appropriate monitoring processes and a clear allocation of responsibility for these processes to personnel within the Department.

□ RESPONSE provided by Secretary, Department of Human Services

The Department of Human Services (DHS) has over many years funded hospitals and non-government agencies to deliver services. DHS does not consider this outsourcing as the majority of these services have never been delivered by DHS.

The example reviewed by the Auditor-General was new funding for expansion of services that had traditionally been provided by non-government organisations.

As this was not an outsource, there was not a formal process to justify the continued use of non-government sector as the provider of these services.

DHS agrees with the Auditor-General that the overall selection and engagement of the successful tender was appropriate, but that there were some procedural issues that could have been improved.

DHS also agrees with the Auditor-General that performance standards and, in particular, quality standards need to be improved and the Department is working on developing improved standards.

While individual junior staff might have been unclear about the allocation of responsibility for monitoring in this case, DHS does not believe that this is a widespread issue.

Department of Infrastructure

Strategic management of outsourcing

Extent of past involvement in outsourcing

4.2.73 The functions of the Department of Infrastructure predominantly encompass policy, planning, strategic co-ordination and management of major government services delivered through statutory authorities, local government and contracts with the private sector.

4.2.74 Given the nature of these functions, the Department's outsourcing activities have comprised 2 main categories, namely:

- services delivered to the community including major capital infrastructure projects, school transport, public bus services and building services; and
- internal organisational support services such as engineering advice, marketing and various administrative functions.

Positive features of strategic approach to outsourcing

4.2.75 Action taken by the Department to manage the implementation of outsourcing has included:

- a case study to explore the application of the concepts of contestability and strategic procurement planning;
- the development of a draft *Strategic Service Procurement Process for Outputs* which was designed to outline a standard approach for use in the Department when obtaining services from private sector providers;
- creation of a Contract Services Division to develop contracting policies and provide advice throughout the Department; and
- implementation of internally developed tendering and contract management guidelines.

4.2.76 The Department has determined not to proceed with finalising the draft strategic procurement process until it has considered the implications of changes in policy under the current Government.

Areas requiring improvement

4.2.77 There was no formal requirement in place for reviewing or reporting to senior management on the outcomes of outsourcing. In practice, most divisions of the Department reviewed the performance of contractors but did not formally report any results to senior management.

Case study - Metropolitan bus services

Outline of the contractual framework

4.2.78 In 1993, the former Government announced a major Public Transport Reform Program. As part of the program, the Department of Infrastructure outsourced 80 per cent of metropolitan bus services previously provided by the Public Transport Corporation. My past *Reports on Ministerial Portfolios* and *Reports on the Finance Statement* have included comment on the tendering processes for this outsourcing arrangement.

4.2.79 During the 1993 tendering process, the Department identified advantages in not awarding contracts for all bus services to a single operator. These advantages included "... a perception of greater fairness, a better position in the case of operator failure and benefits of yardstick competition". As a result, the Public Transport Corporation retained responsibility at that time for management of 20 per cent of services (comprising bus routes within the Footscray and Sandringham areas).

4.2.80 The Department subsequently outsourced this remaining 20 per cent of services in March 1997 which became the focus of our audit examination.

Results of audit examination

Justification of the decision to outsource

- The Department did not undertake a formal evaluation to justify the 1997 outsourcing of bus services on the basis that:
 - government approval had been given for outsourcing of 100 per cent of the services during the initial 1993 tendering process; and
 - a departmental view that the initial outsourcing in 1993 had “*proved very successful*” as payments to the contractor for services provided had remained within initial cost parameters set out in the contract.

Evaluation and selection processes

- The Department had established a sound tendering and selection framework including key elements such as establishment of an evaluation committee comprising both departmental and independent representation, preparation of a detailed evaluation plan and appointment of a probity auditor to oversee the integrity and fairness of the process.
- At the request of departmental management, the evaluation committee reviewed and subsequently changed its initial recommendation for a preferred tenderer. This change arose due to an inappropriate weighting given to price in preference to qualitative factors in initial evaluation criteria used by the Committee. The probity auditor accepted the change in the Committee’s recommendation.

