VICTORIA

Auditor General
Victoria

Report of the Auditor-General on the Finances of the State of Victoria, 2000-01

Ordered to printed
by Authority. Government Printer for the State of Victoria

No. 118 - Session 1999-2001

ISSN 1327-6905
ISBN 0 7311 5980 2

AUDITOR GENERAL
VICTORIA

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

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

Sir

Under the provisions of section 16A of the *Audit Act* 1994, I transmit my *Report on the Finances of the State of Victoria, 2000-01.*

Yours faithfully

J.W. CAMERON
Auditor-General

Contents

Page

Part 1 EXECUTIVE SUMMARY ____ **1**

Overview • 3

Summary of major findings • 4

Part 2 OPINION ON THE GOVERNMENT'S ANNUAL FINANCIAL REPORT ____ **11**

Financial accountability framework • 13

Audit opinion on the Government's Annual Financial Report • 15

Part 3 OPERATING RESULT AND FINANCIAL CONDITION ____ **19**

Summary of operating result and financial condition • 21

Analysis of the State's financial condition • 27

State's credit rating • 32

Performance against key government objectives • 32

Part 4 REVENUE ____ **35**

Summary of State revenues • 37

Taxation revenues • 37

Commonwealth grants • 43

Investment income • 46

Part 5 EXPENDITURE ____ **49**

Summary of State operating expenses • 51

Employee entitlement costs – impact of recent industrial agreements • 52

Major events strategy • 59

Part 6 ASSETS ____ **67**

Summary of State assets • 69

Investments • 69

Physical assets • 74

Part 7 **LIABILITIES, COMMITMENTS AND CONTINGENCIES** ______________83

Aggregate liabilities of the State • 85
Interest-bearing liabilities • 86
Unfunded superannuation • 93
Outstanding claims liabilities • 97
Car fleet financing arrangements • 100
Contingent liabilities of the State • 101
Other financial commitments of the State • 105

Part 8 **DEVELOPMENTS IN FINANCIAL REPORTING AND MANAGEMENT** ___107

Recent developments in the State's financial reporting and management framework • 109

Index ______________119

Part 1

Executive summary

OVERVIEW

This report outlines the results of our audit of the Annual Financial Report for the State of Victoria for the year ended 30 June 2001. The Annual Financial Report presents the financial position of the State of Victoria and the Victorian Budget Sector, and the results of operations and cash flows. A clear audit opinion was provided on the 2000-01 Annual Financial Report.

Our analysis of the State's overall financial condition shows that it remains strong, but there are a number of challenges facing the Government which will impact on its flexibility in responding to future opportunities. These include managing the impact of increasing expenditure pressures including wage growth, reduced State own-source revenues as a result of the introduction of the National Tax Reforms, and in the event of a downturn in economic conditions.

The Government has continued to enhance financial accountability and transparency during the year through the implementation of quarterly financial reports for the Budget Sector and mid-year financial reports covering the whole-of-government.

The ongoing challenge for the Government is to continue to enhance the quality of disclosure and reporting of its activities to the public and Parliament, especially in relation to its analysis and commentary accompanying the financial reports.

SUMMARY OF MAJOR FINDINGS

OPERATING RESULT AND FINANCIAL CONDITION	Page 19

- The State achieved an operating surplus of $1 billion in 2000-01, compared with $1.2 billion for the previous year.

  Paras 3.5 to 3.8

- As at 30 June 2001, the State held net assets of $44.2 billion, an increase of $3 billion since the prior year. A large part of this increase arose through revaluation of assets.

  Paras 3.9 to 3.12

- While the State's overall financial condition remains strong, the Government's flexibility in responding to future opportunities requiring increased financial resources has declined.

  Paras 3.32 to 3.33

- The level of the State's expenditure has increased relative to the size of the Victorian economy.

  Para. 3.33

- As at 30 June 2001, $1.2 billion of appropriations previously applied by the Treasurer remained unspent by departments, an increase of $314 million on the previous year. This amount, which forms part of the Consolidated Fund balance, is available to departments without requiring further parliamentary approval.

  Paras 3.25 to 3.28

- Consideration should be given by the Government to the presentation of a more comprehensive range of performance indicators in future Annual Financial Reports to enhance the usefulness of these Reports in facilitating assessment of the Government's performance and stewardship.

  Paras 3.29 to 3.31

- The Government has been successful in meeting its short-term financial objectives and is progressing towards the achievement of its longer-term objectives.

  Paras 3.37 to 3.39

REVENUE Page 35

- The operating revenues of the State in the 2000-01 financial year totalled $29.5 billion, some $2.1 billion (7.7 per cent) higher than 1999-2000.

  Paras 4.1 to 4.5

- The major factor contributing to the increase in State revenues was the higher level of grants received from the Commonwealth Government, which was partially offset by a reduction in the overall level of State taxation. The movement in these revenue items was largely due to the new funding arrangements established under the National Tax Reforms associated with the introduction of the Goods and Services Tax (GST).

  Paras 4.2 and 4.37 to 4.53

- During 2000-01, gambling revenues totalled $1.3 billion and are forecast by the Government to rise to around $1.6 billion by 2004-05.

  Paras 4.17 to 4.20

- After adjusting for the effect of the reduction in gambling tax rates, gambling revenues increased by approximately $128 million during 2000-01, reflecting a higher turnover in the gaming industry.

  Para. 4.19

- Investment income totalled $1.4 billion in 2000-01, a decrease of $526 million from the previous year. The decrease was largely attributable to the deterioration in the performance of international equity markets during the year which had been performing strongly in previous years.

  Paras 4.54 to 4.59

EXPENDITURE Page 49

- The operating expenses of the State totalled $28.5 billion during the 2000-01 financial year - some $2.3 billion (8.7 per cent) higher than in the previous year.

  Paras 5.1 to 5.4

- The costs associated with employee entitlements, consisting of salaries and wages, allowances and employee related on-costs totalled $8.6 billion in 2000-01, which were $661 million or 8 per cent higher than the previous year.

  Paras 5.5 to 5.7

- The net additional cost of major industrial settlements and additional permanent staffing in the 2000-01 financial year has been estimated at $491 million, increasing to around $979 million for the 2003-04 financial year. This does not include any associated increases to unfunded superannuation liabilities or the impact of certain changes which had not been costed at the date of preparation of this report.

  Paras 5.8 to 5.30

- The estimated cost to the State of hosting the 2006 Commonwealth Games of around $195 million, excluding capital works, is being revised to incorporate items such as the Games licence fees of $30 million which was not originally included, changes in the scope of the Games program and associated activities, and to take account of detailed planning in light of the experience of the Sydney Olympic Games and information obtained from the Manchester 2002 Commonwealth Games organising committee.

  Paras 5.36 to 5.47

- The net cost incurred by the State as at 30 June 2001 in hosting the 2006 Commonwealth Games in Melbourne was $22.3 million.

  Paras 5.41 to 5.43

- Total costs incurred by the State in relation to the Formula One and Motor Cycle Grand Prix events for the 2000-01 financial year amounted to $13.1 million, compared with $8.6 million in 1999-2000.

  Paras 5.48 to 5.52

- The net operating costs to the State associated with the staging of the Grand Prix events since their inception total around $58 million.

  Paras 5.53 to 5.56

ASSETS	Page 67

- The State's assets totalled $95.4 billion as at 30 June 2001, an increase of around $4.8 billion on the previous year.

Paras 6.1 to 6.2

- The State's investments of $19.7 billion include a net amount of $4 billion held by the Treasury Corporation of Victoria, which is available for application towards the retirement of debt and for meeting the State's prudential liquidity requirements. A further amount of $1.2 billion has been set aside by the Government for infrastructure investment over future years under the "Growing Victoria" initiative.

Paras 6.3 to 6.8

- Based on valuation reports provided by the investment fund managers, the downturn in investment markets reduced the value of the State's investment portfolio (post-balance date) by $462 million over the period 1 July 2001 to the date of finalising the Government's Annual Financial Report (which was signed on 12 October 2001). A reduction of $340 million also occurred in the value of investments held by the State Superannuation Fund over the same period, which had a corresponding impact in increasing the value of the State's liabilities for unfunded superannuation.

Paras 6.9 to 6.15

- Without a comprehensive Statewide infrastructure planning assessment, taking into account the State's long-term requirements, and examining economic, social and environmental issues, it is difficult to estimate an ideal or target level of Statewide asset investment.

Paras 6.35 to 6.43

- Of the $1 billion for projects committed from the "Growing Victoria" infrastructure reserve as at June 2001, $53.7 million was spent on capital works in 2000-01 compared with a budgeted $57 million.

Paras 6.44 to 6.47

LIABILITIES, COMMITMENTS AND CONTINGENCIES — Page 83

- The liabilities of the State totalled $51.2 billion at 30 June 2001, an increase of $1.8 billion compared with the previous year. This movement was mainly due to an increase in outstanding insurance claims liabilities of $1.4 billion and interest-bearing liabilities of $882 million, partially offset by a reduction in unfunded superannuation liabilities of $484 million.

  Paras 7.1 to 7.3

- While the Government used the competitive neutrality principle to support its decision to dispose of properties associated with the former Accelerated Infrastructure Program, the rationale for the application of this principle was not clear, given that the State had already acquired ownership of the properties. This principle has not been applied to justify the continued ownership of other government properties.

  Paras 7.17 to 7.22

- The net loss to the State from the un-winding of the Accelerated Infrastructure Program in 2000-01 was estimated at $66.6 million.

  Paras 7.23 to 7.30

- The overall reduction in the State's unfunded superannuation liability arising from the Beneficiary Choice Program (BCP) as at 30 June 2001 was around $368 million. It is estimated that a further reduction of approximately $145 million in the unfunded superannuation liability arising from the BCP will be reflected in the State's financial results for the 2001-02 financial year.

  Paras 7.37 to 7.42

- The aggregate loss associated with vehicle disposals under the Budget Sector motor vehicle leasing arrangement was estimated at $88.3 million at 30 June 2001.

  Paras 7.68 to 7.72

- In February 2001, Transurban submitted a claim to the Government alleging that the construction of a number of public road works, including Wurundjeri Way, will reduce traffic volumes on the City Link, resulting in lost revenue with a net present value of $35.8 million over the concession period. The Government has not accepted that a specified claimable event has occurred.

  Paras 7.91 to 7.97

DEVELOPMENTS IN FINANCIAL REPORTING AND MANAGEMENT

Page 109

- The ongoing challenge for the Government is to seek to improve the quality of disclosure and reporting of its activities to the public and Parliament. The disclosure of the Government's performance against its stated expected outcomes and related indicators remains an area for development.

  Para. 8.2

- The enhancement of the analysis and commentary provided in the unaudited parts of the Government's Annual Financial Report through, for example, the provision of longer-term (say 3 to 5 years) perspectives, would increase its value to Parliament and other users.

  Para. 8.3

Part 2

Opinion on the Government’s Annual Financial Report

FINANCIAL ACCOUNTABILITY FRAMEWORK

2.1 Activities undertaken by the Government are diverse, complex and have far-reaching effects on the community. These activities include the collection of State taxes, borrowing of funds and the provision of various services for community benefit. It is a convention of our Parliamentary system that the Government is held accountable to the public, through the Parliament, for all the activities undertaken on behalf of taxpayers.

2.2 The external financial reporting and audit arrangements which establish the Government's accountability responsibilities to Parliament for the management of the State's finances, are set out in the *Financial Management Act* 1994, *Audit Act* 1994 and *Constitution Act* 1975. The key principles of sound financial management which the Government and public sector agencies are required to observe in their stewardship of State finances are also set out in the *Financial Management Act* 1994.

2.3 As part of the accountability process, the Government annually presents to the Parliament its Budget Papers which include the Estimated Financial Statements, together with the annual Appropriation Bills which seek authority from the Parliament for the expenditure of funds from the Consolidated Fund (which forms part of the Public Account) to finance the expenditure proposals as outlined in the Budget Papers. The Estimated Financial Statements are required by the *Audit Act* 1994 to be subject to review by the Auditor-General, with his report on this review incorporated in the Budget Papers and available for Parliament's consideration prior to voting on the annual Appropriation Bills.

2.4 The Consolidated Fund represents the Government's core operating account and records all departmental revenues such as State taxes and grants received from the Commonwealth Government. Fundamental to the State's accountability framework is the principle that only the Parliament can authorise expenditure from the Consolidated Fund. Accordingly, Appropriation Acts are prepared annually by the Government and sanctioned by the Parliament, which provide the key means by which parliamentary control is exercised over public finances.

2.5 The Trust Fund, which also forms part of the Public Account, comprises various specific purpose trust accounts mainly relating to the on-passing of certain Commonwealth grants to specified recipients, the operation of departmental suspense and working accounts, and the receipt and payment of moneys of a trust nature.

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

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

2.8 In addition to the above financial reporting requirements, individual public sector agencies are required to present annual reports to the Parliament which include audited financial reports. The Government is also required to prepare a mid-year budget update incorporating revised Estimated Financial Statements for the budget sector and, from 2000-01, has been required to prepare quarterly financial reports for the budget sector and a mid-year financial report covering the whole of government. These reports are not required to be audited or reviewed by the Auditor-General.

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

TABLE 2A
STATE OF VICTORIA REPORTING ENTITY *(a)*

State of Victoria				
General government				
Budget sector (b)				
Public Account (Consolidated Fund/Trust Fund)	*Other*	*Non-budget sector*	*Public non-financial corporations(c)*	*Public financial corporations (d)*
Includes - • All government departments; and • Other administrative units, including Office of the Chief Commissioner of Police.	*Includes -* • TAFE institutes; • public hospitals and community health services; and • metropolitan and rural ambulance services.	*Includes -* • Docklands Authority; • Victoria Legal Aid; • Country Fire Authority; and • Metropolitan Fire and Emergency Services Board.	*Includes -* • Water sector authorities; • Alpine Resort Management Boards; • Australian Grand Prix Corporation; • Public Transport Corporation; and • Urban Land Corporation.	*Includes -* • State Trustees Ltd; • Transport Accident Commission; • Treasury Corporation of Victoria; • Victorian Funds Management Corporation; and • Victorian WorkCover Authority.

(a) A full list of Victorian public sector agencies is disclosed in note 34 to the Government's Annual Financial Report.

(b) Includes departments and other budget sector agencies which rely on funding from the Consolidated Fund.

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

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

AUDIT OPINION ON THE GOVERNMENT'S ANNUAL FINANCIAL REPORT

2.10 The Government's Annual Financial Report for the financial year ended 30 June 2001 has been audited as required by the *Financial Management Act* 1994. The Annual Financial Report represents the consolidated financial report of the State of Victoria which includes around 320 public sector agencies, but excludes local government bodies and universities.

2.11 My audit opinion on the Annual Financial Report, issued on 12 October 2001, reads as follows:

AUDITOR GENERAL
VICTORIA

AUDITOR-GENERAL'S REPORT

To the Members of the Parliament, the responsible Ministers and the Acting Secretary to the Department of Treasury and Finance

Audit Scope

The accompanying Annual Financial Report for the State of Victoria (excluding local government bodies and universities) for the year ended 30 June 2001, comprising the consolidated statement of financial performance, the consolidated statement of financial position, the consolidated statement of cash flows and the accompanying notes contained in Section 3 of the Annual Financial Report, has been audited. The Acting Secretary to the Department of Treasury and Finance is responsible for the preparation and presentation of the Annual Financial Report and the information it contains. An independent audit of the Annual Financial Report has been carried out in order to express an opinion on it to the Members of the Parliament, the responsible Ministers and the Acting Secretary to the Department of Treasury and Finance as required by the *Financial Management Act* 1994.

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

The audit opinion expressed in this report has been formed on the above basis.

Audit Opinion

In my opinion, the Annual Financial Report presents fairly the financial position of the State of Victoria and the Victorian Budget Sector as at 30 June 2001 and the results of their operations and their cash flows for the year ended on that date in accordance with Australian Accounting Standards and other mandatory professional reporting requirements and complies with the requirements of the *Financial Management Act* 1994.

MELBOURNE
12 October 2001

J W CAMERON
Auditor-General

Victorian Auditor-General's Office Level 34, 140 William Street, Melbourne Victoria 3000
Telephone (03) 8601 7000 Facsimile (03) 8601 7010 Email comments@audit.vic.gov.au Website www.audit.vic.gov.au

Auditing in the Public Interest

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

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

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

The extent or scope of the audit

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

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

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

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

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

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

Impact of materiality and audit procedures on the audit opinion

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

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

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

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

2.24 The recent performance audit of my Office concluded that the audit procedures applied by my Office in undertaking the audit of the Annual Financial Report were appropriate.

Audit opinion

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

2.26 My audit opinion on the Government's Annual Financial Report concludes that the financial information is presented fairly in accordance with the above reporting framework for the financial year ended 30 June 2001.

What the audit opinion does not provide

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

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

Part 3

Operating result and financial condition

SUMMARY OF OPERATING RESULT AND FINANCIAL CONDITION

3.1 The Government's Annual Financial Report discloses the financial outcomes for the 2000-01 financial year on 3 levels, namely:

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

3.2 Comment follows on each of these outcomes.

State of Victoria

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

3.4 A summary of the operating result achieved by the State for the financial year and its financial position as at 30 June 2001, as disclosed in the Government's Annual Financial Report, is presented in Table 3A.

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

Item	***2000-01***	*1999-00*
Operating result -		
Revenues	**29.5**	27.4
Expenses	**28.5**	26.2
Operating surplus for the year	**1.0**	**1.2**
Financial position -		
Assets -		
Physical assets	**61.9**	59.0
Cash and investments	**21.3**	19.4
Receivables	**11.6**	11.6
Other	**0.6**	0.6
Total assets	**95.4**	**90.6**
Liabilities -		
Interest-bearing liabilities	**14.9**	14.0
Unfunded superannuation	**11.9**	12.4
Employee entitlements	**2.5**	2.3
Payables	**9.0**	9.5
Other	**12.9**	11.2
Total liabilities	**51.2**	**49.4**
Net assets	**44.2**	**41.2**

Operating result

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

3.6 **The Consolidated Statement of Financial Performance indicates that an operating surplus of $1 billion was achieved by the State in 2000-01, compared with $1.2 billion for the previous year.**

3.7 The level of the State revenues increased by $2.1 billion, underpinned by strong economic conditions favourably impacting on taxation revenues, higher Commonwealth grants and increased collections from the sale of goods and services (including insurance premiums).

3.8 The increased revenues in the year were offset by a $2.3 billion increase in the level of State expenditure. This increase was mainly in the areas of supplies and services (largely attributable to the increased costs of insurance claims), employee entitlements, and grants and transfer payments.

Financial position

3.9 The Consolidated Statement of Financial Position serves as an indicator of the Government's financial strength and discloses information on the level and composition of assets and liabilities held by the State as at 30 June 2001.

3.10 **The financial position of the State from a whole-of-government perspective remains sound, with net assets of $44.2 billion, an increase of $3 billion since the prior year.**

3.11 The State's assets increased by $4.8 billion in the year, mainly brought about by increased investment holdings resulting from the investment of surplus revenues for the year and delays in undertaking certain capital works, and an increased value of physical assets due to the revaluation of certain assets and the acquisition of new assets.

3.12 The increase in State assets was in part offset by a $1.8 billion increase in the level of the State's liabilities. This was mainly due to increases in the level of outstanding insurance claims and interest bearing liabilities, partially offset by a reduction in unfunded superannuation liabilities.

Victorian Budget Sector

3.13 The Budget Sector consists of those entities in the general government sector that obtain 50 per cent or more of their funding through Parliamentary appropriations and which are subject to the financial discipline of the annual State budget process. The public sector agencies that comprise the Budget Sector are outlined in note 34 of the Annual Financial Report.

3.14 A summary of the operating result achieved by the Victorian Budget Sector for the financial year and its financial position as at 30 June 2001, as disclosed in the Government's Annual Financial Report, is presented in Table 3B.

TABLE 3B
VICTORIAN BUDGET SECTOR
OPERATING RESULT AND FINANCIAL POSITION
($billion)

Item	*2000-01 Estimate*	***2000-01 Actual***	*1999-00 Actual*
Operating result -			
Revenues	22.1	**23.4**	21.7
Expenses	21.5	**22.2**	20.5
Operating surplus for the year	**0.6**	**1.2**	**1.2**
Financial position -			
Assets -			
Physical assets	31.0	**33.4**	32.3
Cash and investments	3.5	**3.8**	3.0
Receivables	1.1	**1.2**	1.1
Other	0.2	**0.2**	0.2
Total assets	**35.8**	**38.6**	**36.6**
Liabilities -			
Interest-bearing liabilities	6.5	**6.2**	6.2
Unfunded superannuation	12.1	**11.8**	12.3
Employee entitlements	2.3	**2.3**	2.1
Payables	0.9	**1.1**	0.9
Other	0.4	**0.7**	0.4
Total liabilities	**22.2**	**22.1**	**21.9**
Net assets	**13.6**	**16.5**	**14.7**

Operating result

3.15 **The Consolidated Statement of Financial Performance discloses that the Victorian Budget Sector achieved an operating surplus of $1.2 billion for the 2000-01 financial year, which was consistent with the Sector's performance in the previous year.**

3.16 The year's result was $626 million higher than the Government's original budget estimate, primarily due to stronger than expected taxation receipts and higher than expected grants from the Commonwealth Government. These increases were in part off-set by additional expenditures, including the impact of a number of new industrial agreements in the education and health sectors.