Management of key contractual risks

- The 1997 contract was based on agreements put in place for the initial outsourcing of bus services in 1993 with modifications derived from contract management experience gained from the initial arrangement. The 1997 contract adequately addressed key contractual risks such as the contractor not meeting required performance standards, variations to contractual terms and conditions, resolution of disputes and termination of arrangements.

Monitoring of contractor performance

- The contract contained detailed performance standards related to both the quality and quantity of services such as the quantity of bus services required, the punctuality of these services, the needs of passengers, the quality of vehicles and the provision of customer service information.
- The Department did not have in place a structured program for verifying the accuracy of data reported by the contractor against performance standards or for monitoring the ongoing quality of bus services in such areas as punctuality and the quality of vehicles.
- Some inconsistencies were identified in methods used by the contractor to compile data for reporting against contractual standards. In effect, these inconsistencies resulted in overstatement of the performance of the contractor. The Department had not previously identified these inconsistencies but has since addressed this matter with the contractor.
- The Department advised that when information components of the public transport Automated Ticketing System become fully operational, which is currently expected by 30 June 2000, monitoring of the achievement of performance standards will be enhanced.
- The Department has not yet undertaken a review to establish whether envisaged improvements to service quality had been achieved from the outsourcing of these bus services. The Department advised that implementation of service improvements promised at the time of awarding the contract have been delayed due to:
 - teething problems, associated with the condition of the bus fleet and the operation of bus depots, continuing for longer than anticipated; and
 - ongoing disruptions to bus services during the construction of the City Link project.

Overall assessment and recommendations

4.2.81 In future, a more appropriate weighting between quality and price should be reflected in criteria used in the selection of contractors.

4.2.82 The Department also needs to improve its methods of monitoring the ongoing performance of the contractor in line with standards established in the contractual arrangement.

Department of Natural Resources and Environment

Strategic management of outsourcing

Extent of past involvement in outsourcing

4.2.83 The 2 factors listed below have influenced the extent of outsourcing previously implemented by the Department:

- an organisational focus on developing strategies to service its wide range of responsibilities in areas such as the environment, conservation, agriculture, mining and energy, and on addressing achievement of an appropriate balance between development and conservation activities; and
- an identified necessity to maintain a continued presence of internal resources in rural areas to retain the knowledge and expertise necessary for ongoing planning and policy development.

4.2.84 Nevertheless, outsourcing has been pursued within the Department to improve the efficiency of certain activities such as corporate services, digital mapping, the operation of veterinarian research laboratories, provision of information services and the conduct of aerial surveys.

Positive features of strategic approach to outsourcing

4.2.85 The Department had taken a number of initiatives aimed at ensuring effective delivery of services, namely:

- a focus on achieving outcomes, with outsourcing considered through normal business planning processes;
- review of service delivery as part of annual business planning;
- regular examination of service delivery options in order to achieve more economical service provision;
- restructure of departmental operations into purchaser/provider functions;
- a policy focus on contestability; and
- pursuit of business improvement through the Australian Quality Framework and management improvement programs.

4.2.86 The extent to which the Department ultimately proceeds with strategies outlined in these reviews and plans will be largely dependent on the preferred form of any private sector arrangements under revised government policy.

Areas requiring improvement

4.2.87 The Department does not have in place any requirements for the outcomes of outsourcing to be assessed and reported at a departmental level or for review of whether anticipated benefits of outsourcing arrangements have been achieved.

Case study - Digital mapping services

Outline of the contractual framework

4.2.88 In 1992, the former Government engaged a consultant to prepare a framework for the development of geographic information systems in Victoria. At the time of this consultancy, several government instrumentalities had independently developed, or were in the process of developing, digital mapping capabilities in the core area of cadastral mapping (that is, official maps of property boundaries).

4.2.89 The consultancy recommended co-ordinated planning of development and maintenance of digital data resources in Victoria to maximise the benefits of their use throughout government and business. One of the priorities identified during the consultancy as requiring immediate action was the digital cadastral map base.

4.2.90 Prior to June 1994, management of the digital cadastral map base was split between the Melbourne Water Corporation, which managed the metropolitan component (covering 70 per cent of the State's properties) and Survey and Mapping Victoria (a predecessor of Land Victoria, a division of the Department of Natural Resources and Environment) which managed the map base for rural areas.

4.2.91 In June 1994, the State and the Melbourne Water Corporation entered into an agreement that transferred responsibility for managing the entire property map base to Land Victoria which enabled pursuit of the initiative to create a single digital cadastral map base for Victoria. In the interim period, the relevant government agencies were required to continue with the maintenance of their respective map bases.



Using digital mapping to manage assets.

4.2.92 In 1995, Melbourne Water determined (before the advent of action to create a single cadastral map base for the State) that it would no longer maintain the metropolitan map base. Accordingly, following a public tender process, responsibility for the metropolitan component was outsourced by the Department to the private sector.

4.2.93 The initial outsourcing arrangement was subsequently extended in July 1997 to incorporate the management and maintenance of both metropolitan and rural map bases for a 3 year period.

Results of audit examination

Justification of the decision to outsource

- Outsourcing of digital mapping services was predominantly based on the previously mentioned 1992 consultancy and a 1994 Management Analysis and Plan that recommended outsourcing as the preferred strategy for providing mapping services.
- A specific evaluation was not undertaken to justify the outsourcing of management and maintenance of the metropolitan map base in 1995 due to:
 - the urgency of implementing alternative arrangements following the withdrawal of Melbourne Water from maintaining the metropolitan map base;
 - a lack of internal capacity and expertise to meet the requirements of managing a map base of this complexity;
 - a decision to continue previous practices of Melbourne Water Corporation in outsourcing activities of this nature.

Evaluation and selection processes

- The tender evaluation and selection processes were found to be fair, equitable and transparent and of sufficient quality to ensure the selection of the most appropriate service provider.

*Results of audit examination - continued**Management of key contractual risks*

- The contract satisfactorily addressed key contractual matters such as the impact of variations, insurance and indemnity, provisions for termination, dispute resolution, rights to intellectual property and transfer of assets at the termination of the contract.

Monitoring of contractor performance

- Performance standards did not cover key aspects of the computerised digital mapping system such as data integrity and accuracy, the quantity of services to be provided by the contractor or the level of user satisfaction.
- No requirements were in place for regular reporting by the contractor on performance.
- The Department had not established effective processes to monitor the quality of service or assess the extent to which the contractor had met agreed terms and conditions of the arrangement.
- A lack of control existed over progress payments to the contractor in that there was no evidence to indicate that actual costs were monitored against project budgets or that invoices were verified for accuracy prior to payment.
- Many of the benefits envisaged from the outsourcing arrangement had, however, been achieved, including:
 - timely establishment of a digital map base;
 - reductions in the maintenance costs for the data base compared to those previously incurred by Melbourne Water;
 - the introduction of significant technical reforms into the structure of the map base; and
 - increased access to specialist expertise and new technology compared to that available internally.

Overall assessment and recommendations

4.2.94 This outsourcing arrangement has resulted in substantial progress towards the development and implementation of a Statewide digital map base for use by public sector agencies and other users with an interest in the natural resources and environment portfolio.

4.2.95 Since completion of the initial contract in 1997, the Department has implemented improvements to the ongoing management of the outsourcing arrangement for the map base. In addition, the Department has undertaken a mid-term review of the current cadastral maintenance contract that outlined important recommendations for the ongoing management of the contract. During 1999, the Department also reviewed its overall contract management practices.

4.2.96 Nevertheless, the Department needs to further enhance its monitoring of this outsourcing arrangement through implementing performance standards related to all key aspects of the arrangement and through improving current processes utilised to monitor the performance of the contractor.