Financial position

3.17 **The value of net assets held by the Budget Sector of $16.5 billion was $1.8 billion higher than the prior year and $2.9 billion higher than the original budget forecast.** The improved position in the year was in the main attributable to the stronger than forecast financial performance of the Sector in the 2000-01 year, asset revaluations which were not reflected in the budget estimates process and a better than projected outcome from the beneficiary choice program which reduced the unfunded superannuation liability.

The Public Account

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

3.19 The *Financial Management Act* 1994 requires the presentation in the Government's Annual Financial Report of certain information relating to the financial operations of the Public Account. Note 31 to the Annual Financial Report provides these required disclosures.

3.20 **Table 3C outlines the Consolidated Fund result for the year (prior to borrowing transactions), which was a surplus of $845 million compared to $1.9 billion in the prior year.**

TABLE 3C
CONSOLIDATED FUND RESULT FOR THE FINANCIAL YEAR
($million)

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

(a) Borrowing repayments during 2000-01 totalled $520 000.

3.21 Overall, receipts increased by $1.3 billion in the year primarily due to the impact of strong economic conditions within the State favourably impacting on taxation revenues and increased Commonwealth Government grants.

3.22 However, the increase in Consolidated Fund receipts was offset by increased departmental appropriations of $2.3 billion, including:

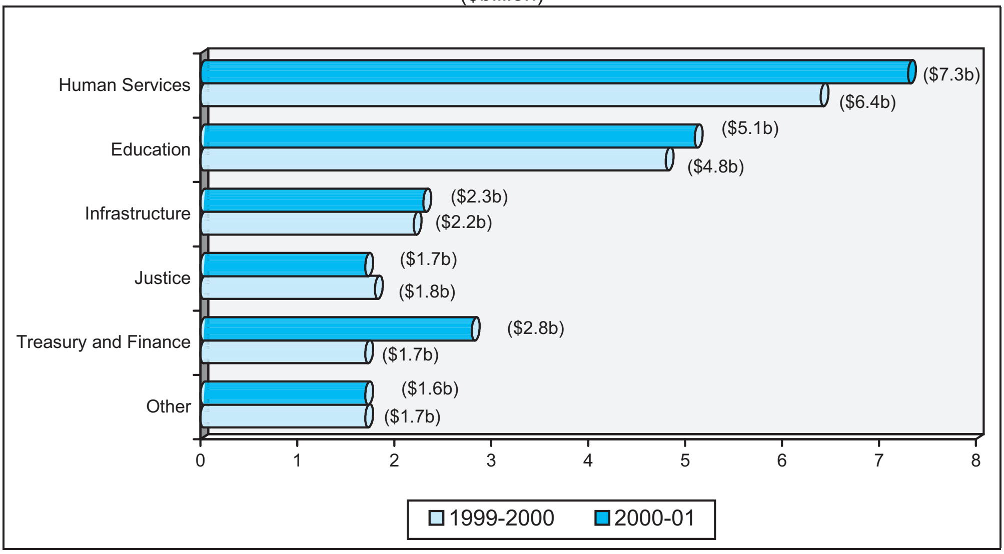
- the impact of increased Annual Appropriations for the provision of outputs, reflecting additional funding provided for implementation of a range of new policy initiatives and industrial relations outcomes, particularly in the human service and education sectors;
- additional payments of $603 million to reduce the State's unfunded superannuation liability; and
- first time payment of GST administrative costs of $247 million and First Home Owners Grants of $237 million.

3.23 As illustrated in Table 3C, the level of borrowing repayments reduced significantly from $269 million in 1999-2000 to $520 000 in 2000-01 reflecting the Government's decision to utilise surplus funds to increase financial assets while maintaining the current level of State borrowings.

Major spending departments

3.24 The key departments accounting for parliamentary appropriations applied during the year were Human Services, Education, Treasury and Finance, Infrastructure and Justice. As illustrated in Chart 3D below, these portfolios collectively represent 94 per cent of total Consolidated Fund appropriations.

CHART 3D
PARLIAMENTARY APPROPRIATIONS APPLIED,
1999-2000 AND 2000-01 *(a)*
($billion)



(a) Represents gross applied appropriations.

Accrual-based output appropriation arrangements

3.25 Our previous report to the Parliament on the Finances of the State of Victoria outlined the current accrual-based appropriation arrangements which commenced in July 1998. These arrangements are based on a purchaser/provider model, under which the Treasurer represents “the purchaser” and is responsible for the application of appropriations to departments for the purposes specified in the relevant Appropriation Acts. The application of appropriations occurs when the Treasurer is satisfied that the required services have been provided by departments.

3.26 The value of appropriations applied represents the price paid by the Treasurer for the purchase of departmental services, based on (but not necessarily equal to) the full “costs incurred” by departments including both the cash and non-cash components. Accordingly, in any one year, the value of appropriations applied may be higher than the expenses actually incurred by departments in the production of outputs in which case the departments will record profits which may be applied in future years without further parliamentary approval. Conversely, the value of appropriations applied may be lower than the costs incurred by departments, in which case the departments will record deficits which will need to be financed from future efficiency improvements in the production of outputs.

3.27 Given that funds are appropriated to departments for the accrual-based cost of service delivery (including depreciation), a number of accounts within the Consolidated Fund (known as the SAU accounts) have been established to record appropriations that have been applied by the Treasurer but for which funds were yet to be accessed by departments. The amounts recorded in these accounts represent a receivable of departments and are disclosed accordingly within departmental financial statements.

3.28 **As at 30 June 2001, $1.2 billion of appropriations previously applied by the Treasurer remained unspent by departments, an increase of $314 million on the previous year. This amount, which forms part of the Consolidated Fund balance, is available to departments without requiring further parliamentary approval.**

ANALYSIS OF THE STATE'S FINANCIAL CONDITION

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

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

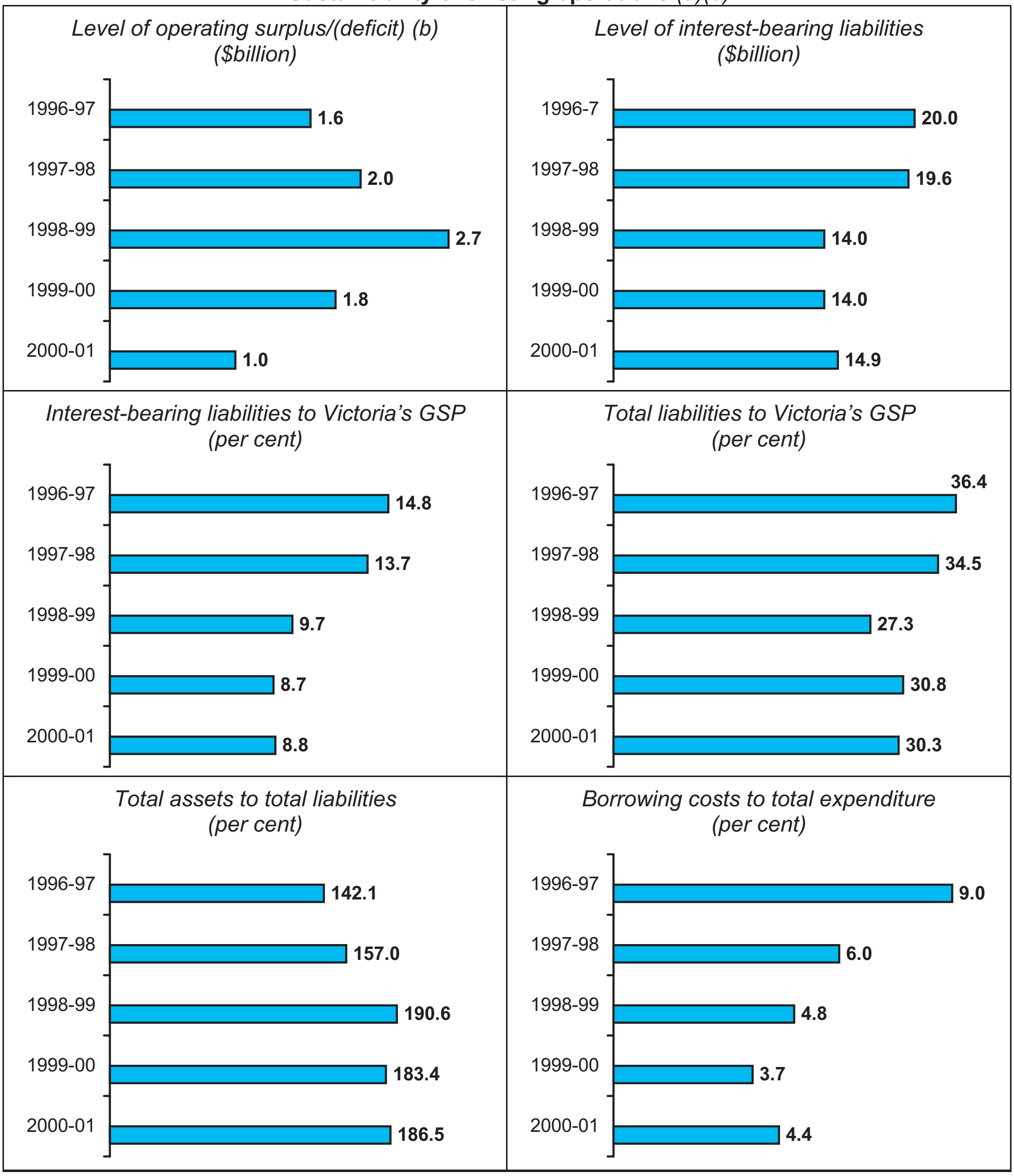
3.30 For a number of years, we have reported on the State's financial condition using a number of key indicators. The Government also reports on a number of indicators in the State's Annual Financial Report, however, we believe that these are limited in perspective as key aspects of financial condition do not appear to be addressed.

3.31 **I reiterate my comments included in my November 2000 Report to Parliament that, consideration should be given by the Government to the presentation of a more comprehensive range of performance indicators in future Annual Financial Reports to enhance the usefulness of these Reports in facilitating assessment of the Government's performance and stewardship.**

3.32 Table 3E presents the key indicators we have applied in assessing the State's financial health for the 5 year period, 1996-97 to 2000-01. Our analysis focuses on historical financial information and, accordingly, its scope does not extend to assessments of the effectiveness of government programs and their associated impacts on the State's revenues and expenditures.

**TABLE 3E
STATE OF VICTORIA,
INDICATORS OF FINANCIAL CONDITION,
1996-97 TO 2000-01 FINANCIAL YEARS**

Sustainability of existing operations *(a)(b)*

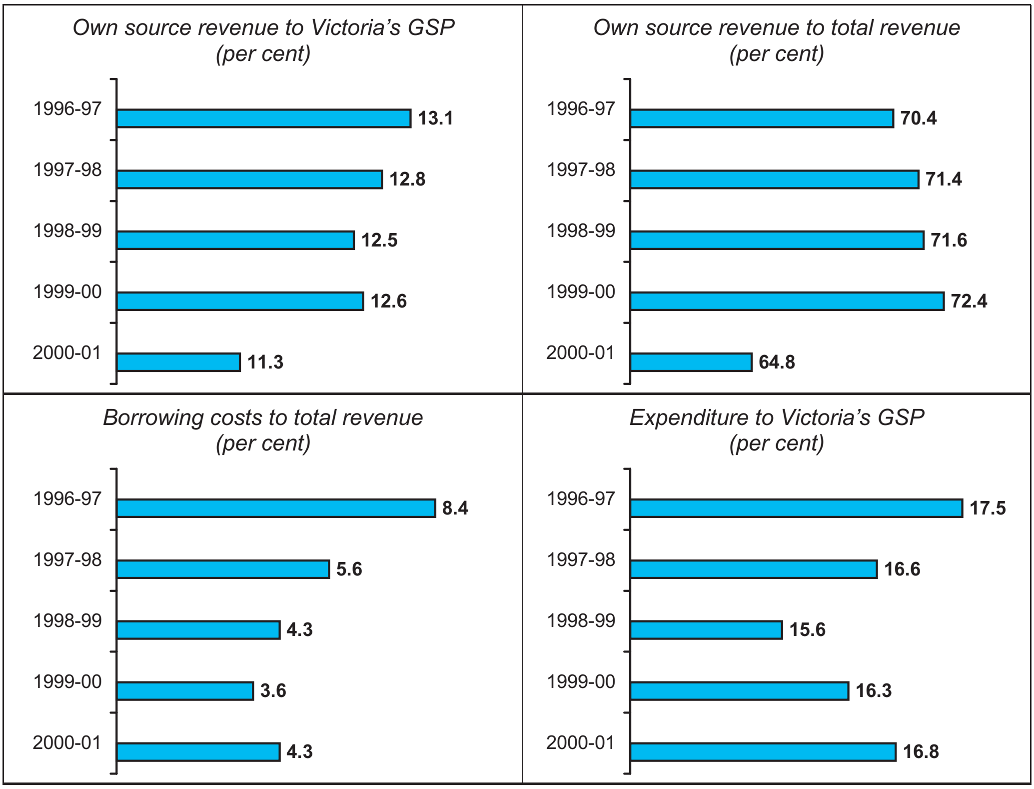


(a) A number of the indicators provide reference to Victoria's GSP. This reference relates to Victoria's Gross State Product, which is a measure of the size of the State economy and is sourced from statistics published by the Australian Bureau of Statistics for the financial years up to 1999-2000, and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

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

TABLE 3E
STATE OF VICTORIA,
INDICATORS OF FINANCIAL CONDITION,
1996-97 TO 2000-01 FINANCIAL YEARS - *continued*

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



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

(b) Own source revenue represents total revenue from ordinary activities less total grants to the State.

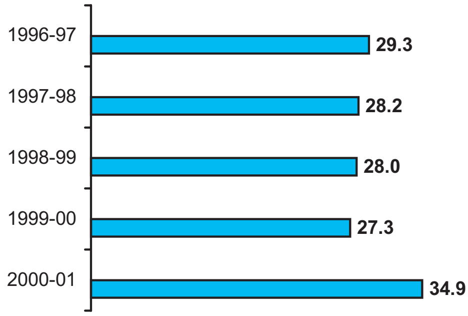
(c) Figures relating to periods prior to 2000-01 do not include abnormal items which, in the main, relate to the impact of privatisations.

(d) Figures relating to 2000-01 reflect the impact of National Tax Reforms which impacted on the level and composition of State revenues and expenditures. Therefore, care needs to be taken when analysing trends associated with these indicators.

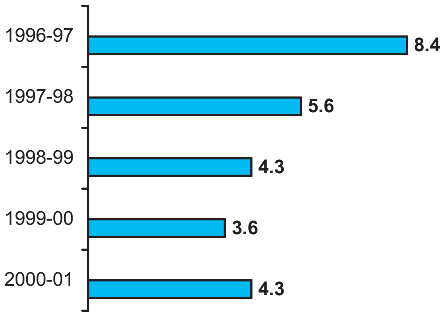
TABLE 3E
STATE OF VICTORIA,
INDICATORS OF FINANCIAL CONDITION,
1996-97 TO 2000-01 FINANCIAL YEARS - *continued*

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

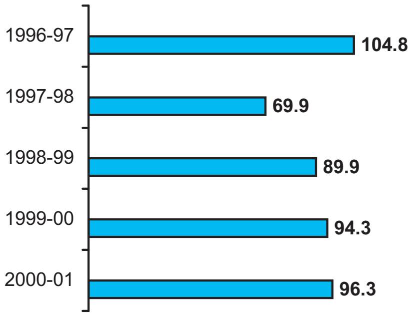
Commonwealth revenues to total revenue
(per cent)



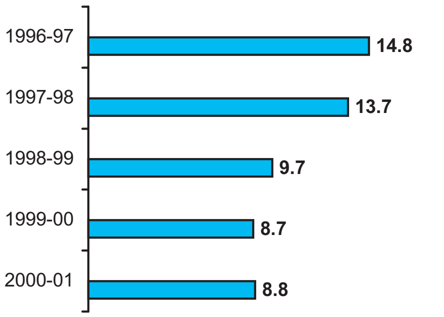
Borrowing costs to total revenue
(per cent)



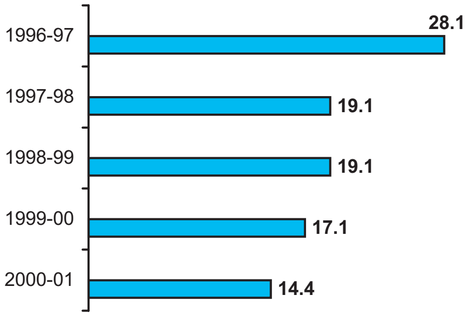
Current assets to current liabilities
(per cent)



Interest-bearing liabilities to Victoria's GSP
(per cent)



Foreign currency borrowings to total interest-bearing liabilities
(per cent)



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

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

(c) Figures relating to 2000-01 reflect the impact of National Tax Reforms which impacted on the level and composition of State revenues and expenditures. Therefore, care needs to be taken when analysing trends associated with these indicators.

3.33 **The information contained in the tables indicates that while the State's overall financial condition remains strong, the Government's flexibility in responding to future opportunities requiring increased financial resources has declined**. In particular:

- **The Government's capacity to maintain existing programs and operations has been maintained.** The State's net asset position has improved while the level of its liabilities relative to the size of the Victorian economy has been maintained. Borrowing costs increased in 2000-01, but this mainly reflected the larger deposits invested with the Government by superannuation funds and certain trust funds which are not consolidated in the Government's Annual Financial Report, and the one-off effects of certain debt restructuring. The operating surplus has declined over the past 3 years but still remains at a reasonably high level;
- **The Government's flexibility in responding to future opportunities requiring increased financial resources has declined**. The State's own-source revenues have decreased significantly as a result of the introduction of the National Tax Reforms, resulting in a reduction in the State's taxation base which has been compensated by the Commonwealth Government's GST grants to the State. The level of the State's expenditure has increased relative to the size of the Victorian economy; and
- **The State's vulnerability to funding sources not directly within its control has increased,** largely due to the greater reliance on Commonwealth Government grants. However, under the National Taxation Reforms, the State during the transitional period is protected against any adverse impacts on its budgetary position (refer to Part 4 of this report for further details). The State's working capital position has improved, however, given the increasing level of financial assets, the State is increasingly vulnerable to both domestic and international market influences outside its control which impact on investment revenue and the market value of the State's financial asset portfolio.

STATE'S CREDIT RATING

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

3.35 In early 2001, Standard and Poor's reaffirmed the State's triple-A long-term rating and stated that "*The outlook is stable. Although there are some risks to the State's immediate financial outlook from the easing economy, its very low financial liabilities provide considerable flexibility. Therefore, a temporary deterioration in the state's financial position would not necessarily jeopardise its 'AAA' rating.*"

3.36 In mid-2001, Moody's Investors Services also reaffirmed the State's Aaa rating for domestic currency debt and Aa2 rating for foreign currency debt. Moody's commented that "*Victoria has maintained a trend of sound fiscal performance over the past six years, generating sizable surpluses after financing both operating and capital expenditures. These surpluses have resulted from the State's prudent fiscal practices, supported in recent years by strong economic growth. Surpluses have been used both for debt reduction and to set up a reserve for future capital spending*".

PERFORMANCE AGAINST KEY GOVERNMENT OBJECTIVES

3.37 A significant element of the Government's financial management reforms as reflected in the *Financial Management (Financial Responsibility) Act* 2000 is a requirement for the Government to provide a statement in the Budget Papers of its short and long-term financial objectives. Table 3F details the objectives presented in the 2000-01 Budget Papers.

TABLE 3F
GOVERNMENT'S KEY FINANCIAL OBJECTIVES 2000-01

Long-term	*Short-term*
• Maintain a substantial budget sector operating surplus.	• Achieve an operating surplus of at least $100 million in each year.
• Provide capital works to enhance social and economic infrastructure throughout Victoria.	• Establish a $1 billion infrastructure reserve.
• Provide improved service delivery to all Victorians.	• Provide expenditure priority on education, health and community safety.
• Ensure competitive and fair taxes and charges to Victorian businesses and households.	• Re-examine and improve Victoria's business taxation system.
• Maintain State Government net financial liabilities at prudent levels.	• Maintain a triple-A credit rating.

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

- achieved a budget sector operating surplus of $1.2 billion for the 2000-01 financial year;
- set aside under its Growing Victoria initiative $1.2 billion of financial assets for application towards the development of State infrastructure over the 4 year period to 2003-04, with $53.7 million expended against this allocation in 2000-01;
- maintained a triple-A credit rating;
- announced in the 2001-02 State Budget, its *Better Business Taxes* package which formed the basis of the business tax reforms; and
- increased funding allocations for education, health and public safety programs in 2000-01 and over the forward estimates period.

3.39 These developments indicate that the Government has been successful in meeting its short-term financial objectives and is progressing towards the achievement of its longer-term objectives.

Part 4

Revenue

SUMMARY OF STATE REVENUES

4.1 **The operating revenues of the State in the 2000-01 financial year totalled $29.5 billion, some $2.1 billion (7.7 per cent) higher than 1999-2000.**

4.2 The major factor contributing to the increase in State revenues was the higher level of grants received from the Commonwealth Government, which was partially offset by a reduction in the overall level of State taxation. The movement in these revenue items was largely due to the new funding arrangements established under the National Tax Reforms relating to the introduction of the Goods and Services Tax (GST), and its on-passing to the States via Commonwealth grants, and the abolition of certain categories of State taxation and general purpose Commonwealth grants.

4.3 Other factors contributing to the year's revenue outcome were higher collections from the sale of goods and services (including insurance premiums), offset by reduced returns from investments due to adverse market conditions, and the one-off impact on the previous year's outcome of the reported loss on the sale of transport rolling stock.

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

TABLE 4A
OPERATING REVENUES OF THE STATE
($billion)

Revenue source	***2000-01***	*1999-2000*
Taxation	**8.5**	9.7
Grants revenue	**10.4**	7.7
Sale of goods and services	**7.8**	7.3
Investment income	**1.4**	2.0
Other	**1.4**	0.7
Operating revenue	**29.5**	**27.4**

4.5 Taxation revenues now provide 29 per cent of the revenues of the State compared with 35 per cent in the previous year. Grants received from the Commonwealth now represent the largest source of State revenues, accounting for 35 per cent of total revenues compared with 28 per cent in the previous year.

TAXATION REVENUES

4.6 Taxation revenues now represent the second largest source of State revenues and principally comprise payroll tax, various stamp duties and taxes on financial and capital transactions, property holdings and gaming activities, motor vehicle fees, and other licences and levies. **In the 2000-01 financial year, taxation collections totalled $8.5 billion, a decrease of $1.2 billion on the previous year**. Table 4B summarises the major sources of taxation revenue over the last 3 financial years.

TABLE 4B
TAXATION REVENUES
($billion)

Taxation source	*1998-99*	*1999-2000*	***2000-01***
Payroll tax	2.2	2.3	**2.5**
Financial and capital transactions	1.9	2.4	**2.4**
Gambling	1.4	1.5	**1.2**
Motor vehicle	0.9	0.9	**1.0**
Taxes on immovable property	0.5	0.5	**0.6**
Other	1.9	2.1	**0.8**
Total taxation revenue	**8.8**	**9.7**	**8.5**

4.7 The overall reduction in taxation revenue in 2000-01 was attributable to the impact of National Tax Reforms, including the introduction of the GST and its on-passing to the States and Territories. Under these reforms, the Commonwealth Government ceased the payment of around $1.4 billion in replacement revenues associated with petroleum, tobacco and liquor fees that were previously abolished. A further reduction of $244 million occurred in State gambling taxes resulting mainly from a reduction in taxes payable to the State Government to offset the impact of the GST payable by gambling operators. The reduction in State taxes, including replacement revenues, resulting from the introduction of the GST were fully compensated by an equivalent increase in the level of grants received from the Commonwealth Government.

4.8 **Revenues from taxation items not directly impacted by the National Tax Reforms increased by around $633 million mainly in the areas of payroll taxation - reflecting increases in labour costs and employment growth; taxes on immovable property - associated with continued strong property market conditions and growth in land values; and taxes on motor vehicles – reflecting an increase in the number of registered vehicles. The increases in these taxation categories largely reflected the ongoing strength in the State's economy throughout the 2000-01 financial year.**

Tax competitiveness

4.9 Our previous reports to Parliament and the Government's Budget Papers have highlighted successive Governments' aims of reducing the taxation burden on Victorian businesses and households by bringing the State's tax rates into alignment with the national average.

4.10 Overall, variances in the relative tax burden between States are due to differences in the nature of taxes levied and in the level of reliance placed on taxation as a source of revenue. However, these variances are also indicative of relative differences in the size and structure of State economies and, as a consequence, the ability of individual States to raise revenue through a given form of taxation.

4.11 The Budget Papers over recent years have compared and reported on the State's tax competitiveness against 3 recognised performance measures, namely, taxation revenue as a percentage of Gross State Product, taxation revenue on a per capita basis, and the Commonwealth Grants Commission measure of the relative tax burden, which includes adjustments for each State's revenue raising capacity. Table 4C illustrates the results of these measures for 1998-99 and 1999-00, and forecast for the 2000-01 financial year.

TABLE 4C
MEASURES OF VICTORIA'S TAX COMPETITIVENESS

	Compared with the national average		
Measure	*1998-99*	*1999-2000*	*Estimate 2000-01*
Taxation revenue per capita	$81 per capita higher	$56 per capita higher	$113 per capita higher
Taxation revenue relative to GSP	0.16 per cent higher	0.06 per cent higher	0.29 per cent higher
Commonwealth Grants Commission	$59 million higher	$238 million higher	Not available

Source: Department of Treasury and Finance. Based on the latest available Commonwealth Grants Commission *Report on State Revenue Sharing Relatives 2001 Update*, (in respect of the 1999-2000 financial year) and Australian Bureau of Statistics Taxation Revenue Australia 1999-2000 (catalogue 5506.0) and revised estimates of taxation revenue for 2000-01 as published in all State and Territory 2001-02 Budgets.

4.12 Based on the first 2 measures, the State's competitiveness improved in 1999-2000 but deteriorated in 2000-01, with the gap between the level of the State's tax revenue and the national average increasing. On the basis of the third measure, namely, the Commonwealth Grants Commission revenue measure of relative tax burden, Victoria's taxation revenue in the 1999-2000 financial year was $238 million above the national average, a deterioration of $179 million from the 1998-99 financial year, with data not available to calculate this measure for the 2001-02 financial year.

4.13 **The key reason for the deterioration in the State's tax competitiveness over the comparative period relates to the stronger performance of the Victorian economy relative to other States, which resulted in a higher level of tax collections in Victoria.**

4.14 A major initiative of the Government in the 2000-01 State Budget was a proposal to review the State's taxation system, with a particular focus on reducing State business taxes by $400 million over the following 4 years.

4.15 The review of State business taxes was undertaken during 2000-01 and culminated in the announcement of various reforms aimed at reducing the level of taxation collections commencing from 2000-01, and improving the administration of State taxes.

4.16 The announced measures are estimated by the Government to result in a reduction in the level of taxation collections of $100 million in 2001-02, gradually increasing to around $351 million by 2004-05. The aggregate reduction in taxation revenues over the 4 year period to 2004-05 attributable to these measures has been estimated by the Government at $774 million.

Gambling fees and taxes

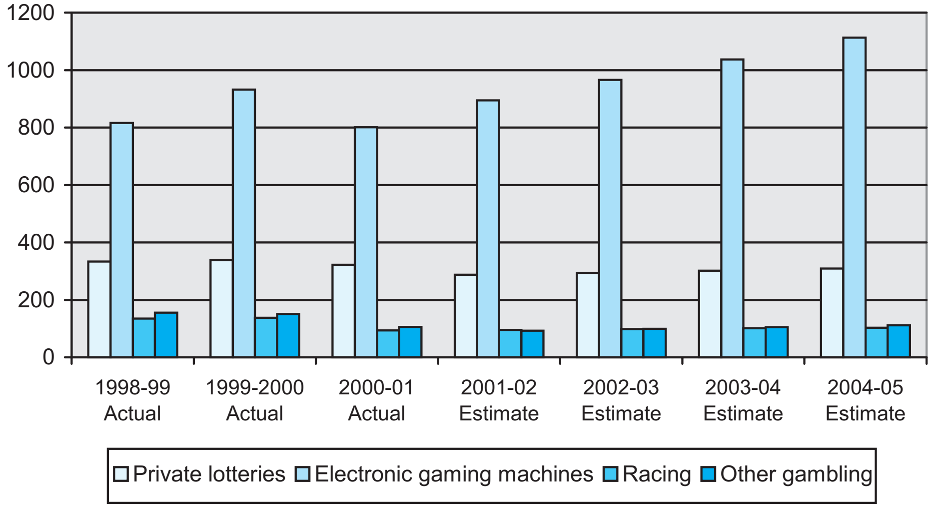
4.17 Fees and taxes levied on gambling activities, including electronic gaming machine operations, private lotteries, and racing and casino operations comprise 15 per cent of State taxation revenues and 4.3 per cent of the total State revenues.

4.18 During 2000-01, gambling revenues decreased by $244 million from the previous year to $1.3 billion due to the State adjusting the gambling tax arrangements to take into account the impact of the GST on gambling operators which was estimated to reduce gambling tax revenue by $372 million. However, as indicated previously, the adverse impact of the gambling tax rate reduction on State revenue is compensated by increased grants from the Commonwealth Government.

4.19 **After adjusting for the effect of the reduction in gambling tax rates, gambling revenue increased by approximately $128 million during 2000-01, reflecting a higher turnover in the gaming industry.**

4.20 The Government's Budget Papers 2001-02 forecast that gambling taxation will rise to around $1.6 billion by the 2004-05 financial year, as illustrated in Chart 4D.

CHART 4D
GAMBLING REVENUE PROFILE IN VICTORIA, 1998-99 TO 2004-05
($million)



Source: For 1998-99 to 2000-01, amounts are sourced from the Annual Financial Reports for the State of Victoria, with the amounts extracted from note 31 Public Account Disclosure – Consolidated Fund Gross Receipts. For 2001-02 to 2004-05, gambling estimates obtained from Department of Treasury and Finance – Forward Estimates. Electronic gaming machine forward estimates include full impact of gaming machine levy amounting to $46 million from 2001-02.

Write-down of Transurban concession fees

4.21 Under arrangements established for the development and operation of the Melbourne City Link, concession fee notes (promissory notes) are received by the Melbourne City Link Authority on behalf of the State from Transurban City Link Limited, in consideration of Transurban's obligation to pay concession fees to the State.

4.22 The Melbourne City Link Authority reports the value of the concession fee notes as both an asset (i.e. the value receivable from Transurban) and a liability (i.e. the value payable to the State) in its financial statements. In 1999-2000, the notes were included in the Authority's and the Government's Annual Financial Statement at an estimated net present value of $103.3 million, based on a number of assumptions.

4.23 One of the key determinants of the estimated net present value of the notes is the timing of Transurban achieving a specified return on equity after tax. Once the specified return has been achieved, the concession fees become payable. One of the key assumptions made by the Authority when calculating the net present value of the notes was that they will be deductible for income tax purposes by Transurban in the year in which the notes are raised.

4.24 We were advised that the Australian Taxation Office has issued a tax assessment to Transurban without the notes being allowed as a deductible expense. Transurban has lodged a formal objection to the tax assessment and a legal process was in progress at the time of preparation of this report.

4.25 In recognition of the above, during 2000-01, the Authority reduced the value of the concession notes by $62.6 million. This write-down in the value of the notes was recognised in the Government's Annual Financial Report for 2000-01.

Impact of Supreme Court decision on payroll taxation revenues

4.26 In July 1993, the Commissioner of State Revenue (the Commissioner) refused a claim by a private employment agency to obtain a refund of tax paid by the agency to the State Revenue Office relating to services provided by temporary workers under contracts to clients from January 1984 to June 1992. The employment agency contested that such contract employees should not be considered as employees under the *Payroll Tax Act* 1971.

4.27 In June 1998, the employment agency's objection to its tax assessment was upheld, in part, by the Supreme Court of Victoria. However, this ruling was subsequently overturned by the Victorian Court of Appeal in June 2000. The Court held that contract employees on-hired by the agency to its clients were employees of the agency and, therefore, the agency was liable to pay the associated payroll tax liability.

4.28 As a result, the Commissioner commenced action to collect payroll tax in arrears backdated to July 1998, estimated at $12.4 million, from all employment agencies affected by the decision. While the matter was on appeal to the High Court, ongoing mediation with the employment agency and other industry representatives resulted in a negotiated agreement being reached in November 2000.

4.29 The proceedings also highlighted an anomaly that existed in the operation of the general refund provisions in the relevant legislation. That is, where the Commissioner agrees to an application to refund tax incorrectly paid, a limited refund period of 3 years applies. However, if the Commissioner disagrees with the claim and the disputing party is successful on objection or appeal, an unlimited refund period applies.

4.30 To overcome this exposure, the Government introduced the *State Taxation Acts (Further Miscellaneous Amendments) Act* 2000 to make various amendments including changes to the refund provisions, to allow applications for payroll tax refunds to be backdated 3 years from the date of application.

4.31 As was reported in our previous year's report, amendments to the *Payroll Tax Act* 1971 effective from February 1999 specifically requires employers who engage the services of contract temporary employees to pay payroll tax. However, payroll tax is only payable by the employers if the term of the engagement of the temporary worker exceeds 8 days a month.

"Mirror" State taxes on activities conducted at Commonwealth places

4.32 Our previous report on the *Finances of the State of Victoria* commented on the impact of a High Court decision in November 1996, which gave rise to a degree of uncertainty regarding the validity of the imposition of State taxes on activities conducted at Commonwealth locations. The Commonwealth Government in April 1998 enacted the *Commonwealth (Mirror Taxes) Act* 1998 with effect from October 1997.

4.33 The Act enables the levying of Commonwealth taxes which "mirror" the taxes imposed by the States in relation to Commonwealth places, and ensures that each State would continue to receive revenue equivalent to the taxes that would have been received prior to the ruling. In essence, the effect of the Commonwealth legislation is that the State taxing laws are applied and operate in Commonwealth places as laws of the Commonwealth. In addition, the State introduced the *Commonwealth Places (Mirror Taxes Administration) Act* 1999, amending the State taxation legislation to facilitate the collection of these mirror taxes.

4.34 Under these arrangements, the State Revenue Office is to collect the Commonwealth taxes imposed under the applied laws on the Commonwealth's behalf, which then returns an equivalent amount to the State in the form of a statutory payment provided for under the Commonwealth legislation. The State will continue to have discretion over the taxation rates to be applied and will continue to oversee compliance with the legislation. A survey undertaken by the State Revenue Office has estimated that approximately $95 million per annum will be collected under these arrangements. These mirror taxes have been disclosed in the Government's Annual Financial Report as part of State taxation revenues.

4.35 At the time of preparation of this report, bi-lateral agreements between the Commonwealth and the States to facilitate the collection and reporting of these mirror taxes had not been finalised. The State Revenue Office advised that it anticipates that these agreements will be finalised in the 2001-02 financial year.

4.36 **As previously advised to Parliament, in my opinion such receipts are more appropriately classified as grants from the Commonwealth Government given that they are raised under the authority of Commonwealth legislation**.

COMMONWEALTH GRANTS

4.37 Commonwealth grants include GST-sourced revenue received from the Commonwealth Government and other amounts paid under specific funding agreements such as the Australian Health Care Agreement and National Competition Policy Agreement. Commonwealth grants paid to the State increased in 2000-01 as a result of the introduction of the Commonwealth Government's National Tax Reforms, and increases in specific purpose payments for non-government schools and road programs.

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

Financial impact of the National Tax Reforms on State finances

4.39 Under the new taxation arrangements applying from 1 July 2000, the Commonwealth Government provided an undertaking that the budgetary positions of the States and Territories would not be adversely affected by the reforms. To assist States and Territories which would be adversely affected by the introduction of the reforms over several years, the Commonwealth is to provide budget balancing assistance payments.

4.40 Forecasts indicate that Victoria would not be in a position of net budgetary gain from the National Tax Reforms until the 2007-08 financial year, with the position gradually improving thereafter.

4.41 In June 2001, the Commonwealth advised all States and Territories that, in accordance with established arrangements, the Commonwealth Commissioner of Taxation had determined that the total amount of the GST revenue available for distribution to the States and Territories for 2000-01 was $24.36 billion. Following this determination, the aggregate budget balancing assistance package for the financial year was calculated by the Commonwealth Treasurer to be $2.82 billion for all States and Territories.

4.42 The State's share of the GST revenue was calculated to be $5.1 billion (after deducting administration costs), together with a $681 million budget balancing assistance grant payable to the State in respect of the 2000-01 financial year.

4.43 Table 4E outlines the impact of the National Tax Reforms on the State's finances during 2000-01, and that estimated for the 3 year forward estimates period.

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

	Estimate 2000-01	*Revised estimate 2000-01*	*2000-01 actual*	*2001-02 estimate*	*2002-03 estimate*	*2003-04 estimate*
GST revenue grants	5 061	5 534	**5 099**	5 933	6 060	6 337
Revenue forgone	(5 470)	(5 461)	**(5 466)**	(6 239)	(6 422)	(6 600)
Other revenue adjustments	72	77	**77**	94	111	128
Total revenue change	(337)	150	**(290)**	(212)	(251)	(135)
Net additional expenditure	(345)	(386)	**(391)**	(261)	(224)	(215)
Net Impact	(682)	(236)	*(a)* **(681)**	(473)	(475)	(350)
Net Commonwealth Guarantee Payments	682	236	**681**	473	475	350
Net impact on Victoria's budget	0	0	**0**	0	0	0

(a) Includes $26 million agreed to be paid to the State but not received as at 30 June 2001.
Source: Budget Statement 2000-01, Budget Statement 2001-02 and Government's Annual Financial Report 2000-01.

Risk management and compliance framework

4.44 Under the National Tax Reforms, all Victorian public sector entities are now required to comply with Commonwealth taxation obligations in full, including Australian business registrations, business activity reporting obligations, goods and services tax, and pay-as-you-go and fringe benefits tax requirements. In relation to these obligations, as at 30 June 2001 the Government's Annual Financial Report recognised a GST liability of $73 million and a GST receivable of $198 million.

4.45 To effectively meet these obligations, the State Government established various support mechanisms for public sector entities (excluding local government and Universities) during the implementation phase, including implementation methodology, guides, training and a tax information website. However, primary responsibility for the effective and efficient implementation of the new tax changes remains with individual entities.

4.46 As a final phase in the whole-of-government implementation program, the Victorian Government engaged consultants to conduct a GST strategic impact and risk analysis review to assist in identifying any major strategic or systemic risks or opportunities arising from the implementation of the GST, and options to manage and mitigate these risks.

4.47 **The GST strategic impact and risk analysis review identified a number of key taxation management risks confronting the Government, including financial/budget risks (such as non realisation of embedded tax savings, input tax credits leakage, and pricing determinations), cash flow opportunities, technical compliance risks, corporate governance risks arising from major machinery of government changes, and risks associated with the public disclosure of any non-compliance.**

4.48 To manage these key risks and taxation compliance in the public sector, the Government engaged consultants to assist in the development of a tax compliance assurance framework. After considering several options between a centralised and decentralised tax compliance framework proposed by the consultant, it elected a model under which the Department of Treasury and Finance acts as a standard setter. The Department will also perform a monitoring role through the establishment of a monitoring and reporting process, centred around the requirement for annual certification of compliance by entities to their portfolio Ministers, which is then reported to the Department for monitoring purposes. The Government in August 2001 released the Tax Compliance Framework for the Victorian public sector based on the consultant's recommendations.

4.49 To highlight and address key issues arising from the 2000-01 financial year, the Department engaged consultants in May 2001 to conduct strategic tax compliance reviews on 20 major public sector entities. The significant issues arising from the review included the need for enhanced taxation knowledge, including GST training and the need for the identification and clarification of entity-specific GST-related issues.

Embedded tax savings

4.50 Under the Intergovernmental Agreement, the States and Territories were expected to realise certain savings in the costs of government administration as a result of tax savings flowing from the National Tax Reform changes, referred to as "embedded tax savings". The estimates of the embedded tax savings for each State and Territory were calculated by the Commonwealth based on the impact of the abolition of the wholesale sales tax and other indirect charges on goods and services. For Victoria, the Commonwealth Government estimated embedded tax savings of $100.4 million in 2000-01 increasing to $131.5 million by 2004-05.

4.51 The State Government commissioned a consultant to review the economy wide experience with achieving embedded tax savings. In April 2001, the consultant's report concluded that the estimated savings in the short to long-term were realistic and that there was no basis for adjusting government agency appropriations based on the available evidence at that time.

4.52 **As a consequence, the State Government confirmed that there would be no adjustment to departmental forward estimates from those agreed in the 2000-01 Budget. As such, any saving targets not achieved would need to be absorbed by departments within existing budgets.**

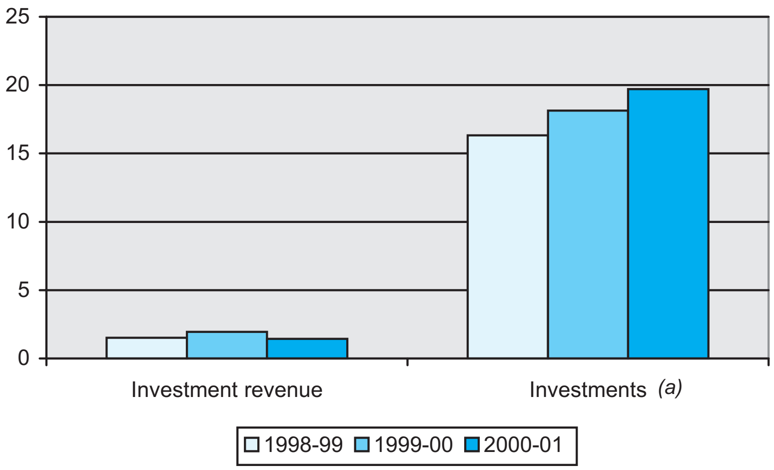
4.53 **We were informed by a number of departments that they could not establish whether the embedded tax savings were achieved in the 2000-01 financial year and that any savings were either negligible or not identifiable.** Suppliers have claimed that any savings have been offset by implementation costs or that they were not previously subject to wholesale sales tax. Departments also indicated that price reductions could not be directly related to the embedded tax savings and could reflect others factors such as economic conditions and various supply and demand factors.