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

With regard to the monitoring of contractor performance, the contract provides that the services supplied by the contractor shall conform to written specifications of functional requirements. The contract and its schedules provide details of:

- *maintenance procedures;*
- *quality assurance (through a quality assurance plan provided by the contractor); and*
- *service specifications (incorporating requirements to maintain the data at least according to quality and accuracy standards.*

These incorporate requirements for maintaining data integrity and accuracy.

A monthly dollar amount was estimated in the contract representing an estimate of the minimum volume of maintenance that was likely to be undertaken. The requirements of users were addressed in the contract under clauses related to distribution requirements and procedures.

Land Victoria was able to monitor the quality of service provided by the contractor by controlling the “inputs” into the map base. All transactions are required to pass through Land Victoria for collation and quality assurance before being supplied to the contractor for incorporation into the map base.

The contract for the maintenance of the digital cadastral map base was based on fixed unit prices for each transaction and minimum volumes of work. The overall value of the contract will always be subject to external influences such as the state of the property market. As a result, expenditure is managed up to a maximum level.

The contractual arrangements put in place for the maintenance of the digital cadastral map base have resulted in significant savings in the management of this service. A saving of more than 30 per cent on previous outsourcing arrangements was achieved as a result of the contract, while the number of full-time equivalent staff responsible for managing the function fell to 2.

Department of Treasury and Finance

Strategic management of outsourcing

Extent of past involvement in outsourcing

4.2.97 The major role of the Department of Treasury and Finance is to provide leadership and advice to the public sector in economic, financial and resource management, and to manage key activities such as the State’s budget and debt portfolio. The Department also plays a principal role in overseeing economic and financial reform throughout the public sector.

4.2.98 The Department has generally performed its key roles using internal resources supplemented, where necessary, by engaging consultants. Nevertheless, the Department has entered into a range of outsourcing arrangements for specific activities including:

- administration of unclaimed moneys;
- accommodation and property management services;
- leasing of vehicles;

- information technology; and
- human resource management.

Positive features of strategic approach to outsourcing

4.2.99 The Department engaged consultants in 1996 to assist in identifying activities for potential outsourcing. The consultants recommended development of a strategic sourcing policy to address the fact that decisions on outsourcing had previously been made on an ad-hoc basis. The consultants also advised that they could not identify any major impediments to outsourcing many of the activities performed by the Department.

4.2.100 Throughout the 1990s, the Department instituted a number of organisational restructures focussed on the promotion of commercial principles and practices. In addition, a recent initiative has been the establishment, in December 1999, of a Contract Resourcing Unit to manage procurement activities and assist other divisions of the Department in the management of procurement and contracting activities.

Areas requiring improvement

4.2.101 The Department has not developed appropriate mechanisms to assess and report on outsourcing outcomes on a departmental basis. It however advised that the development and implementation of such mechanisms will be a key responsibility of the new Contract Resourcing Unit.

Case study - Project management services

Outline of the contractual framework

4.2.102 From early 1993, the former Government progressively implemented major reforms to the State's electricity industry. These reforms involved sale to the private sector of the assets or management rights of various components of the industry. In 1996, the reform program was expanded to incorporate the gas and aluminium sectors.

4.2.103 As part of the reform process, the Department appointed an external consultant, Dr Peter Troughton, in July 1993, to advise on the reforms. In October of that year, the Department formally engaged the consultant as a full-time employee to head the Victorian Electricity Supply Industry Reform Unit. From February 1995, the individual's relationship with the Department reverted to that of a consultant.

4.2.104 In July 1996, the Department engaged the consultancy firm of Troughton, Swier & Associates, which included a number of former members of the Department's Reform Unit, including Dr Troughton. The firm was appointed to act as the principal consultant for energy reform and to provide strategic and general project management services relating to government reforms in the electricity, gas and aluminium industries.

*Results of audit examination**Justification of the decision to outsource*

- No formal justification of the decision to outsource was undertaken as, following the departure of key staff from its Industry Reform Unit, the Department considered that it no longer had the necessary internal skills and expertise to manage significant reform projects.