INVESTMENT INCOME

4.54 Investment income comprises dividends, interest, investment gains, royalties, rental and other miscellaneous revenue. **In the 2000-01 financial year, investment income totalled $1.4 billion, a decrease of $526 million from the previous year. The decrease is largely attributable to the deterioration in the performance of international equity markets during the year which had been performing strongly in previous years.**

4.55 As illustrated in Chart 4F, since 1998-99 the amount of investments held has increased by approximately 10 per cent per annum. Investment revenue has correspondingly increased each year, with the exception of the 2000-01 financial year.

CHART 4F
INVESTMENT REVENUE AND FINANCIAL ASSET TRENDS, 1998-99 TO 2000-01
($billion)



(a) Represents the amount of investments held as at the end of the respective financial years.

4.56 As a result of the State Government's decision to apply operating surpluses to financial assets, investment returns are increasingly becoming an important source of revenue for the State, representing around 5 per cent of the State's total revenue. However, the return from investments can be subject to volatility as it is dependent on factors outside the Government's direct and indirect control or influence. The sensitivity of investment returns on the State's fiscal outcomes is illustrated in the Government's 2001-02 Budget Papers which estimate that a one per cent movement in both domestic and international equity prices will impact on the budget sector operating surplus alone by around $51 million in a full year.

4.57 The performance return for each agency varies as a result of the different investment objectives, strategies and the portfolio asset mix adopted to meet their short-term and long-term operational requirements, which include the matching of asset and liability profiles. Under the management arrangements established for the major investing agencies, the overall investment objectives, strategies and risk profiles are established by the relevant investing agencies to meet their differing liabilities, while the investments are administered within these parameters by either the Victorian Funds Management Corporation or the Treasury Corporation of Victoria. Further commentary of the State's investments is provided in the *Assets* section of this report.

4.58 Investment holdings by the Department of Treasury and Finance – Budget Sector Long Term Investment Fund, Treasury Corporation of Victoria, Transport Accident Commission and the Victorian WorkCover Authority, make up around 94 per cent of total State's investments. As illustrated in Table 4G, with the exception of the Transport Accident Commission, rates of return on investments were achieved by these agencies above the CPI movement.

TABLE 4G
KEY AGENCIES' INVESTMENT PERFORMANCE, 30 JUNE 2001
(per cent)

Entity	*Actual return*	*Return above CPI movement (a)*
Department of Treasury and Finance *(b)*	7.36	4.36
Treasury Corporation of Victoria *(c)*	6.58	3.58
Transport Accident Commission *(b)*	2.02	(1.02)
Victorian WorkCover Authority *(b)*	7.10	4.10

(a) Adjusted for CPI for the 2000-01 financial year excluding impact of the GST estimated at 3 per cent by the Victorian Funds Management Corporation.
(b) Source: Victorian Funds Management Corporation.
(c) Source: Agency's financial statements. Includes the investment of $2.7 billion of funds deposited by public sector agencies, superannuation funds and trust funds.

4.59 **Overall, despite the significant decrease in investment revenue in the year and the volatility in the investment markets, these agencies have generally exceeded the respective benchmark for the asset portfolio classes.**

Part 5

Expenditure

SUMMARY OF STATE OPERATING EXPENSES

5.1 **The operating expenses of the State totalled $28.5 billion during the 2000-01 financial year, some $2.3 billion (8.7 per cent) higher than in the previous year.** The key factors contributing to this outcome were increased costs associated with:

- supplies and services ($1 306 million) – largely attributable to the increased costs of insurance claims on the State's workers' compensation and transport accident schemes; the impact of the national tax reform program under which the State has been required as from 1 July 2000 to meet a share of the cost to the Australian Taxation Office in administering the GST; and general increases in external service provider costs;
- employee entitlements ($661 million) – representing the impact of general wage increases and higher staffing levels mainly in the education and human services portfolios, and the consequential effect on the cost of employee leave entitlements;
- grants and transfer payments ($646 million) – largely reflecting higher level Commonwealth Government grants on-passed to non-government schools, and home owners under the First Home Owners Scheme.

5.2 These increases were partially offset by a lower superannuation expense, compared with the previous year which included the adverse impact of an actuarial revaluation of the unfunded liabilities.

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

TABLE 5A
STATE OPERATING EXPENSES
($billion)

Item	***2000-01***	*1999-2000*
Supplies and services	**12.6**	11.3
Employee entitlements	**8.6**	8.0
Grants and other transfer payments	**2.9**	2.2
Superannuation	**1.5**	2.3
Depreciation and amortisation	**1.3**	1.3
Interest and other financing costs	**1.3**	1.0
Other expenses	**0.3**	0.1
Operating expenses	**28.5**	**26.2**

5.4 An analysis of State expenditure trends over the past 3 years, as illustrated in Table 5B, indicates that there has been a 5.6 per cent increase in government expenditure in real terms between the 1999-2000 and the 2000-01 financial years, representing a 4.3 per cent increase on a per capita basis. These outcomes have been influenced by the factors outlined in the preceding paragraphs.

TABLE 5B
EXPENDITURE TRENDS, 1998-99 TO 2000-01 *(a)*

Year	*Total amount (nominal value)*	*Total amount (real value)*	*Percentage movement in real terms*	*Per capita (nominal value)*	*Per capita (real value)*	*Percentage movement in real terms*
	($m)	*($m)*	*(%)*	*($)*	*($)*	*(%)*
1997-98	23 632	23 632	n.a	5 563	5 563	n.a
1998-99	23 794	23 577	(0.2)	5 049	5 004	(10.1)
1999-00	26 189	25 281	7.2	5 523	5 332	6.6
2000-01	**28 470**	**26 683**	**5.6**	**5 933**	**5 561**	**4.3**

(a) Consumer price index (CPI) data sourced from Australian Bureau of Statistics publications, with 1997-98 used as the base year. CPI for 2000-01 excludes impact of the GST estimated at 3 per cent. Population growth data has been sourced from Victorian Budget Papers 2000-2001.

EMPLOYEE ENTITLEMENT COSTS – IMPACT OF RECENT INDUSTRIAL AGREEMENTS

5.5 **As indicated previously, costs associated with employee entitlements, consisting of salaries and wages, allowances and employee-related on-costs totalled $8.6 billion in 2000-01, some $661 million or 8 per cent higher than the previous year.**

5.6 The State's public sector employee profile has changed significantly over the past decade following staff reductions and the impact of privatisation and outsourcing arrangements. Notwithstanding these significant structural changes to the public sector, employee costs remain a significant component of public sector expenditures (30 per cent).

5.7 The importance of this cost driver on the State's expenditure outcomes was highlighted in the Government's 2001-02 Budget Papers which identified that a one per cent rise in the level of wages for all budget sector employees would cost approximately $135 million in the first year. In recognition of the importance of the effective management of employee entitlement costs on expenditure outcomes, and the impending expiration of a number of significant public sector industrial awards, the Government in May 2000 approved the establishment of a centrally-managed wage contingency allowance to facilitate control over future wage and salary increases. Under these arrangements, departmental budgets were to be supplemented from this contingency allowance for approved wage increases as they occur.

5.8 During the 2000-01 financial year, the Government entered into a number of industrial agreements impacting on employee entitlements, including those relating to government school teachers, and an interim 12 month agreement covering staff eligible for membership of the Community and Public Sector Union (CPSU). The Government also agreed on a TAFE Enterprise Bargaining Framework in early 2000, which came into effect in the 2000-01 financial year.

5.9 In addition to the direct negotiation and settlement of the above agreements, the Government referred certain industrial claims to the Australian Industrial Relations Commission (AIRC) for arbitration. Subsequently, the AIRC handed down decisions in the 2000-01 financial year covering nurses, medical scientists and health professionals, and State public sector staff not covered by Australian Workplace Agreements (AWA) or who were employed under common law contracts.

5.10 In June and August 2001, the industrial agreements covering staff eligible for membership of the CPSU and the Police Association expired and, as at the date of preparation of this report, the Government was in the process of negotiating new agreements or referring these claims to the AIRC for arbitration. In addition, 2 TAFE teacher and 5 TAFE non-teaching agreements had not been finalised.

5.11 This report does not seek to comment on salary and wage equity issues in the various employment sectors within the Victorian public sector, however, it does detail the additional costs that will be incurred as a result of the industrial relations settlements in the 2000-01 financial year and the following 3 years.

5.12 **As outlined in Table 5C, the net additional cost of major industrial settlements and additional permanent staffing in the 2000-01 financial year has been estimated at $491 million, increasing to around $979 million for the 2003-04 financial year. This does not include any associated increases to unfunded superannuation liabilities or the impact of certain changes which had not been costed at the date of preparation of this report.**

TABLE 5C
COST OUTCOMES OF MAJOR SECTOR INDUSTRIAL AGREEMENTS AND POLICY INITIATIVES RESULTING IN ADDITIONAL STAFF FOR 2000-01 TO 2003-04 *(a)*
($'000)

Salaries and on-costs	*2000-01*	*2001-02*	*2002-03*	*2003-04*
New agreements cost -				
Health Industry employees *(b) (c) (e) (h)*	215 508	374 693	441 818	486 676
Government school teachers *(d)*	84 056	183 229	259 626	302 546
TAFE teachers/non-teachers *(f)*	18 407	38 744	50 782	55 411
Portfolio-wide CPSU/Non-AWA	71 269	63 845	63 983	63 507
Total estimated cost of new agreements	**389 240**	**660 511**	**816 209**	**908 140**
Less redirections of existing funding towards new agreements -				
Health industry	9 950	9 380	7 210	7 300
Government school teachers	23 900	65 400	65 400	65 400
Total redirections of existing funding	**33 850**	**74 780**	**72 610**	**72 700**
Total net cost to the State of new agreements excluding impact of policy decisions	**355 390**	**585 731**	**743 599**	**835 440**
Policy decisions – Additional permanent staff -				
Health sector; (2001-02 Budget Initiative) 400 additional staff recruited in 2000-01	16 000	24 000	24 000	24 000
Government school staffing (2000-01 Budget initiative) 2 000 additional staff *(g)*	120 000	120 000	120 000	120 000
Total estimated cost of policy decisions	**136 000**	**144 000**	**144 000**	**144 000**
Total net cost Including additional staff	**491 390**	**729 731**	**887 599**	**979 440**

(a) Data extracted from estimates provided by Department of Treasury and Finance, Department of Human Services (DHS) and Department of Education, Employment and Training.

(b) Includes additional 1 300 staff to meet changes in conditions recommended by AIRC, and the associated impact on long service leave entitlements.

(c) Includes other employee group outcomes within the health portfolio, including kindergarten teachers and ambulance service officers.

(d) These estimates are based on the full cost of the agreement at 1 April 2001, comprising salary rises and the associated impact of long service leave costs and the introduction of a new career structure including the new category of Experienced Teachers With Responsibility. Costs in excess of these estimates are to be funded from redirections of existing funds.

(e) DHS has established working parties to analyse additional cost implications of the AIRC decisions impacting on condition changes. Accordingly, these impacts are not reflected in these figures.

(f) As at 30 June 2001, 2 TAFE Teacher and 5 TAFE Non-Teaching Agreements remained outstanding and therefore have not been included in these figures.

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

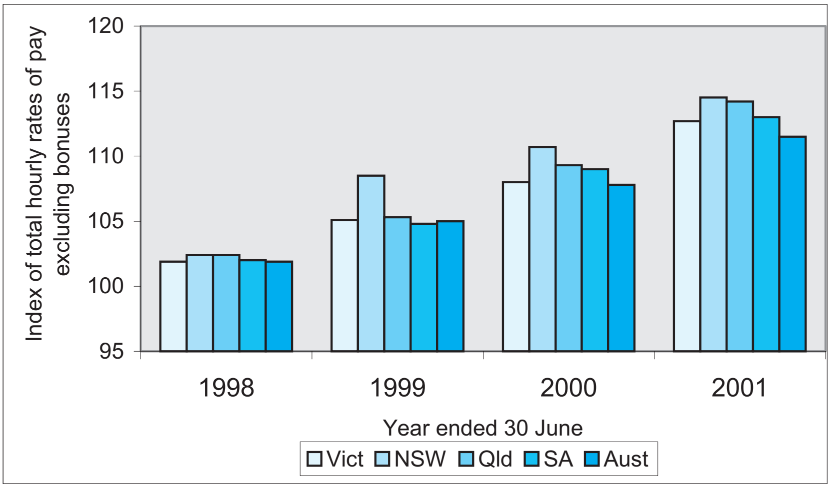
(h) Includes total cost of revisions to nurse/patient ratio resulting in the employment of additional 350 staff estimated at a gross $21 million per annum.

5.13 **As indicated in the above table, part of the estimated cost of the new industrial agreements is to be funded from the redirection of existing departmental resources. The extent of such redirection of funding ranges from an estimated $34 million in 2000-01 to $73 million by 2003-04. The progress made by departments in achieving these savings will need to be carefully monitored by the Government to minimise any potential budgetary impact that may arise in the event that they cannot be achieved, without adversely impacting on service delivery by the respective departments.**

Labour cost indicators

5.14 A commonly used labour cost indicator is the Wage Cost Index – Total Hourly Rates of Pay Excluding Bonuses. As illustrated in Chart 5D, this indicator which relates to the public sector highlights that, in recent years, wage rates in Victoria have begun to edge higher than the Australian average, however, the Victorian public sector wage cost index remains below certain other States, including New South Wales and Queensland.

CHART 5D
TOTAL HOURLY RATES OF PAY EXCLUDING BONUSES, PUBLIC SECTOR, JUNE 1998 TO JUNE 2001



Source: Australian Bureau of Statistics, Wage Cost Index, June quarter 2001.

Settlement outcomes – health sector

5.15 From mid-2000, the Government progressively approved the referral of the Australian Nursing Federation and Health Services Union pay claims to the AIRC for determination. The AIRC made a number of recommendations covering salary and conditions which are detailed in Table 5E.

TABLE 5E
DEPARTMENT OF HUMAN SERVICES,
IMPACT OF AIRC RULINGS ON WAGE SETTLEMENT OUTCOMES

Classification	*Effective date of AIRC ruling*	*Outcome (a)*	*Comments*
Nurses employed by health services, public hospitals and other health agencies covered by the Nurses (Victoria Health Services) Award 1992 (expired 30/9/2000).	31 August 2000	3.5% 1/10/00; 3% 1/03/01; 3% 1/3/02; and 3% 1/3/03. Changes in conditions generally take effect from 1 October 2000.	AIRC decision made recommendations in relation to level of staffing and recruitment in hospitals including the establishment of fixed nurse-patient ratios. A subsequent decision on 13 March 2001 found that the implementation of the original decision should require no more than 1 300 additional nurses.
Psychiatric staff employed by health services, public hospitals and other health agencies covered by the Psychiatric Services Certified Agreement 1997 (expired 30/09/00).	29 September 2001	3.5% 1/10/00; 3% 1/03/01; 3% 1/03/02; and 3% 1/03/03. Changes in conditions generally take effect from 1 October 2000. A separate salary increase of 3% was awarded from 1 July 2000 for psychologists.	AIRC also made recommendations in relation to recruitment and retention of staff in hospitals. Major issues subject to review are rostering and case-load arrangements which are excluded from the costings.
Health professionals employed by public hospitals and other health agencies covered by the Health Services Union of Australia (Victoria-Public Sector) Interim Award 1993 (expired 30/9/00).	21 December 2000	0.8% 1/04/00; 3% 1/10/00; 3% 1/03/01; 3% 1/03/02; and 3% 1/03/03. Changes in conditions generally take effect from 1 October 2000.	AIRC also made recommendations in relation to recruitment and retention of staff which are not included in the costings.
Pharmacists, medical scientists, psychologists, dieticians, audiologists and clinical professionals employed by public hospitals and other health agencies covered by the Health Services Union of Australia (Victoria-Public Sector) Interim Award 1993 (expired 30/09/00).	1 July 2000 21 December 2000	AIRC approved an agreement for a graduated increase in rates of pay of between 0% to 6.5% from 1 April 2000. AIRC also recommended a further increase of 3% from 1 July 2000 and further increases as follows: 1% 1/10/00; 3% 1/03/01; 3% 1/03/02; and 3% 1/03/03. The changes in conditions generally take effect from 1 October 2000.	AIRC also made recommendations in relation to recruitment and retention of staff which are not included in the costings.

(a) Working parties established by the Department of Human Services are determining the implementation arrangements and the financial outcomes of changes in conditions.

5.16 In August 2001, the nurse-patient ratio was further amended resulting in the requirement to engage an additional 350 nurses. The cost of the revision to the nurse-patient ratio is estimated at around $21 million per annum to be partly funded from savings resulting from certain changes to the original AIRC agreement. The total cost of implementing the AIRC recommendations, including kindergarten teacher and ambulance driver outcomes, in the 2000-01 financial year is estimated by the Department of Human Services at $215 million, increasing to $487 million by the 2003-04 financial year. This does not take into account redirected funding within the sector which will, in part, fund this additional cost.

5.17 In addition, the Government announced in the 2001-02 budget that 400 additional nurses are to be recruited into the system to assist in the management of demand growth in hospital services. The 400 additional nurses are estimated to cost around $24 million per annum.

Settlement outcomes - Government school teachers

5.18 In December 2000, the Government entered into an agreement with the Australian Education Union whose membership includes around 40 000 employees in State government schools. This agreement is estimated by the Department of Education, Employment and Training (DEET) to have cost the State approximately $84 million in the 2000-01 financial year, rising to $302 million by the 2003-04 financial year. The DEET is required to partially fund the additional cost by redirecting internal funds from within the School Global Budget and non-program areas.

5.19 The Department of Treasury and Finance, based on advice from DEET, estimated the cost of implementing the Experienced Teachers With Responsibility component of the above Agreement at $8.2 million for 2001-02. However, as at late August 2001, 8 616 teachers had been promoted to the new Experienced Teacher With Responsibility category at an estimated cost of $14.1 million per annum with further appeals to be heard. **This was $5.9 million above the Department of Treasury and Finance's estimate, which is required to be funded from existing resources.** DEET have advised that this amount will be able to be accommodated within existing school global budgets.

5.20 In 2000-01, the Government provided an additional $637 million to the Department of Education, Employment and Training over 4 years for output funding targeted towards fulfilling the Government's election commitments. The Government estimated that an additional 2 000 permanent staff would be required to enable the output targets to be achieved. Based on the average teacher salary level, the employment of the additional staff will cost approximately $120 million per annum. The impact of the employment of an additional 2 000 staff on the Department's total employee costs is dependent on the rate of the Department's progression towards meeting the output funding requirements.

5.21 **In addition to the impact of the new agreement, in the 2000-01 financial year teachers received an across-the-board 2 per cent increase as from 1 July 2000 under the terms of the former agreement. This amounted to an additional $74.6 million per annum, which is not included in Table 5C.**

Settlement outcomes - TAFE sector

5.22 In February 2000, the Government agreed to a TAFE Enterprise Bargaining Framework under which TAFE institutes would be supplemented for salary increases up to a specified cap. The Framework enabled the TAFE institutes to further bargain at the institute level, however, institutes would not be funded for salary increases above the specified cap. The Framework provided for budget supplementation for teacher salary increases of 10.6 per cent and 8 per cent for non-teaching TAFE staff over a 3 year period.

5.23 As at 30 June 2001, the total budget supplementation to fund the signed agreements was $18.4 million in 2000-01 rising to $55.4 million in 2003-04. As indicated previously, 2 TAFE teacher and 5 TAFE non-teaching agreements had not been finalised as at 30 June 2001 and have not been included in these estimates.

Settlement outcomes – CPSU and non-AWA staff

5.24 In late November 2000, the AIRC certified the Victorian Public Service (Non Executive Staff – Victoria) Agreement 2000 for staff eligible for membership of the CPSU. The certified agreement involved a 3 per cent increase from 1 July 2000 plus a further one per cent increase for certain eligible staff through the redistribution of existing departmental performance pay pools.

5.25 Victorian Public Service staff who were not employed under Australian Workplace Agreements (AWAs) or were employed under common law contracts were granted pay increases of 9.5 per cent by the AIRC and a further 2 per cent to those staff on section 170LK certified agreements. The Government subsequently approved a 2 per cent increase backdated to April 1999 for the balance of staff who were employed on AWAs.

5.26 The full-year financial impact of both agreements was estimated at around $71 million for the 2000-01 financial year, reducing to $64 million in subsequent years.

Impact on unfunded superannuation liability

5.27 The actuary for each superannuation fund estimates the fund’s position based on a number of assumptions including salary inflation rates. The actuary of the State Superannuation Fund has assumed an annual growth rate of 4 per cent for salaries. Increases above this level would adversely impact on the level of unfunded liabilities.

5.28 When reviewing the salary increases awarded in the 2000-01 financial year, including increases awarded under expired agreements, a number of employee groups have significantly exceeded the actuary's estimated salary growth assumptions, including government school teachers, TAFE institute teachers and Victorian Public Service staff who were not employed under AWA agreements or who were engaged under common law contracts.

5.29 Initial estimates provided to the Department of Treasury and Finance by the actuary of the State Superannuation Fund show that the teachers' wage agreement alone has caused the unfunded superannuation liability to increase by approximately $300 million at 30 June 2001, falling to $200 million by December 2003. This increase occurs because the new agreement and the last phase of the previous agreement provided many teachers who are members of the State Superannuation Fund with around 9 per cent increase in salaries in 2001-02 compared with the actuary's assumed rate of wages growth of 4 per cent.

5.30 **The ultimate impact of these known wage adjustments on the State's total unfunded superannuation liabilities will be dependent on the wages growth of other public sector employee groups. The Department of Treasury and Finance has engaged the State Superannuation Fund actuary to review major assumptions on a more regular basis, including the salary inflation rates to determine the impact on the position of the Fund. At the time of preparation of this report, the actuary had not completed this review.**

MAJOR EVENTS STRATEGY

5.31 In August 2000, the Government announced a funding limit of up to $40 million per year in financial support for the staging of major sporting and tourism events (excluding the Melbourne 2006 Commonwealth Games) as part of its new major events strategy. This cap was subsequently revised to $35 million when the Rally Australia event was not secured. The major events strategy underpins the Government's objective of *attracting and retention of major national and international sporting and other events to strengthen the State's sport, recreation and tourism base*.

5.32 The new strategy includes a detailed framework to be used in the assessment of new major events, including the application of a standard model to calculate the event's overall direct economic impact, and the impact on employment, tourism, the State's international profile, and the associated social and environmental impacts.

5.33 When announcing the new strategy, the Government estimated that the consolidated economic impact on the State of hosting ongoing major events was $277.3 million per annum. In relation to the one-off international events (excluding the 2006 Commonwealth Games), the total economic benefit was estimated to be $99.8 million.

5.34 **The new framework provides a systematic and uniform approach to the evaluation of proposals to host major events. Currently, post-event evaluations are only conducted every 3 to 4 years for ongoing major events to assess their actual impact. More regular evaluations would allow the timely availability of information to assess the viability of continuing to financially support such events with reference to the benefits they provide to the Victorian economy.**

5.35 Comment follows on a number of major events which receive financial support from the State.

Melbourne 2006 Commonwealth Games

5.36 The staging of the 2006 Commonwealth Games represents a significant financial commitment of the Government in the short to medium-term. Our previous 2 *Reports on the Finances of the State of Victoria* have provided commentary on the State's successful bid for hosting the 2006 Commonwealth Games, and the subsequent establishment of an organising committee company known as the Melbourne 2006 Commonwealth Games Pty Ltd.

5.37 An economic impact study undertaken by external consultants estimated that the short-term financial impact of hosting the Games would be an increase in Victoria's Gross Domestic Product (in 1998 dollars) of around $373 million, and an increase in State taxation revenues of around $14.5 million. The study also identified longer lasting and intangible benefits to the State such as increased tourism, improved reputation for hosting "world class" events and an opportunity to foster long-term business relationships.

5.38 Our previous reports also outlined that, based on the Government's estimates, the Melbourne 2006 Commonwealth Games Pty Ltd would incur an operating loss of around $93 million (in 1998 dollars) from hosting the 2006 Commonwealth Games in Melbourne. It was estimated that the State would incur a cost of around $102 million for the provision of services associated with the event and would need to undertake related capital works at a cost of $97 million. Commonwealth and local governments will also incur expenditure estimated at $58 million. The total cost to the State Government in hosting the 2006 Games was estimated to be $195 million, excluding capital works.

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

Progress in organising the Games

5.40 During the 2000-2001 financial year, the organising committee company prepared a draft business plan for the 2006 Commonwealth Games and commenced development of detailed operational plans. Integral to this process was the review of the original budget contained in the bid document prepared in 1998. **At the date of preparation of this report, the budget was being revised to incorporate items such as the Games licence fees of $30 million which was not originally included, changes in the scope of the Games program and associated activities, and to take account of detailed planning in light of the experience of the Sydney Olympic Games and information obtained from the Manchester 2002 Commonwealth Games organising committee.**

5.41 As from 1 July 2000, the Department of State and Regional Development assumed responsibility for the co-ordination of the Government's involvement in the Games and the Minister for Sport and Recreation was appointed as the Minister responsible for the Games. A Commonwealth Games Budget Review Committee comprising representatives of the Department of Treasury and Finance and the Department of State and Regional Development has been established to develop a whole-of-government budget for the Games.

5.42 **The net cost to the State of attaining the right to stage the 2006 Commonwealth Games in Melbourne was $6.1 million. In mid-July the organising committee was established to commence planning and organising the games. Since then, the State has provided further funding of $8.5 million in 2000-01 in relation to planning the Games ($7.7 million in 1999-2000), bringing the total State contribution to the organising committee of $16.2 million as at 30 June 2001.**

5.43 A further $1.4 million was allocated to the Department of State and Regional Development in the 2000-01 financial year for planning the Commonwealth Games Village. However this allocation was not expended in the year and will be carried forward to the 2001-02 financial year.

5.44 In the winning bid document, the former Government committed itself to "fast track" capital works programs for the required sporting facilities to meet the standards required for the Commonwealth Games. In recent years, work on a number of facilities has been co-ordinated to ensure that the facilities will be available for the Commonwealth Games, including the State Netball Hockey Centre, State Gymnastic Centre, State Weightlifting Centre, State Rifle Shooting Centre, Velodrome, Melbourne Sports and Aquatic Centre Stage 2 and the Melbourne Cricket Ground redevelopment. As was detailed in our previous reports to Parliament, the former Government stated that apart from the Commonwealth Games Village, the "fast tracked' capital works projects would have been undertaken even if the Games were not held in Melbourne.

5.45 In November 2001, Parliament passed the *Commonwealth Games Arrangements Act* 2001. The Act:

- establishes a legislative framework to enable preparation for, and the staging of, the Commonwealth Games;
- streamlines the planning and approvals processes for capital projects relating to the event, including the MCG redevelopment, the construction of the games village and Melbourne Sports and Aquatic Centre new competition pool, and any other facilities associated with the Commonwealth Games; and
- facilitates the improved management of the financial risks associated with the timeliness of the provision of facilities and services for the Commonwealth Games.

5.46 The Act provides the Treasurer with the authority to execute a guarantee relating to an agreement or contract for a Commonwealth Games project in respect of the performance of any obligation. Under the Act, the Treasurer may also execute an indemnity or covenant relating to a Commonwealth Games project in respect of any expense, loss, damage, cost or liability incurred.

5.47 In view of the ongoing significance of the event, I will continue to report progress on this major event.

Australian Grand Prix Corporation

5.48 The Australian Grand Prix Corporation was established in October 1994, under the provisions of the *Australian Grands Prix Act* 1994, to stage the Australian Formula One Grand Prix in Melbourne from 1996. The Government further secured the Australian Motor Cycle Grand Prix which has been staged at Philip Island since May 1995. This event is also managed by the Corporation. Following successful re-negotiations, the Corporation is contracted to stage the Australian Formula One Grand Prix at Melbourne until 2010 and the Australian Motor Cycle Grand Prix at Philip Island until 2006.

Studies undertaken of Grand Prix events

5.49 My previous reports have commented upon economic impact studies commissioned by the Department of State and Regional Development and the Department of Treasury and Finance with respect to the 2 Grand Prix events. The most recent studies were conducted in 1997 for the Australian Motor Cycle Grand Prix event and, in 2000, for the Formula One Grand Prix event.

5.50 The economic impact study relating to the 2000 Formula One Grand Prix event concluded that this event increased the Victorian Gross State Product by $130.7 million and resulted in additional taxation receipts for the State of $9.8 million. The Motor Cycle Grand Prix event conducted in 1997 was estimated to have contributed $54 million to the Victorian Gross State Product and $3.7 million in additional taxation receipts. These studies have not been updated since that time. The Corporation has advised that a review will be conducted for the 2002 Motor Cycle Grand Prix event.

Financial outcome of Grand Prix events

5.51 **Table 5F illustrates that the total costs incurred by the State in relation to the Formula One and Motor Cycle Grand Prix events for the 2000-01 financial year amounted to $13.1 million compared with $8.6 million in 1999-2000.**

TABLE 5F
COSTS INCURRED BY THE STATE IN RELATION TO THE STAGING OF THE FORMULA ONE GRAND PRIX AND MOTOR CYCLE GRAND PRIX, 2000-2001 FINANCIAL YEAR
($million)

Item	*Formula One Grand Prix*	*Motor Cycle Grand Prix*	*Total 2000-01*	*Total 1999-00*
Operating loss in staging the events *(a) (b)*	7.8	5.3	13.1	8.4
Net operating costs incurred by other public sector agencies	-	-	-	0.2
Total operating costs incurred by the State *(c)*	**7.8**	**5.3**	**13.1**	**8.6**

(a) Reflects the operating loss incurred by the Corporation during the 2000-01 financial year, including components relating to both the October 2000 and 2001 Australian Motor Cycle Grand Prix.

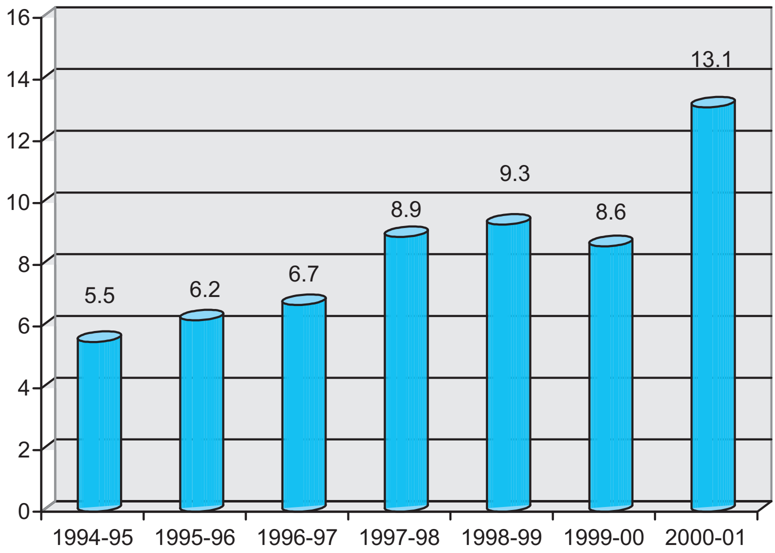
(b) Costs amounting to $496 000 incurred by Victoria Police and VicRoads for provision of services to the Corporation during 2000-01 were fully recouped from the Corporation and are reflected in the operating loss in staging the events.

(c) The Corporation paid a fee to the Department of Infrastructure for the provision of public transport to the Formula One Grand Prix event. The rail franchise contracts include a requirement for franchise operators to provide public transport to the events, with the costs to be met from the overall franchise fees. The Department was unable to confirm if the fee fully reimbursed it for the cost of running the services under the franchise agreements.

5.52 Under the contractual arrangements, the Government has provided an undertaking to underwrite any deficits incurred by the Corporation in relation to these events.

5.53 **Chart 5G illustrates that the net operating costs to the State associated with the staging of the events since their inception total around $58 million.**

CHART 5G
GRAND PRIX EVENTS NET OPERATING COSTS TO THE STATE FOR THE PAST 7 YEARS
($million)



5.54 As illustrated in Chart 5G, **the net operating costs of hosting these events have increased by $4.5 million or 52 per cent over the previous year**. The Corporation advised that the net operating costs for the Formula One Grand Prix increased mainly as a result of higher contractual costs resulting from a re-tender of a number of long-term engineering contracts. In respect of the Motor Cycle Grand Prix, the 1999 event result was positively impacted by a one-off exchange gain of around $1 million. In relation to the 2000 event, there was a decrease in revenues due to lower attendances at the event. The Corporation believes that this was due to the change in the date of the event, the staging of Sydney Olympics in September 2000, the absence of an Australian world champion and poor weather conditions leading up to and during the event.

5.55 In staging the Formula One Grand Prix, the Corporation incurred capital costs during 2000-01 of $237 500 (1999-2000, $160 800) under its licence from Parks Victoria. The Government also increased capital funding for event infrastructure to $1.9 million, an increase of $1.2 million over the previous year. This was for capital works undertaken during 2000-01 for the Corporation's headquarters located on Albert Road and additional event infrastructure.

5.56 As outlined in my previous reports to Parliament, a number of inherent risks have been identified that may impact on the Corporation's finances, with actions taken by the Corporation to mitigate these risks. The Corporation's public liability insurance policy for the Formula One Grand Prix is spread across a number of insurers to minimise the risk to the Corporation. During 2000-01, one of the insurers had been placed into provisional liquidation. As a consequence, the Corporation is currently reviewing insurance policies and placement for future events.

Part 6

Assets

SUMMARY OF STATE ASSETS

6.1 **The State's assets mainly comprise physical assets, receivables, cash and investments. Assets with an aggregate value of $95.4 billion were reported in the Government's Annual Financial Report as at 30 June 2001, an increase of around $4.8 billion on the previous year.** The major factors contributing to this increase were:

- increased investment holdings of $1.5 billion, mainly resulting from the investment of surplus revenues for the year and delays in undertaking certain capital works; and
- the increased value of physical assets of $2.9 billion, mainly due to the revaluation of certain physical assets ($1.9 billion) and the acquisition of new assets.

6.2 Table 6A presents a summary of the assets controlled by the Government as at 30 June 2001.

TABLE 6A
SUMMARY OF STATE ASSETS
($billion)

Type of assets	***2000-01***	*1999-00*
Financial and other non-physical assets -		
Investments	**19.7**	18.2
Receivables	**11.6**	11.6
Cash	**1.6**	1.2
Other assets	**0.6**	0.6
	33.5	31.6
Physical assets -		
Land and buildings	**28.5**	26.3
Plant, equipment and infrastructure systems	**19.5**	19.0
Roads and earthworks	**12.1**	12.0
Other	**1.8**	1.7
	61.9	59.0
Total State assets	**95.4**	90.6

INVESTMENTS

6.3 Investments represent the largest component of the State's financial assets. **At 30 June 2001, the State's investments totalled $19.7 billion, an increase of $1.5 billion on last year. These investments include a net amount of $4 billion held by the Treasury Corporation of Victoria, which is available for application towards the retirement of debt and for meeting the State's prudential liquidity requirements. A further amount of $1.2 billion has been set aside by the Government for infrastructure investment over future years under the "Growing Victoria" initiative.**

6.4 The majority of the State's investments are held by the Department of Treasury and Finance (Budget Sector Long Term Investment portfolio) the Treasury Corporation of Victoria and agencies within the insurance sector, namely the Transport Accident Commission, the Victorian WorkCover Authority and the Victorian Managed Insurance Authority. Table 6B outlines the key investment holdings of the State at 30 June 2001 and the movements in those holdings since the previous year. These movements result from the placement and redemption of funds throughout the year and, for certain investment types, unrealised gains or losses arising from changes in the market value of investments.

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

Agency	*Investments 30 June 2001*	*Investments 30 June 2000*	*Movement between years*
Department of Treasury and Finance	1 922	*(b)* 1 211	711
Treasury Corporation of Victoria *(c)*	6 646	6 365	281
Transport Accident Commission	5 227	5 211	16
Victorian WorkCover Authority	4 746	4 296	450
Victorian Managed Insurance Authority	411	357	54

(a) All investments are recorded at their market value except for those held by the Department of Treasury and Finance which are recorded at the lower of their cost and net realisable value.

(b) Investments held by the Department of Treasury and Finance at 30 June 2000 includes debt securities with a net value of $133 million associated with the Accelerated Infrastructure Program. These securities were settled during the year.

(c) Includes cash investments but excludes cash at bank and on hand. The investments incorporate $2.7 billion of funds deposited by public sector agencies, superannuation funds and trust funds.

Source: Annual reports of the respective agencies.

6.5 In addition, significant investments are held by public sector superannuation funds. While not recorded in the State's Annual Financial Report (because they are not the assets of the State), the level of investments held by these funds, and related investment performance, has a direct impact on the State's liability for unfunded superannuation obligations.

6.6 The majority of State investments are managed via:

- the Victorian Funds Management Corporation, which acts as a manager of fund managers, providing services to Victorian public sector agencies mainly for long-term investment requirements; and
- the Treasury Corporation of Victoria, which is the central financing authority for the State and manages short-term investments, mainly in fixed interest securities.

6.7 The State's investments are managed within a risk management framework established through the *Borrowing and Investment Powers Act* 1987 and associated policy documents issued by the Department of Treasury and Finance, which include a prudential policy statement covering public sector investments. The framework is designed to ensure financial risks are contained, monitored and effectively managed by individual agencies, within an acceptable risk profile.

6.8 It is the responsibility of each agency to establish relevant policies and procedures to comply with this risk management framework.

Impact of downturn in equity markets since 30 June 2001

6.9 The State and its major investor agencies hold significant investments in domestic and international equities. Table 6C outlines the significance of equity investments held by major insurance agencies and the State Superannuation Fund as at 30 June 2001.

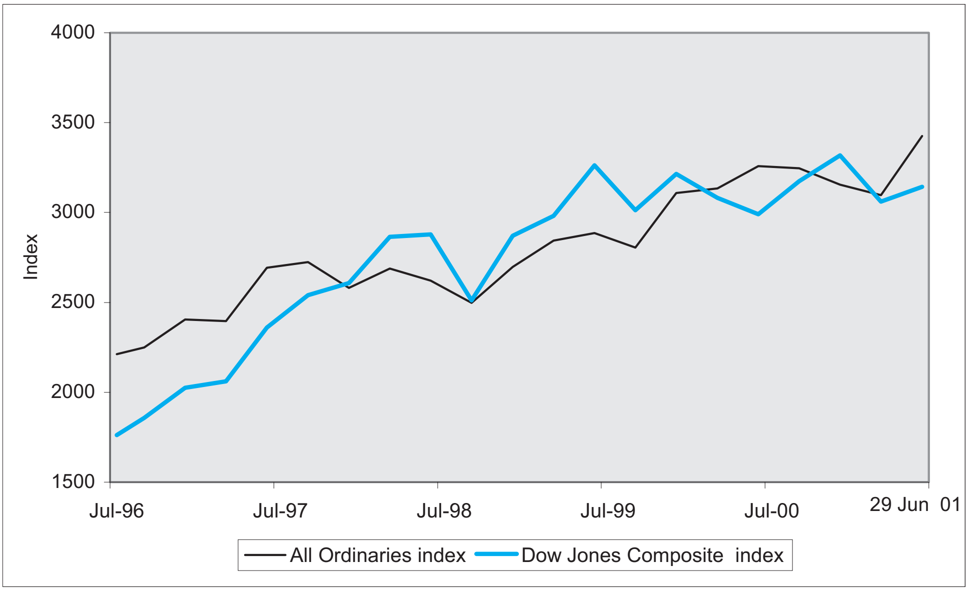
TABLE 6C
EQUITY INVESTMENTS HELD BY MAJOR AGENCIES, AT 30 JUNE 2001 *(a)*

Type of investment	*Transport Accident Commission*		*Victorian WorkCover Authority*		*Victorian Managed Insurance Authority*		*State Superannuation Fund (b)*	
	($m)	*(%)*	*($m)*	*(%)*	*($m)*	*(%)*	*($m)*	*(%)*
Domestic equities	1 506	29	1 715	36	141	34	2 017	22
International equites	1 277	24	961	20	84	20	1 072	12
Other investments	2 444	47	2 070	44	186	46	5 915	66
Total investments	**5 227**	**100**	**4 746**	**100**	**411**	**100**	**9 004**	**100**

(a) Treasury Corporation of Victoria not included in table as it did not hold equity investments.
(b) Investments of the State Superannuation Fund are not included in the Government's Annual Financial Report but are disclosed in this Table as they impact on the value of the State's unfunded superannuation liabilities.

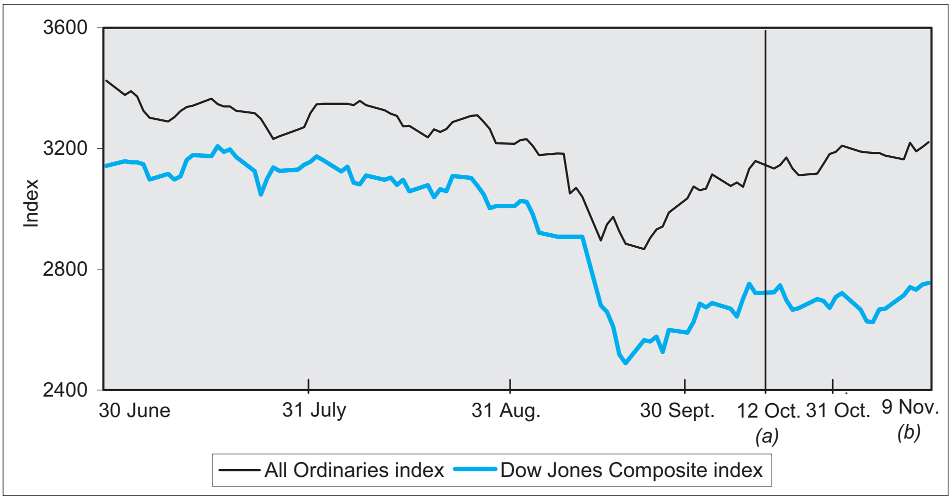
6.10 While, over the long-term, equity investments have provided significant returns to the above investing agencies through increasing share values, these investment holdings are subject to the volatility of the equity markets in the short to medium-term. To illustrate this point, Chart 6D outlines movements in the Australian (All Ordinaries Index) and the United States (Dow Jones composite index) equity markets over the last 6 years.