Evaluation and selection processes

- The Department did not undertake competitive tendering processes for the appointment of Dr Peter Troughton as a consultant in July 1993, nor for the engagement of Troughton, Swier & Associates in July 1996.
- My predecessor's October 1997 *Report on the Government's Annual Financial Statement, 1996-97* outlined the circumstances surrounding the above appointments. In particular, reference was made in that Report to the Department's rationale for not conducting competitive tendering processes in that:
 - the skills or expertise of the appointed consultants were not available in the public sector or the external market place; and
 - given the complexity and magnitude of the project, any alternative appointment would entail significant task familiarisation and would therefore give rise to additional costs.

Management of key contractual risks

- The contract with Troughton, Swier & Associates provided significant protection to the Department and the Government if agreed terms and conditions were not achieved by the contractor. For example, the Department had the power to immediately terminate the contract if a change in the organisation structure of the consultant limited the consultant's capacity to provide the required services.

Monitoring of contractor performance

- Significant effort was devoted to establishing agreed criteria for the assessment of contractor performance and remuneration. Detailed performance reports by the contractor and associated evaluation by the Department subsequently formed the basis for performance monitoring and payment approvals.
- The contract provided for payments to the contractor based on 3 components comprising:
 - *set fees* for completion of service requirements paid on a monthly basis;
 - an "*At Risk*" component, or deferred payment, subject to the meeting of specified performance criteria which was paid at the end of each year; and
 - a *bonus scheme*, paid at completion of the arrangement, based on the achieving of specified performance criteria.
- Payments to the contractor for the 3 year period between 1996-97 and 1998-99 totalled \$34.4 million compared with initial budget estimates set by the Department of \$27.1 million. Increased payments were mainly due to the appointment of the contractor to assist the Government in management of the Longford gas disaster and the payment of the full bonus available to the contractor at the end of the 3 year term of the arrangement.

Overall assessment and recommendations

4.2.105 With the exception of the absence of a competitive tendering process, the arrangement for project management services was well managed by the Department.

4.2.106 This outsourcing arrangement resulted in substantially higher costs to the former Government than would have occurred had project management continued to be undertaken using internal resources of the Department. However, the resignation of key staff and the lack of internal capabilities placed the Department in a difficult situation, given the importance and complexity of the industry reform and privatisation process.

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

The Department confirms the broad analysis of this transaction provided by audit. The Department stands by the process followed in the appointment of Troughton Swier & Associates and the quality of outputs achieved in managing this consultancy project.

SCHEDULE A
STATUS OF MATTERS RAISED IN PREVIOUS REPORTS

<i>Report</i>	<i>Subject</i>	<i>Status at date of preparation of this Report</i>
MATTERS RESOLVED OR ACTION COMMENCED		
CORPORATE CARD – FOLLOW-UP		
<i>Ministerial Portfolios, May 1999, pp. 359-63</i>	The Corporate Card guidelines have not been strengthened to address the issues previously identified by audit.	The Minister for Finance approved a new Ministerial Direction and Corporate Card guidelines on 20 March 2000. The Department of Treasury and Finance advised that the purpose of the revised rules was to strengthen the control environment over credit card use in line with previous recommendations of the Auditor-General. The Minister for Finance has also written to non-general government entities and their respective Ministers recommending that they institute a control environment no less rigorous than that applying in the general government sector. Audit committees of affected entities will be required to lodge an annual letter of assurance confirming that proper governance arrangements are in place in respect of credit cards.
YEAR 2000 ISSUE		
<i>Ministerial Portfolios, May 1999, pp. 364-82.</i>	Audit examination as at 12 April 1999 concluded that a major part of the total effort required to complete Year 2000 readiness was yet to be undertaken.	The Department of Treasury and Finance advised that as at 1 January 2000, 99.86 per cent of critical systems and processes monitored by the Victory 2000+ reporting tool had been tested and 99.46 per cent of the contingency plans were put in place. Further, the lag in preparedness identified in the May 1999 <i>Report on Ministerial Portfolio</i> report was redressed in sufficient time for the Y2K risk to be managed. Lastly, no significant Y2K related incidents affecting the operation of the State Government were reported on or after 1 January 2000.

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