CHART 6D
MOVEMENT IN ALL ORDINARIES AND DOW JONES (COMPOSITE) INDEX, JULY 1996 TO JUNE 2001



6.11 Since 30 June 2001, international events and a general downturn in economic conditions, at both an international and domestic level, have had a significant impact on the investment market. Chart 6E illustrates the impact of these factors on the value of the Australian and United States equity markets between 30 June 2001, the date of finalising the Government's Annual Financial Report (12 October 2001), and the date of preparation of this report.

CHART 6E
MOVEMENT IN THE ALL ORDINARIES AND DOW JONES (COMPOSITE) INDEX
30 JUNE 2001 TO 9 NOVEMBER 2001



(a) 12 October 2001 – Date of finalising of the Government's Annual Financial Report.
(b) 9 November 2001 – Date of preparation of this report.

6.12 **Based on valuation reports provided by the investment fund managers, the downturn in investment markets reduced the value of the State's investment portfolio by $462 million over the period 1 July 2001 to the date of finalising the Government's Annual Financial Report (which was signed on 12 October 2001). A reduction of $340 million also occurred in the value of investments held by the State Superannuation Fund over the same period, which had a corresponding impact on the value of the State's liabilities for unfunded superannuation.**

6.13 As required by the Australian Accounting Standards, the impact of the downturn in equity markets subsequent to balance date (30 June 2001) is not recognised in the value of investments reported in the State's Consolidated Statement of Financial Position but has been disclosed within note 30 (Events subsequent to reporting date) to the Government's Annual Financial Report. Table 6F outlines the reduction in investment values by relevant government agencies.

TABLE 6F
DECREASE IN MARKET VALUE OF FINANCIAL ASSET PORTFOLIO FROM JULY 2001 TO OCTOBER 2001 COMPARED WITH AGENCY OPERATING RESULTS FOR 2000-01
($million)

Entity	*Decrease in market value of portfolio (a)*	*Operating result for 2000-01 Profit/(Loss)*
Transport Accident Commission	(209)	(192)
Victorian WorkCover Authority	(239)	(260)
Victorian Management Insurance Authority	(14)	(10)
State Superannuation Fund	*(b)* (340)	*(c)* (508)

(a) These amounts which are included in note 30 to the Government's Annual Financial Report, were based on the latest available information as at the date of finalising the Government's Annual Financial Report which was signed on 12 October 2001.
(b) A reduction in the value of the State Superannuation Fund's investments increases the value of the State's unfunded superannuation liabilities.
(c) Reflects change in net assets after income tax and extraordinary items for the year.

6.14 The above table illustrates that volatility in investment markets can impact on the reported financial performance of investing agencies in any one year, even though these investments are held to fund longer-term liabilities, with the ultimate value of these investments crystallising upon their realisation.

6.15 **Since the date of finalising the Annual Financial Report, there has been an upward movement in equity markets. Accordingly, the value of the State's investments is also likely to have experienced some recovery over this period.**

PHYSICAL ASSETS

6.16 The State's physical assets mainly comprise Crown and freehold land, buildings, roads, infrastructure systems, and plant and equipment. The agencies forming part of the general government sector control and manage the vast majority of land, buildings and roads, while public non-financial corporations hold the majority of plant, equipment and infrastructure assets, reflecting their role in providing key services to the community.

6.17 Table 6G outlines the major movements during 2000-01 financial year in the value of the State's physical assets.

TABLE 6G
STATE'S PHYSICAL ASSETS,
SUMMARY OF 2000-01 MOVEMENTS
($billion)

Opening balance – 1 July 2001	**59.0**
Additions	2.4
Disposals	(0.4)
Revaluations	1.9
Depreciation	(1.3)
Other	0.3
Closing balance – 30 June 2001	**61.9**

Source: Government's Annual Financial Report 2000-01.

6.18 Major additions to the asset base in the financial year included additional infrastructure, public housing and road construction. Other additions included the acquisition of the Metropolitan Women's Correctional Centre for $17.8 million, following termination of the correctional services contract with the private sector service provider, and the recognition of an additional $64 million for the Federation Square project, representing a contribution from the Melbourne City Council, following an agreement that the Council will no longer directly participate in ownership of the Square.

6.19 **During the 2000-01 financial year, parliamentary appropriations available for application towards additions to net assets totalled $515 million, of which only $355.5 million was actually applied to departments.** The shortfall of $159 million is attributable to delays experienced in the capital work programs undertaken across a number of departments, and in particular within the Department of Premier and Cabinet, which accounted for $96 million of this under expenditure. This was due to delays experienced by the arts agencies, including the National Gallery of Victoria building redevelopment due to heritage issues, and general construction delays at the Federation Square project, relating to the Museum of Australian Art and the Cinemedia element of the project.

6.20 The revaluation of certain assets during the year resulted in an increase of $1.9 billion in the value of the State's physical asset holdings. Major increases resulting from revaluations occurred in the education portfolio ($300 million), public housing ($719 million) and the infrastructure portfolio ($303 million), with the balance of the revaluation adjustments occurring across the other portfolios.

6.21 The privatisation process commenced by the previous Government essentially concluded in 1999-2000 following the franchising of the passenger rail businesses. Since that time, there have been no significant asset disposals, with the exception of the disposal of land and buildings, for a combined price of $46.9 million, associated with the unwinding of the Accelerated Infrastructure Program as outlined in the Part of this report relating to Liabilities, Commitments and Contingencies.

6.22 Certain assets of the State continue not to be recognised in the State's Consolidated Statement of Financial Position. These include the State's share of assets managed by the Murray-Darling Basin Commission which are yet to be valued, and land under roads associated with the State's road network which is not required to be recognised under the Australian Accounting Standards.

Revaluation of non-current assets

6.23 Victorian public sector organisations control large and varied portfolios of assets and expend large amounts of resources on the acquisition and maintenance of non-current physical assets. In this context, an appropriate framework for valuing these assets is fundamental to facilitate the effective management and accountability for this substantial resource and to support effective decision-making, control and risk management.

6.24 In January 1995, the Department of Treasury and Finance (DTF) issued guidelines relating to the "Recognition & Valuation of Non-Current Physical Assets". The guidelines require that certain budget sector entities, including government departments, revalue their assets at least every 5 years and review their carrying values annually.

6.25 Given that the guidelines were first applicable for reporting periods ended 30 June 1996, a large number of public sector entities were due to revalue their non-current physical assets during the 2000-01 financial year. We found a relatively high degree of compliance with the requirements of the guidelines, although there were instances where entities chose not to undertake a revaluation of a proportion of their assets. In most of these cases, this did not result in a material impact on the financial reports of the entities concerned.

6.26 **Our Office has been, and continues to be, concerned that the valuation requirements do not apply to all Victorian public sector entities. Uniformity in the application of the guidelines to all Victorian public sector entities would serve to improve the accountability framework with respect to the management of significant public assets. It is understood that the Department of Treasury and Finance is working towards achieving this outcome.**

Revaluation requirements under Australian Accounting Standards

6.27 In addition to the above DTF guidelines, Australian Accounting Standards contain requirements applicable to entities that report non-current assets on a revalued basis. The release of Australian Accounting Standard AAS 38 "Revaluation of Non-Current Assets" in December 1999 has highlighted an emerging issue in relation to a potential difference between the "fair value" basis of accounting advocated by that Standard, and other valuation methodologies, such as the "deprival value" basis, required by the DTF guidelines.

6.28 In July 2001, DTF issued supplementary guidance which permitted the use of either the "deprival value" basis of valuation or the "fair value" basis of valuation by public sector entities in order to meet the requirements of AAS 38. The resolution of the issue of whether these 2 valuation methods result in significantly different outcomes in terms of public sector reporting is currently being addressed by the Australian Accounting Standards Board. The outcome of this review may have implications on the valuation policies adopted by public sector agencies in future reporting periods.

Ongoing revaluation requirements

6.29 The requirements of Australian Accounting Standard AAS 38 "Revaluation of Non-Current Assets" were recently superseded by Australian Accounting Standard AASB 1041 "Revaluation on Non-Current Assets" issued in July 2001. Under the requirements of AASB 1041, which is applicable to annual reporting periods ending on or after 30 September 2001, the revaluation of non-current assets is required to be made with sufficient regularity to ensure that the carrying amount of each asset in a class of non-current assets does not differ materially from its fair value at the reporting date.

6.30 **This requirement creates a higher level of obligation for managers of public sector assets to ensure that the value assigned to non-current assets is appropriate on an annual basis. It is likely that most public sector entities will, therefore, be required to revalue non-current assets more frequently than the minimum 5 year requirement set out in the existing DTF guidelines.**

Government Asset Management Policy Statement – "Sustaining Our Assets"

6.31 Over recent years, the importance of asset management has been increasingly recognised by governments as critical to the delivery of social objectives and core functions. Governments across Australia and the world are facing critical asset management issues such as ageing infrastructure, an ageing population, increased community expectations, changing technology and non-asset alternatives, private sector investment potential and the principles of sustainable development. Against these asset management dilemmas, many governments seek to maintain ongoing financial surpluses as a key fiscal objective.

6.32 To assist public sector agencies in enhancing asset management, in December 2000 the Government released a policy document "*Sustaining Our Assets.*" This document provides a high level framework for the management of the State's public sector assets and is to be supported through the updating of the detailed guidance provided by the Department of Treasury and Finance through the "Asset Management Series", which was originally released in November 1995.

6.33 The main principles of the policy include:

- *Service delivery needs, form the basis of all asset management practices and decisions* – asset management activities should aim to improve service delivery throughout the State;
- *An integrated approach to planning* – asset planning and management are to be integrated into corporate and business plans, and budgetary and evaluation processes;
- *Informed decision-making* – asset management decisions are to be based on evaluation of all alternatives that take into account all costs incurred throughout the life cycle of the asset;
- *Asset management within a whole-of-government policy framework* – asset management activities are to be undertaken as part of the Government's overall resource allocation and management framework for the whole of the State;
- *Accountability and responsibility* – ownership, control, accountability and reporting requirements for assets are to be established, clearly communicated and implemented. Evaluations of the contribution of asset management to meeting departmental objectives is to form a key part of performance management; and
- *Sustainability* – planning is to include evaluation of all methods to meet the demands for service delivery, including non-asset solutions and demand management strategies.

6.34 The Government intends that the application of these principles should underpin and help co-ordinate other recent initiatives such as the Partnerships Victoria policy. **Overall, this asset management framework is aimed at addressing a number of risks associated with infrastructure investment and assisting in a co-ordinated approach to asset replacement and management decisions**.

State's infrastructure investment

6.35 It is widely recognised that infrastructure is a key input to economic development, community building and environmental enhancement. Infrastructure investment can entail the creation of new assets, upgrading of existing assets to higher levels of performance and capacity, and the maintenance of existing assets in a fit-for-purpose condition.

6.36 Over the past decade, the direct investment in the State's infrastructure has progressively moved from the public sector to the private sector, primarily as a result of the previous Government's privatisation program, including the sale of the electricity and gas sectors and franchising of passenger rail transport services. In addition, the traditional service delivery roles of the Government have changed to include partnering arrangements with the private sector, such as the Melbourne City Link project.

6.37 A key financial objective of the current Government is to provide capital works to enhance social and economic infrastructure throughout Victoria.

6.38 A number of public sector groups, including the health and education sectors, are currently facing major asset renewal challenges to meet a number of medium to long-term requirements, including growth in demand for services and the impact of advances in technology. Our previous report to the Parliament highlighted that the State's infrastructure investment levels have been consistently below the national level for over a decade when calculated as a proportion of Gross State Product and Gross Domestic Product.

6.39 Table 6H outlines the expenditure on property, plant and equipment over the last 5 years. As indicated in the table, while the level of infrastructure investment by the State has been below the national average, the State has consistently invested more in capital expenditure than the amount incurred for depreciation on the State's assets. This analysis may, however, understate the total expenditure on assets as it does not include assets arising from public/private partnerships in infrastructure delivery (where ownership of the asset remains with the private sector and the Government purchases services from the private sector).

TABLE 6H
NET ADDITON TO STATE'S ASSET BASE
($million)

Financial year	*1996-1997*	*1997-1998*	*1998-1999*	*1999-2000*	*2000-2001*
Purchase of property, plant and equipment	4 630.0	2 450.8	2 731.8	2 418.3	2 399.2
Depreciation	(1 487.6)	(1 409.4)	(1 381.0)	(1 267.7)	(1 315.6)
Net addition to State's asset base	3 142.4	1 041.4	1 350.8	1 150.6	1 083.6

Source: Government's Annual Financial Reports.

6.40 It is difficult to estimate an ideal level of asset investment or target, without a comprehensive Statewide infrastructure planning assessment, taking into account the State's long-term requirements and examining economic, social and environmental issues. **Without a comprehensive infrastructure review with a long-term focus and the associated setting of infrastructure targets, it is difficult to evaluate the Government's degree of success in achieving its strategic objective of providing *"capital works to enhance social and economic infrastructure throughout Victoria".***

6.41 The Government in mid-2000, through the Department of Premier and Cabinet, established an Infrastructure Planning Council whose role is to assist the Government's infrastructure planning by:

- undertaking a broad evaluation of network infrastructure provision across the State;
- identifying the strategic infrastructure issues facing Victoria over the next 5 to10 years;
- developing a framework of principles for assessing the State's future infrastructure requirements; and
- providing strategic advice to the Government on major infrastructure priorities and initiatives.

6.42 The Council was required to provide the Government with an interim report in October 2001 and a final report in 2002. **However, the advice of the Council will generally be confined to transport, water, energy and telecommunications facilities, and excludes significant sectors such as health and education. The report will, therefore, not be a comprehensive assessment of the State's infrastructure requirements.**

6.43 **The Department of Infrastructure is currently preparing a multi-year strategy (focusing on a 5 to 10 year outlook) to complement the work of the Infrastructure Planning Council. The major objective of the strategy will be to assist the Government in establishing asset investment priorities.**

"Growing Victoria" infrastructure reserve

6.44 As outlined in our previous *Report on the Finances of the State of Victoria, 1999-2000*, a major initiative of the Government, announced in the 2000-01 Budget, was the establishment of a $1 billion "Growing Victoria" infrastructure reserve, funded from the 1999-2000 budget surplus, over and above the capital expenditure funded through existing asset programs.

6.45 Following the achievement of a better than expected Budget Sector financial outcome for 2000-01, the Government subsequently increased the level of the reserve by an additional $175 million to $1.175 billion.

6.46 In late August 2000, the Government agreed that eligibility for funding from the reserve would be limited to infrastructure projects, which satisfy all the following criteria:

- the project must enhance sustainable economic growth and development across the whole of the State, with a particular focus on projects which contribute to:
    - improving major transport infrastructure across the State (Linking Victoria);
    - modernisation, enhancement and/or replacement of education infrastructure (Skilling Victoria); and
    - improving Budget Sector information and communication technology facilities and capabilities and the infrastructure base for innovation across the State (Connecting Victoria);
- the project applicant must be a Victorian Budget Sector department or agency;
- the project must add to the physical asset stock of the Victorian Budget Sector (i.e. funding is restricted to Budget Sector asset investment projects); and
- the project must not impact adversely on the Government's financial objectives, particularly the maintenance of a substantial Budget Sector operating surplus of at least $100 million per annum. To be eligible for funding, asset investment projects must therefore:
    - result in either no or minimal net increase in ongoing Budget Sector operating expenses (including depreciation, maintenance and/or other operating costs); or
    - generate ongoing operating savings.

6.47 **Of the $1.025 billion for projects committed from the reserve as at June 2001, $53.7 million was spent on capital works in 2000-01 compared with a budgeted $57 million.** The Government has projected to spend a further $224 million in the 2001-02 financial year, $255 million in the 2002-03 financial year, $190 million in the 2003-04 financial year, and $170 million in the 2004-05 financial year. The committed projects include:

- Fast Rail Project (Bendigo, Ballarat, the Latrobe Valley and Geelong) - $550 million;
- School modernisation/upgrade - $110 million;
- Enhanced learning environments for schools - $90 million;
- Science innovation and education precincts across regional Victoria - $50million; and
- Enhanced learning environments for TAFE - $45 million.

Part 7

Liabilities, commitments and contingencies

AGGREGATE LIABILITIES OF THE STATE

7.1 In this Part of the report, we analyse the State's financial obligations and commitments as at 30 June 2001 and provide an assessment of the impact of the year's activities on the State's financial position.

7.2 **The Government's Annual Financial Report details liabilities of the State totalling $51.2 billion at 30 June 2001, an increase of $1.8 billion compared with the previous year. This movement was mainly due to an increase in outstanding claims liabilities of $1.4 billion and interest-bearing liabilities of $882 million, partially offset by a reduction in unfunded superannuation liabilities of $484 million.**

7.3 Table 7A illustrates the composition of the State's liabilities at 30 June 2001.

TABLE 7A
COMPOSITION OF STATE LIABILITIES
($billion)

Type of liability	***Total June 2001***	*Total June 2000*
Interest-bearing liabilities *(a)*	**14.9**	14.0
Unfunded superannuation liabilities	**11.9**	12.4
Outstanding claim liabilities	**10.2**	8.8
Payables and other liabilities *(a)*	**11.7**	11.9
Employee entitlements	**2.5**	2.3
Total State liabilities	**51.2**	49.4

(a) Interest-bearing liabilities and payables comparatives adjusted to reflect gross derivative values.

7.4 In addition to the liabilities outlined in the above table, the State also has quantifiable and non-quantifiable contingent liabilities. These contingent liabilities represent potential commitments the occurrence of which is dependent on future events or outcomes. **Quantifiable contingent liabilities were estimated at around $1.6 billion at 30 June 2001,** which were similar to the previous year. The most significant quantifiable contingent liability relates to the value of correctional services undertaken by the private sector, beyond an initial 5 year contract period, which is subject to re-tender at that time and subsequent intervals over a 20 year period. The major non-quantifiable contingent liabilities include those associated with contracts and agreements for the 2006 Commonwealth Games and the provision of public transport services by private sector operators.

7.5 The State has also entered into various arrangements giving rise to operating, capital and other commitments. These do not form part of the liabilities included in the Government's Consolidated Statement of Financial Position as the relevant goods or services had not been received or consumed at balance date**. The aggregate value of these commitments was estimated at $12.1 billion at 30 June 2000 ($11 billion at 30 June 2000).**

INTEREST-BEARING LIABILITIES

7.6 Interest-bearing liabilities represent the largest component of State liabilities and predominantly comprise public sector debt raised domestically and overseas through the State's central borrowing authority, the Treasury Corporation of Victoria (TCV), deposits with TCV held by entities not consolidated in the Government's Annual Financial Report, loans and advances from the Commonwealth Government and finance leases entered into by various public sector agencies.

7.7 **At 30 June 2001, the State's interest-bearing liabilities totalled $14.9 billion (8.8 per cent of Victoria's Gross State Product), compared with $14 billion (8.7 per cent of Victoria's Gross State Product) in the previous year.** The increase in these liabilities of $882 million was largely due to an increase in deposits held by TCV from superannuation and trust funds which are not consolidated in the Government's Annual Financial Report.

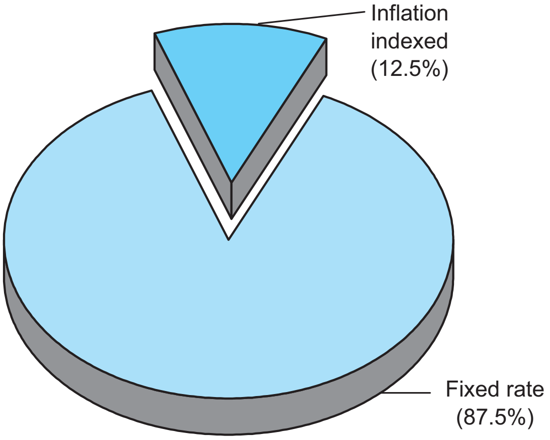
7.8 Over the past 3 years, debt levels have remained relatively stable, consistent with the Government's objectives for debt management which include:

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

Composition of State borrowings

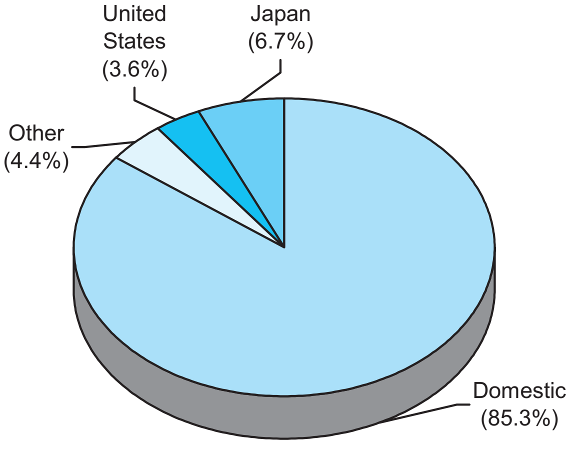
7.9 The State manages risks associated with its debt portfolio by borrowing from both domestic and overseas markets, issuing a mix of fixed rate, floating rate and inflation-indexed debt, and managing the maturity profile of its debt portfolio. Charts 7B and 7C show the composition of State debt at 30 June 2001 in terms of the types of debt instrument, and the markets in which they were raised.

CHART 7B
COMPOSITION OF STATE DEBT,
BY INSTRUMENT TYPE, AT 30 JUNE 2001 *(a)*
(per cent)



(a) Based on market value.

CHART 7C
COMPOSITION OF STATE DEBT,
BY MARKET IN WHICH RAISED,
AT 30 JUNE 2001 *(a)*
(per cent)



(a) Based on market value of domestic and offshore borrowed funds.

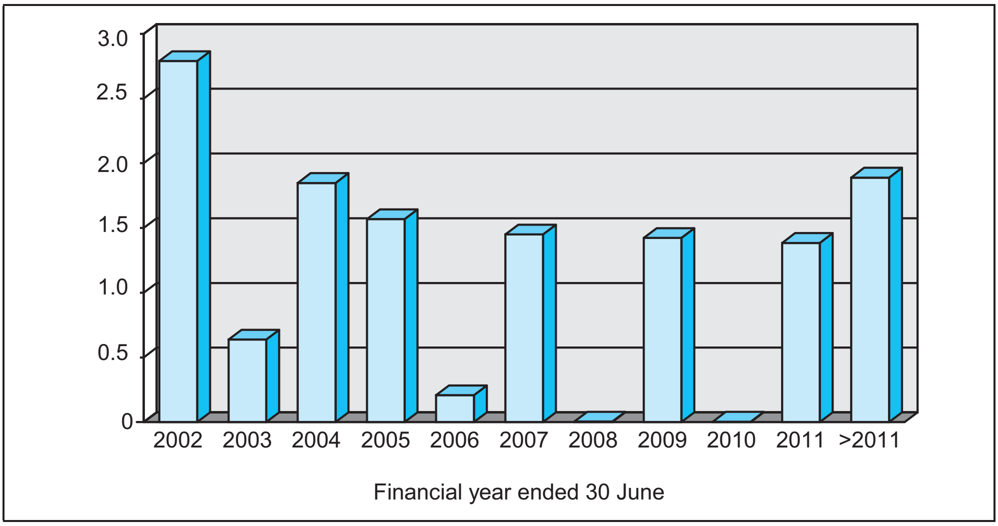
7.10 As indicated in the preceeding charts, fixed rate debt accounted for 87.5 per cent of the State's total debt portfolio at 30 June 2001 - an increase from 82 per cent of total debt at 30 June 2000. This increase reflects the Government's strategy to achieve certainty in interest rate costs through holding long-term fixed interest debt. During 2000-01, the Department of Treasury and Finance changed the composition of the Budget Sector Debt Portfolio by refinancing $33 million of debt which matured during the year and the conversion of an additional $661 million to fixed rate debt through the buy-back and refinancing of index-linked debt. These re-financing arrangements also lengthened the maturity profile of the Budget Sector Debt Portfolio.

7.11 The State's exposure to market risks is also managed by using various financial instruments known as derivatives. At 30 June 2001, the State held derivatives which had net receivables of $433 million. The majority of these derivatives transactions were undertaken to manage interest rate exposures.

State debt maturity profile

7.12 The State issues various debt instruments with terms to maturity ranging from 1 to 30 years. Chart 7D summarises the maturity profile of the State's debt as at 30 June 2001.

CHART 7D
STATE DEBT MATURITY PROFILE FOR THE NEXT 10 YEARS, AS AT 30 JUNE 2001 *(a)*
($billion)



(a) Borrowings are shown at their market value.

7.13 The distribution of debt along the maturity spectrum reflects the aim to maintain an even spread of debt maturities in order to minimise the refinancing risk associated with movements in market interest rates.

7.14 As indicated in the above chart, **$2.7 billion of debt will require repayment or refinancing during the 2001-02 financial year.** The Treasury Corporation of Victoria's current investment holdings are sufficient to enable repayment of this amount if this option is exercised.

Borrowing costs

7.15 As illustrated in Table 7E, the significant reduction in debt since the mid-1990s, mainly due to the impact of privatisations, has led to a corresponding reduction in the level of borrowing costs in both absolute terms and as a proportion of the State's total operating expenditure. This reduction in borrowing costs has provided the Government with greater flexibility in its decisions on the allocation of funding to government programs.

7.16 Borrowing costs increased marginally in 2000-01, reversing the downward trend, largely due to:

- the impact of the introduction of the GST, increasing the cost of financing indexed borrowings;
- higher costs associated with the Budget Sector motor vehicle finance lease facility;
- increased deposits with the TCV from superannuation and trust funds which are not consolidated in the Government's Annual Financial Report; and
- costs associated with un-winding the Accelerated Infrastructure Program.

TABLE 7E
BORROWING COSTS, 5 YEAR COMPARISON

Year ended 30 June	*Borrowing costs*	*Borrowing costs as a percentage of total operating expenditure*
	($b)	*(%)*
1997	2.14	8.8
1998	1.42	6.0
1999	1.14	4.8
2000	0.98	3.7
2001	1.26	4.4

Finalisation of the Victorian Accelerated Infrastructure Program

7.17 Our previous *Reports on the Finances of the State of Victoria* have outlined the financial arrangements relating to the Accelerated Infrastructure Program. The Program was established in the early 1990s to provide social infrastructure for the State, consisting of 10 police stations with adjoining court complexes, the Werribee Hospital and the Dandenong Community Health Centre. Under the arrangements, a private sector company, namely, Property Leasing Limited (the company), was established to build and lease properties to the Government. The company funded the construction costs through the issue of long-term bonds, which were subject to government indemnity, thereby effectively transferring the associated financing risks to the State.

7.18 **The need to un-wind the Program was recognised by the Government in 1995. An independent analysis undertaken at that time indicated that the Program provided minimal benefits to the State. The financial arrangements under the Program also resulted in the State bearing unacceptable levels of risk, including the financial deficit of the company and any Commonwealth taxation-related exposures.**

7.19 Following the Government's decision to un-wind the Program, all bonds that were issued by the company were purchased by the Department of Treasury and Finance during 1995-96 at a cost of $258 million.

7.20 To facilitate the un-winding of the Program, the Arada Trust was established in April 1999 by the Government, with the sole beneficiary being the Treasurer of Victoria. The Trust subsequently acquired the company's shares for a nominal amount from the private shareholders of the company. This effectively resulted in the Government taking ownership of the various properties established under the Program.

7.21 Following the decision to un-wind the arrangements, external consultants were appointed by the Department to examine the available options. **The consultants concluded that there was a clear advantage in the State owning these assets, given that the State's capital cost of ownership was 6.4 per cent compared with market-based rentals of around 9 per cent. However, when applying the principle of competitive neutrality used by the Government in analysing the various options, the ownership advantage was negated. The Department subsequently elected to dispose of the properties as part of its overall un-winding strategy.**

7.22 **While the Government used the competitive neutrality principle to support its decision to dispose of these properties, the rationale for the application of this principle was not clear, given that the State had already acquired ownership of the properties via the purchase of the bonds and shares of the private company. Furthermore, this principle has not been applied to justify the continued ownership of other government properties.**

New leasing arrangements and disposal of properties

7.23 Prior to placing the properties on the market, new lease arrangements were entered into for each of the properties based on normal commercial terms. Key changes to the leasing arrangements included decreasing the lease term from 20 years to 15 years, with a 5 year renewal option, and amending the rental basis to market rates from the previous rates which were based on the recovery of interest and other outgoings.

7.24 In early June 2001, the Department accepted an offer for the sale of 9 of the 12 properties at $46.9 million, based on an assessment by the Valuer-General that the offer price was acceptable when taking into account a discount for the sale of the properties as a single contract. The Valuer-General had valued the 9 properties (police stations and adjoining court complexes) at a combined value of $52.8 million without applying a discount in the valuation for the bulk sale.

7.25 The 3 remaining unsold properties were the Williamstown Police Station, the Werribee Hospital and the Dandenong Community Health Centre.

Williamstown Police Station.

7.26 The Williamstown Police Station was retained by the State Government in view of the strategic location of the property on the Williamstown foreshore and the development of the new facilities for the Water Police on the site. This property was valued at $3.3 million by the Valuer-General and formed part of the consideration by the company in the repayment of its liabilities to the Treasurer.

7.27 At the request of the Department of Human Services, the Werribee Hospital and the Dandenong Community Health Centre were transferred by the company to the Department in June 2001 for a consideration equivalent to their market valuations of $17.9 million.

7.28 The proceeds from the sale of the 9 police stations and adjoining court complexes to the private sector and the health facilities to the Department, together with cash reserves held by the company, totalling $181.5 million, were paid by the company to the Consolidated Fund between March 2001 and June 2001 as part consideration for the repayment of its liabilities to the Treasurer.

7.29 **In June 2001, the Treasurer approved the forgiveness of the remaining liabilities of the company to the Treasurer in return for payment of the company's remaining assets into the Consolidated Fund upon its liquidation. As shown in Table 7F, upon the liquidation of the company, the value of the outstanding liabilities forgiven by the Treasurer is estimated at $66.6 million. This represents a net loss to the State following the un-winding of this Program.**

TABLE 7F
PROCEEDS FROM FINALISATION OF THE PROGRAM 2000-01*(a)*
($million)

Item		*Amount*
Value of debt assumed by Treasurer		258.0
Less repayments from company		
Cash payments to Consolidated Fund in March 2001	(100.0)	
Cash payments to Consolidated Fund in June 2001	(81.5)	
Other cash payments to the Consolidated Fund	(4.6)	
Value of Williamstown Police Station transferred to the Crown	(3.3)	
Remaining cash forecast to be paid to the Consolidated Fund after 1 July 2001	(2.0)	191.4
Loss incurred by the State to un-wind the Program		**66.6**

(a) Source: Department of Treasury and Finance.

7.30 The Department has advised that a number of administrative arrangements remain outstanding to finalise the un-winding of this Program. These are expected to be completed and the company deregistered by December 2001.

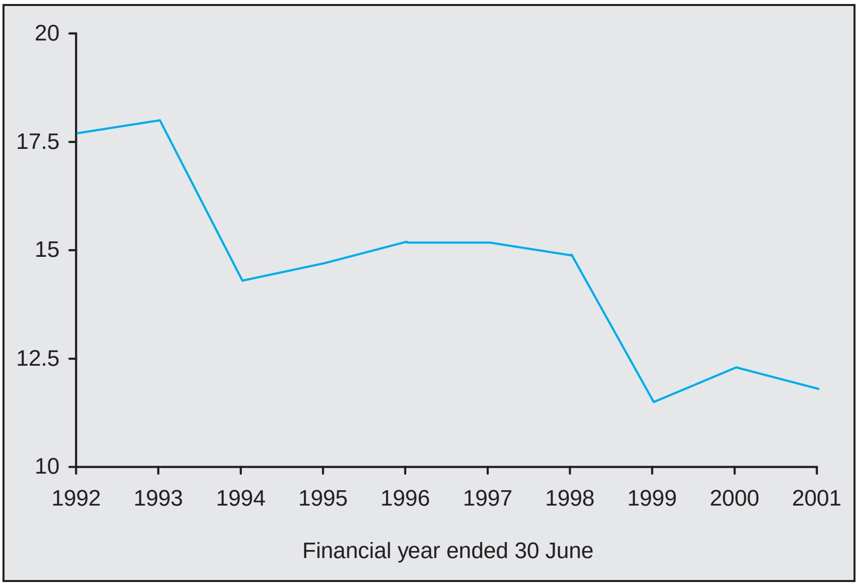
UNFUNDED SUPERANNUATION

7.31 Unfunded superannuation liabilities represent the second largest component of the State's liability portfolio. The liability represents employer superannuation contributions yet to be paid by the Government to superannuation schemes for services previously provided by government employees net of the market value of assets held by the respective funds. The liability has resulted from decisions of previous governments to progressively meet the employer share of superannuation benefits when, or after, employees retire (i.e. on a "pay-as-you-go" basis) rather than as benefit entitlements accrue over the working lives of employees.

7.32 **The Government's Annual Financial Report disclosed an unfunded superannuation liability as at 30 June 2001 of $11.9 billion ($12.4 billion in the previous year)**.

7.33 Approximately 99 per cent of the State's unfunded superannuation liability is attributable to the State Superannuation Fund. Chart 7G shows the movement in the level of the State's unfunded superannuation liability since 1992.

CHART 7G
MOVEMENT IN THE STATE'S UNFUNDED SUPERANNUATION LIABILITY, 1992 TO 2001 *(a)*
($billion)



(a) All figures are presented in nominal values.

7.34 During the 2000-01 financial year, the State's unfunded superannuation position was favourably impacted by the Beneficiary Choice Program and an additional contribution made by the Government. That is, in addition to the $554 million contribution recommended by the Fund's actuary, a further $603 million was paid to the Fund by the Government in June 2001. The additional payment represents the early payment of an amount that would normally have been paid by the Government in the 2001-02 financial year.

7.35 These positive impacts were partially offset by the impact of wages and salaries growth and the lower earning rates of the Fund's assets.

7.36 Actuarial projections indicate that the State's unfunded superannuation liability will increase in nominal terms until approximately 2007 and then gradually reduce until the liability is eliminated by 2035. However, if the Government continues to make the previously actuarially determined level of contributions, given the positive effect of the Beneficiary Choice Program on the unfunded liabilities as outlined below, the target date of 2035 will be brought forward.

Beneficiary Choice Program

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

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

7.39 Under the BCP, eligible deferred beneficiaries and pensioners could elect to fully commute their benefits by specified dates, ranging from mid-February 2001 to early November 2001. It is estimated that commutation offers were made to approximately 51 000 pensioners and 28 000 deferred beneficiaries and that the ongoing change in fund rules will further apply to approximately 73 000 existing members.

7.40 The BCP at its inception was expected to have a beneficial impact on both the Fund's unfunded liability and the Government's long-term contribution requirements. Although the benefit payments would increase in the short-term due to the increased lump sum payments, this situation would be reversed in later years leading to lower benefit payments overall. The BCP may also have an impact on the long-term contribution rates of employing authorities for current employees.

7.41 As at 30 June 2001, lump sum elections to the value of approximately $1.55 billion had been processed for payment to pensioners in early July 2001. The actuary factored the outcome of the BCP into the calculation of the unfunded superannuation liability as at 30 June 2001. However, no allowance has been made for the impact of any additional BCP benefit payments processed in the 2001-02 financial year.

7.42 At the time of preparation of this report, the Department of Treasury and Finance estimates that around 35 per cent of pensioners and deferred beneficiaries elected to commute part or all of their pension entitlement to a lump sum. **The overall reduction in the State's unfunded superannuation liability arising from the BCP as at 30 June 2001 was around $368 million. It is estimated that a further reduction of approximately $145 million in the unfunded superannuation liability arising from the BCP will be reflected in the financial results for the 2001-02 financial year.**

Superannuation funds with excess assets

7.43 In recent years, we have commented on the funding position of the Emergency Services Superannuation Scheme which now holds assets in excess of its superannuation liabilities. To reduce the excess funding levels, over a period of time, the Scheme's Board accepted the actuary's recommendation for specific reductions in employer contribution rates commencing from the 2000-01 financial year.

7.44 **Nevertheless, the aggregate surplus of superannuation assets over superannuation liabilities of the Scheme increased from $266 million at 30 June 2000 to $274.8 million at 30 June 2001. These excess assets are not recognised in the Government's Annual Financial Report on the basis that the Government has no recourse to repatriate these surplus assets.**

7.45 Table 7H discloses the key entities whose share of the Scheme's assets exceeded their superannuation liability.

TABLE 7H
SUPERANNUATION ASSETS IN EXCESS OF THEIR SUPERANNUATION LIABILITIES BETWEEN 30 JUNE 1999 TO 30 JUNE 2001
($million)

Related agency	*30 June 1999*	*30 June 2000*	*30 June 2001*
State Electricity Commission of Victoria	66	58	53
Ambulance Service Victoria	49	64	60
Country Fire Authority	42	52	50
Metropolitan Fire and Emergency Services Board	56	69	63
Victoria Police	(398)	20	47
Other	-	3	1.8
Total	**(185)**	**266**	**274.8**

7.46 As the above table illustrates, the surplus position of the key employer entities, with the exception of Victoria Police, reduced during the year. The Scheme's actuary attributes this decline to the lower contribution rates and the unfavourable investment experience in the past 12 months. The surplus position of Victoria Police increased by $27 million during the year despite a reduction in the employer contribution rate from 27.5 per cent to 15.5 per cent at the commencement of the 2000-01 financial year, due to the impact of the BCP which resulted in an overall saving of $43 million.

7.47 The actuary is to review the Scheme's funding position and make a recommendation to the Scheme's Board in relation to the employer contribution rates for the 2002-03 financial year.

7.48 In addition to the Emergency Services Superannuation Scheme, the Parliamentary Contributory Superannuation Fund also had a surplus of $13.1 million as at 30 June 2001. The actuary of this Fund is to review the contribution rates at the end of 2001-02 financial year.

State obligations for funding university superannuation

7.49 Under the *State Grants (General Purpose) Act* 1994, the State in previous years has been required to make annual payments to the Commonwealth Government, as determined by the Commonwealth Minister for Education, to assist in the funding of superannuation costs incurred by universities located in Victoria, related to staff who are members of the State Superannuation Fund.

7.50 Following the changes to the Commonwealth tax system from 1 July 2000, that Act was repealed. However, it was agreed that the existing arrangements will continue in the interim under a Memorandum of Understanding between the State and the Commonwealth Governments.

7.51 An inter-jurisdictional steering committee proposed to the Commonwealth Government in early 2001 a revised and simplified set of funding arrangements to take effect from 1 July 2001, however, this proposal was not accepted by the Commonwealth Government.

7.52 Under the current agreements, the State is required to contribute 25 per cent of the costs associated with the universities' obligations as employers. As at 30 June 2001, the aggregate value of Victorian universities' unfunded liabilities was $918 million, of which $230 million represented the State's obligation under this arrangement ($220 million as at June 2000) which is recognised as part of the State's unfunded superannuation liabilities.

7.53 In past reports comment was made on the practice of universities disclosing an asset, equivalent in amount to their unfunded superannuation liabilities, in their statement of financial position representing the funding they expect to receive from the Commonwealth Government by way of future annual grants to meet these liabilities. It continues to be my opinion that as the universities do not exercise control over the future Commonwealth Government funding associated with the unfunded superannuation liabilities, a right to these funds should not have been recognised as an asset in the universities balance sheet. As a result, qualified audit opinions were re-issued to universities as at 31 December 2000 that disclosed such an asset.

7.54 The State Government is continuing with its efforts to establish more simplified arrangements, which will essentially enable the State to make payments directly to superannuation funds rather than to the Commonwealth Government.

OUTSTANDING CLAIMS LIABILITIES

7.55 The level of outstanding claims liabilities increased by around 15 per cent during 2000-01, to $10.2 billion at 30 June 2001. The majority of these obligations are managed by the Transport Accident Commission (motor vehicle and public transport personal injury), the Victorian WorkCover Authority (personal workplace injury) and the Victorian Managed Insurance Authority (participating public sector agencies' insurance cover).

7.56 The respective liabilities for outstanding claims relating to each of these insurance entities at 30 June 2001 are detailed in Table 7I.

TABLE 7I
COMPOSITION OF OUTSTANDING CLAIMS LIABILITIES, AT 30 JUNE *(a)*
($million)

			Total	
Entity	*Current*	*Non-current*	**2001**	2000
Victorian WorkCover Authority	1 195	4 426	**5 621**	4 940
Transport Accident Commission	574	3 508	**4 082**	3 499
Victorian Managed Insurance Authority	54	354	**408**	300
Other agencies	32	23	**55**	32
Total outstanding claims liabilities	**1 855**	**8 311**	**10 166**	**8 771**

(a) Sourced from note 26 of Government's Annual Financial Report, 2000-01.

7.57 **Over the past 5 years, the State's outstanding insurance claims liabilities have increased by 50 per cent,** as reflected in Table 7J. This growth has been due to a number of factors, including the impact of increasing number of claims reflecting the maturing nature of the schemes, increasing claims costs for medical, legal, rehabilitation and settlement expenditure, and higher number of motor vehicle and workplace accidents that have led to costly serious injury and catastrophic claims.

TABLE 7J
SUMMARY OF TOTAL OUTSTANDING CLAIMS LIABILITIES, 30 JUNE 1997 TO 30 JUNE 2001 *(a)*
($million)

Entity	*1997*	*1998*	*1999*	*2000*	*2001*
Victorian WorkCover Authority	3 538	3 930	4 384	4 940	**5 621**
Transport Accident Commission	3 006	3 259	3 348	3 499	**4 082**
Victorian Managed Insurance Authority	83	96	229	300	**408**
Other agencies	11	18	32	32	55
Total outstanding claims liabilities	**6 638**	**7 303**	**7 993**	**8 771**	**10 166**

(a) Sourced from Government's Annual Financial Reports.

7.58 The Victorian WorkCover Authority (VWA) is the only State-owned insurance entity that does not hold sufficient assets to cover its liabilities, with an excess of liabilities of $683 million as at 30 June 2001.

Understanding the uncertainty in actuarial assessments

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

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

7.61 The likelihood of variation in the actuarial assessments is high since the calculations are based on economic (i.e. inflation rates and discount factors) and non-economic (i.e. claim payment trends) assumptions. The economic assumptions for the 2000-01 financial year were generally consistent with those of the prior year. However, the actuarial assessment of the outstanding claims liabilities for the VWA and the Transport Accident Commission (TAC) were significantly impacted by changes in non-economic assumptions such as actuarial projections of common law costs (VWA) and long-term care costs for seriously injured claimants (TAC).

7.62 An important inclusion in the actuarial assessment is the addition, in the case of the TAC and the Victorian Managed Insurance Authority (VMIA), of differing levels of prudential margin to the "central or best estimate" arrived at by the actuaries. The need to incorporate a margin within the actuarial assessment is a reflection of the significant uncertainty in the claim payment and claims experience profile for each insurance entity.

7.63 The extent of the "tail" for the State's insurance obligations is indicated by the "weighted average expected term to settlement" for claims, which varied at 30 June 2001 from 4.6 years in the case of the VWA to 8.4 years for the VMIA and 9.5 years for the TAC. These settlement terms differ from the previous year, with the major change relating to the TAC, which increased from 9 years to 9.5 years, reflecting the growth trends associated with seriously injured claimants and the maturing of the stock of claims.

7.64 The decision on whether to incorporate a prudential margin and the quantum of such a margin is made by each insurance entity's governing board. For the VWA, no prudential margin is included in the actuarial assessment and reliance is placed on the "central" or "best" estimate arrived at by the actuaries to adequately reflect the inherent uncertainty in the estimation process. **The prudential margin for the TAC and the VMIA at 30 June 2001 were $516 million and $80 million, respectively, and effectively represent in total 13.2 per cent on their outstanding claims liability of $4.5 billion.**

Removal of "emphasis of matter" in audit opinion

7.65 A significant development in the Victorian WorkCover Authority (VWA) was the enactment in May 2000 of the *Accident Compensation (Common Law and Benefits) Act* 2000 which restored common law remedies to employees from October 1999 ("new" common law). This legislation also imposed a 1 September 2000 statutory deadline for serious injury certification for claims incurred prior to November 1997 ("old" common law).

7.66 The VWA and its external actuaries sought to factor in their outstanding claims liability calculations the likely influx of applications up to the 1 September 2000 statutory deadline. However, in the weeks leading up to the deadline, a substantially larger number of "old" common law claims were received, which were far greater than anticipated by the VWA. It was not possible, at that time, for the VWA or its actuaries to determine the effect of this late surge of applications on the assessment of the outstanding claims liability. **As a consequence, an "emphasis of matter" paragraph was included in our audit opinion on the VWA's 1999-2000 financial statements and the Government's Annual Financial Report for that year.** The paragraph referred to the notes to the financial statements, which explained the nature and extent of the uncertainty in reliably estimating the amount of liability the "old" common law applications.

7.67 **For the 2000-01 financial year, the VWA and its actuaries were in a position to adequately assess the likely impact of the "old" common law applications. Accordingly, there was no need to include an "emphasis of matter" paragraph in the audit opinion.**

CAR FLEET FINANCING ARRANGEMENTS

7.68 Our 1996-97 *Report on the Government's Annual Financial Statement* outlined an arrangement under which the Minister for Finance, in July 1997, entered into a 7 year Master Lease Agreement (MLA) with the Commonwealth Bank of Australia (CBA), involving the sale and leaseback of the Budget Sector vehicle fleet. At that time, the State sold and leased back approximately 7 200 vehicles, with the sale proceeds of $168 million paid into the Consolidated Fund. As at the end of the 2000-01 financial year, approximately 8 000 vehicles were under lease with annual rental payments of approximately $40.6 million.

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

7.70 To date, the CBA has not increased lease rentals associated with the shortfall which has occurred on vehicle disposals resulting in the gradual accumulation of a deficit in the PLAA. The Department attributes the significant growth of the deficit in the PLAA to the downward movement in used car prices.

7.71 **At 30 June 2001, the Department estimated the aggregate loss associated with vehicle disposals under the leasing arrangement at $88.3 million, including $68.3 million incurred to 30 June 2001 and $19.5 million of potential losses on future sales of motor vehicles being leased at year-end.**

7.72 **At the date of preparation of this report, the Government was investigating options in relation to the future management of the motor vehicle fleet.**

CONTINGENT LIABILITIES OF THE STATE

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

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

7.75 **The Government's Annual Financial Report discloses that the estimated quantifiable contingent liabilities of the State at 30 June 2001 were approximately $1.6 billion, a level similar to last year.**

7.76 In addition to the quantifiable contingent liabilities, the Government's Annual Financial Report details a number of non-quantifiable contingencies, including contingencies relating to Melbourne 2006 Commonwealth Games, the Longford gas incident and public transport franchise agreements.

7.77 Comments follow on some of the more significant developments during 2000-01.

Impact of High Court ruling on responsibility for road accident liabilities

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

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

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

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

7.82 State and local government authorities can no longer assume that they are immune from being sued for damages in respect of accidents caused by failure to maintain roads and infrastructure. These authorities may, in future, need to provide for possible damages claims. At the date of preparation of this report, the extent of the financial implications and possible exposures for the State, which includes VicRoads, following the High Court decision were unclear. The Government is currently analysing the High Court decision and the related implications.

Automated ticketing system

7.83 In May 1994, the Public Transport Corporation (PTC) entered into arrangements with OneLink Transit System Pty Ltd (OneLink) to provide an automated ticketing system (ATS) and fare collection services for the metropolitan public transport system over a period of 10 years ending in 2007. Under the terms of the arrangement, the Treasurer of Victoria provided a guarantee for the payment obligations of the PTC to OneLink.

7.84 It is intended that the PTC's rights, interests and obligations under the ATS agreements be assigned to the Revenue Clearing House Pty Ltd (RCH), to reflect the fact that franchisees now operate the public transport system. RCH is jointly owned by the public transport franchisees and the Secretary of the Department of Infrastructure on behalf of private bus operators.

7.85 OneLink agreed to the assignment of the PTC's rights, interests and obligations under the ATS agreements to the RCH, provided that the Treasurer continued to provide a guarantee for the payment obligations of RCH. In the meantime, the PTC and RCH entered into interim arrangements that continue until such time that the service contract is formally assigned to RCH. As at the date of preparation of this report, formal assignment of the ATS agreement to RCH has not occurred and discussions are continuing between the parties.

7.86 Our previous *Report on the Finances of the State of Victoria, 1999-2000* referred to an arrangement between the PTC and OneLink relating to the administration of damages claims between the parties. Under the arrangement, both parties agreed to waive certain rights and obligations with respect to the ATS agreement. However, OneLink retained the right to claim for variations to specifications lodged between May 1994 and March 1997, but these rights were suspended until after the commissioning of the pilot stage of the ATS.

7.87 Consistent with the above arrangements, in April 2000, OneLink submitted a claim to the PTC amounting to $132 million plus $17 million per annum from April 2000 to March 2007 for ongoing maintenance of the equipment. The basis of the OneLink claim is that the scope of the ATS project was increased by the PTC between May 1994 and September 1995.

7.88 In April 2001, the PTC formally rejected the OneLink claim on the basis that it was not supported by the established contractual arrangements. At the time of preparation of this report, negotiations were continuing between the parties to resolve this matter.

Transmission of business issues

7.89 The Government's Annual Financial Report discloses a contingent liability of the State emerging from a Federal Court decision under the provisions of the *Commonwealth Workplace Relations Act* 1996. The decision indicates that former public sector award rates and conditions may apply to a contractor's employees performing what were previously government functions prior to the implementation of outsourcing arrangements or the privatisation of State-owned business enterprises. Where applicable, the principle embodied in the decision may cause increases in employment costs for the contractor.

7.90 **The Court's decision highlights the need for the Government to carefully consider the implications of outsourcing. The State's financial exposures relating to past outsourcing decisions by various government agencies remains unclear. However, we have been advised by the Department of Treasury and Finance that it is unlikely that there will be any substantial impacts.**

Melbourne City Link

7.91 Our previous reports to Parliament have analysed the highly complex arrangements established between the State and Transurban, a private sector consortium, for the financing, construction and operation of the Melbourne City Link.

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

7.93 Under the contractual arrangements, while the users of the City Link via toll payments will, in substance, be the financiers of the project, Transurban has accepted substantial obligations associated with the delivery and operation of the City Link, including traffic and revenue risks.

7.94 As part of the contractual arrangements with Transurban, the State has provided a number of indemnities in relation to the impact of certain events which may have a material adverse effect on the contract.

7.95 **In February 2001, Transurban submitted a claim to the Government, alleging that the construction of Wurundjeri Way (a recently built public road within the Docklands precinct), Network Roads (the Latrobe Street and Bourke Street extensions and alterations to Footscray Road and Flinders Street Extension) and the widening of the West Gate Freeway, will reduce traffic volumes on the City Link, resulting in lost revenue with a net present value of $35.8 million over the concession period.**

7.96 **The State has accepted the validity of the notice in respect of the material adverse effects claim received from Transurban, but has not accepted that a specified claimable event has occurred. The Concession Deed provides a dispute resolution mechanism whereby Transurban and the Melbourne City Link Authority agree to the appointment of an "independent expert" to make a determination which, although binding on both parties, is subject to appeal.**

7.97 **Transurban has referred the above matter for expert determination. However, at the date of preparation of this report, a determination has not been made and the Authority and Transurban were continuing negotiations.**

OTHER FINANCIAL COMMITMENTS OF THE STATE

7.98 In addition to the financial obligations commented upon earlier in this Part of the report, public sector bodies have entered into a number of arrangements which will impact on the future financial operations of the State. **At 30 June 2001, the State had operating, capital and other commitments of $12.1 billion (30 June 2000, $11 billion),** including:

- operating lease commitments ($8.7 billion);
- capital commitments associated with works not performed under existing contracts ($1.2 billion); and
- other commitments arising from commercial arrangements ($2.2 billion).

7.99 The increase in the reported value of the State's financial commitments in 2000-01 was mainly due to the recognition for the first time in the Government's Annual Financial Report of a number of major outsourcing arrangements. This was in part off-set by the impact of the termination during the year of the financial arrangements associated with the Metropolitan Women's Correctional Centre. Further comment on this development in the year follows.

Metropolitan Women's Correctional Centre

7.100 My June 2001 *Report on Ministerial Portfolios* commented on the key issues surrounding the transfer of the ownership and management of the Metropolitan Women's Correctional Centre at Deer Park, Melbourne from private interests to the State. The report included an analysis of the financial and operating arrangements for the Centre, commented on the events leading to the agreed action to terminate the contract, and provided an analysis of the terms of settlement and the financial impact on the State.

7.101 **In November 2000, the Government reached an agreement with the contractor to transfer the ownership and management of the Centre to the State. The settlement amount was $20.2 million, consisting of $17.8 million to purchase the Centre's buildings, infrastructure and chattels, and $2.4 million to finance the costs associated with terminating the loan facility.**

7.102 The agreed settlement included a $14.8 million payment to the project financier to pay-out the contractor's existing loan facility and relinquish a performance bond of $125 000 held by the Department of Justice. The settlement package also recognised an amount of $1.2 million in direct costs incurred by the State as part of the step-in and administration of the Centre.

7.103 **The Government was able to terminate the contract on favourable terms to itself, while at the same time avoiding a prolonged legal dispute with the contractor through negotiating a commercial settlement on mutually agreed terms.**

7.104 As a result of the agreed termination of the outsourcing arrangement with the contractor, the State has included the Centre as an asset in the 2000-01 consolidated statement of financial position at a carrying value of $24.6 million.

Part 8

Developments in financial reporting and management

RECENT DEVELOPMENTS IN THE STATE'S FINANCIAL REPORTING AND MANAGEMENT FRAMEWORK

Annual reporting

8.1 The Government's Annual Financial Report has evolved over recent years to incorporate changes in both legislative and professional requirements. Recent changes have included the incorporation of the budget sector outcome within the financial report and the disclosure of longer-term contractual expenditure commitments. These developments represent significant enhancements in public sector reporting.

8.2 The ongoing challenge for the Government is to seek to improve the quality of disclosure and reporting of its activities to the public and Parliament. The disclosure of the Government's performance against its stated expected outcomes and related indicators remains an area for development.

8.3 The enhancement of the analysis and commentary provided in the unaudited parts of the Annual Financial Report, through for example the provision of longer-term (say 3 to 5 years) perspectives, would also increase its value to Parliament and other users.

Interim and half yearly financial reporting

8.4 As previously mentioned in this report, recent amendments to the *Financial Management Act* 1994 have established requirements for more frequent reporting of the State's financial affairs, including the publication of unaudited quarterly budget sector financial reports and half yearly whole-of-government financial reports.

8.5 The overall objective of interim and half yearly financial reporting is to provide updated information to the Parliament to facilitate an understanding of the changes in the financial position and performance of the budget sector and the State of Victoria since the most recent annual reporting date.

8.6 We have examined, but not audited, the information presented in these financial reports and have identified the following issue which, if addressed, will enhance the quality of the reports.

8.7 **In relation to the quarterly reports for the budget sector, explanations were provided for major variances against the most up-to-date budget estimates. While this information is useful for analytical purposes, we believe that the original budget presented to the Parliament should also be disclosed in the quarterly financial reports to provide accountability against these estimates, which represent the Government's fiscal plan supporting the annual appropriation process.**

Probity and transparency in the contracting-out of government services

8.8 An essential aspect of any government procurement process is to ensure probity or procedural integrity. That is, established tender processes and procedures should be fair and open, and able to withstand external or independent scrutiny. The importance of these principles has been heightened over the last decade, with the shift by governments towards increased contracting-out of service delivery and the increased involvement of the private sector in infrastructure developments.

8.9 Following a number of external reviews and parliamentary committee reports relating to contracting which identified deficiencies in existing procurement and disclosure practices, in October 2000 the Government issued a policy statement, *Ensuring Openness and Probity in Victorian Government Contracts.* The policy statement was designed to enhance probity and transparency in contracting for the supply of goods and services to government, investment attraction and for the transfer of assets to the private sector.

8.10 The policy statement establishes requirements and provides guidance in relation to the appointment of probity auditors and the preparation of probity plans. The policy also provides for the full disclosure of contracts, on the Victorian Government Purchasing Board website, of all contracts in excess of $10 million. Summary information for all contracts above $100 000, but less than $10 million, is also required to be disclosed on the website. The level of disclosure required takes account of the criteria set out in the *Freedom of Information Act* 1982. Where major events and business attraction contracts cannot be disclosed due to contractual terms, the Minister is required to notify Parliament and explain the reasons for non-disclosure.

8.11 **We believe that the implementation of this new policy should contribute to an improvement in procedural integrity in purchasing practices and decision-making, and promote a more open and accountable governance process.**

8.12 The Government's purchasing guidelines provide for a standard clause to be included in new contracts, requiring contractors to provide any information that departments or agencies reasonably require to comply with requests from the Auditor-General. While this requirement enables my Office to assess whether a contractor has expended funds in compliance with the requirements of the contract, it does not provide me with express legislative power to conduct a review of the contractor's operational performance under the contract.

8.13 **An explicit access authority to contractor's records, incorporated in legislation, would enable the interests of Parliament and taxpayers to be adequately protected in situations where our audit procedures identify that the oversight mechanisms of the responsible government agency were less than effective and concerns were held as to the integrity of data furnished by contractors. In the meantime, we will continue to monitor the adequacy of access facilitation as promulgated above and, should any circumstances be found where taxpayers' interests are not adequately protected, they will be brought to Parliament's attention accordingly.**

Partnership Victoria

8.14 In June 2000, the Government launched the Partnership Victoria policy which provides a high level framework for public/private sector partnering arrangements, where the present value of a capital project exceeds $10 million.

8.15 A public/private partnership arrangement is a procurement process under which public sector and private sector parties allocate between themselves the risks, rewards and responsibility for the success of a project. Essentially, the partnership arrangements differ from conventional government procurement processes in that the emphasis is on defining the service outputs desired by governments as opposed to detailed specification of inputs.

8.16 The key objective for the Victorian Government under such an arrangement is to obtain better value for the taxpayers' dollar by shifting the responsibility for the operation and/or financing of non-core activities to the private sector. There are also secondary objectives, including increasing the efficiency of the public sector by letting it access private sector expertise, in an orderly manner, thereby gaining benefit from the efficient execution and administration of projects.

8.17 As at 30 June 2001, there were 9 major projects that were being considered under Partnership Victoria which were either in the market place or prepared to go to the market. These projects included the regional fast rail project, Spencer Street Station redevelopment, Melbourne Airport Transit Link, Scoresby transport corridor, the Wodonga and the Echuca/Rochester wastewater treatment projects, mobile data network for emergency service organisations and the Westgate terminal project. These projects are estimated to have a combined value in excess of $1 billion.

8.18 To support the Partnerships Victoria policy, the Government in June 2001, released practical guidance materials for public sector agencies and interested private sector parties which provide a detailed step-by-step application of the policy, and include:

- a Practioners' Guide – which sets out best-practice procedural details, how to identify a potential project, and the value-for-money and public interest tests;
- a Risk Allocation and Contractual Issues Guide – which describes the common risks and contractual issues encountered in public/private partnerships and the Government's preferred approach on each of these issues; and

- a Technical Note – which provides guidance on the construction and application of a public sector comparative model that will be used to evaluate bids on a value-for-money basis.

8.19 **Overall, the guidance material is welcomed as a systematic and consistent evaluation framework, which enables the consideration of partnership arrangements in assessing the overall value-for-money to taxpayers.**

Procurement practices under Partnership Victoria

8.20 Recent government reviews of procurement practices have shown that public sector agencies can achieve better value-for-money by co-ordinating their purchasing power to negotiate better deals. The recent release of the Partnership Victoria policy requires a broad range of professional advice for projects including legal, engineering, property, economic and business appraisal. The Partnership Victoria guidelines refer agencies to existing guidelines for the engagement of external advisers from accredited purchasing units in the respective departments and from the Procurement Branch of the Department of Treasury and Finance.

8.21 Given the anticipated level of projects under Partnership Victoria, we believe that this provides an opportunity for the Procurement Branch of the Department of Treasury and Finance to take a pro-active role in the engagement of consultants. The United Kingdom (UK) is widely considered the leader in the field of private/public sector partnering arrangements. The establishment of a consultancy panel in each professional area was adopted by the UK in implementing English Partnerships. Under these arrangements, it was found that the panels facilitated better access by government agencies to required services and reduced processing costs.

8.22 The Department currently utilises a limited panel of consultants under agreements that expired in October 2001. **We, therefore, recommend that the Department investigate opportunities that may exist to implement the most effective procurement strategies for consultants to be engaged under the public/private partnership arrangements.**

Index

Accelerated Infrastructure Program, finalisation of.................................... 90

Annual Financial Report, opinion on.................................. 11, 15

Assets 67

Australian Grand Prix Corporation 62

Automated ticketing system 102

Car fleet financing arrangements 100

Commonwealth grants......................... 43

Contingent liabilities of the State 101

Credit rating, State's........................... 32

Employee entitlement costs, impact of recent agreements 52

Expenditure 49

Financial accountability framework..... 13

Financial reporting and management, developments in....................... 107, 109

Gambling fees and taxes...................... 40

Interest-bearing liabilities.................... 86

Investment income 46

Liabilities, aggregate, of the State........ 85

Liabilities, commitments and contingencies 83

Major events strategies 59

Melbourne 2006 Commonwealth Games 60

Melbourne City Link 103

Metropolitan Women's Correctional Centre...105

National Tax Reforms, financial impact of 43

Operating result and financial condition 19

Outstanding claims liabilities 97

Partnership Victoria 111

Performance against key government objectives 32

Physical assets 74

Revenue 35

State assets, summary of......................69

State operating expenses, summary of 51

State revenues, summary of.................37

State's financial condition, analysis of 27

Superannuation, unfunded 93

Transurban concession fees, write-down of....................................41

AUDITOR GENERAL
VICTORIA

150 Years of Auditing in the Public Interest

AVAILABILITY OF REPORTS

Copies of all reports issued by the Victorian Auditor-General's Office are available from:

- Victorian Auditor-General's Office
  Level 34, 140 William Street
  Melbourne Vic. 3000
  AUSTRALIA

  Phone: (03) 8601 7000
  Fax: (03) 8601 7010
  Email: comments@audit.vic.gov.au
  Website: www.audit.vic.gov.au

- Information Victoria Bookshop
  356 Collins Street
  Melbourne Vic. 3000
  AUSTRALIA

  Phone: (03) 1300 366 356 (local call cost)
  Fax: (03) 9603 9920