VICTORIA

Auditor General
Victoria

Report of the Auditor-General on the Finances of the State of Victoria, 2002-03

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

No. 51 - Session 2003

ISSN 1327-6905
ISBN 0 9750755 1 9

AUDITOR GENERAL
VICTORIA

The Hon. Monica Gould MP
President
Legislative Council
Parliament House
MELBOURNE

The Hon. Judy Maddigan MP
Speaker
Legislative Assembly
Parliament House
MELBOURNE

Under the provisions of section 16A of the *Audit Act* 1994, I transmit my *Report on the Finances of the State of Victoria, 2002-03.*

Yours faithfully

J.W. CAMERON
Auditor-General
20 November 2003

Contents

Part 1 EXECUTIVE SUMMARY 1

Overview *3*

Summary of major findings *4*

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

Audit of the Annual Financial Report for the State of Victoria 13

Audit opinion on the Annual Financial Report 14

My Report on the Finances of the State of Victoria 17

Annual Financial Report preparation and disclosures 17

Part 3 OPERATING RESULT AND FINANCIAL CONDITION 21

Summary of operating result and financial position 23

Key indicators of State's financial condition 30

Part 4 REVENUE 39

Summary of State revenues 41

Grant revenues 42

Taxation revenues 46

Sale of goods and services, and other revenue 50

Investment revenue 52

Part 5 EXPENDITURE 59

Summary of State operating expenses 61

Employee benefits 62

Supplies and services expenditure 67

Additional costs under the public transport franchising arrangements 69

Melbourne 2006 Commonwealth Games 76

Part 6 ASSETS 81

Summary of State assets 83

Investments 84

Physical assets 87

Regional fast rail project 89

Part 7 LIABILITIES, COMMITMENTS AND CONTINGENCIES ____ 91
Aggregate liabilities of the State 93
Interest-bearing liabilities 95
Unfunded superannuation 97
Outstanding claims liabilities 99
Payables and other liabilities 102
Commitments 104

Index ____ 109

Part 1

Executive summary

OVERVIEW

This report sets out my examination of the *Annual Financial Report* for the State of Victoria for the year ended 30 June 2003. A clear audit opinion was provided on the 2002-03 *Annual Financial Report*.

The State's financial condition remains sound, however annual operating surpluses continue to decline, notwithstanding the strong economic activity levels in Victoria.

While there has been a 21 per cent growth in State revenues over the 5 year period 1999 to 2003, expenditure levels have increased at a greater rate, at 35 per cent. The level of expenditure is not only growing in nominal terms but in the last financial year, it increased marginally faster than the growth in the Victorian economy. Any downturn in the economic cycle and further expenditure pressures, including wage growth, beyond those anticipated will place pressures on the State's finances.

The variability in investment returns and superannuation costs highlights the State's vulnerability to movements in financial markets. While the strong property market has positively contributed to the State's operating result, the unpredictability of this market presents a risk to future State revenue levels.

The trends in the State's finances demonstrate a continuing need for vigilance by the Government to ensure that public sector activity and program levels remain sustainable in the longer-term. To this end, the ongoing imperative for the Government remains that of ensuring that the key risks to the State's finances are regularly reviewed and factored into ongoing financial planning and management.

SUMMARY OF MAJOR FINDINGS

OPERATING RESULT AND FINANCIAL CONDITION Page 21

- The State reported an operating surplus of $54 million in 2002-03 - some $553 million lower than in 2001-02.

Paras 3.3 to 3.5

- While State revenues increased by $1 420 million in the year, expenditure increased by $1 973 million.

Para 3.5

- The major sources of increased revenues in 2002-03 were taxation ($484 million) mainly reflecting the continuing impact of favourable property market conditions, investment income ($672 million), grants from the Commonwealth Government ($214 million) and revenues from fees and fines ($140 million). These positive influences were offset by reduced gas sales revenues ($340 million) and increased expenditure on employee entitlements ($701 million), workcover claims ($440 million), and general supplies and services ($506 million).

Paras 3.6 to 3.8

- Over the 5 year period 1999 to 2003, revenue levels increased by 21 per cent, while expenditure increased at a greater rate, at 35 per cent.

Paras 3.9 to 3.10

- The State's annual operating surpluses have continued to decline notwithstanding the State's strong economic activity.

Paras 3.25 to 3.36

- The financial position of the State continues to remain sound, with net assets of $52 856 million – an increase of $3 429 million since the previous year.

Paras 3.11 to 3.13

- The General Government Sector recorded an operating surplus of $236 million for 2002-03; a decrease of $37 million on the previous year and $286 million below the original budget estimate. This result is above the Government's target of maintaining a budget sector surplus of at least $100 million.

Paras 3.14 to 3.18

REVENUE

Page 39

- The operating revenues of the State in 2002-03 totalled $32 016 million, some $1 420 million (4.6 per cent) higher than 2001-02.

  Para 4.1

- The key factors contributing to the increase in State revenues in the year were higher investment earnings and increased taxation collections - in particular stamp duty on property transactions.

  Para 4.2

- Funding to the State under the new Commonwealth-State Housing Agreement (CSHA) is expected to decline in present value terms from $200.7 million in 2003-04 to $193.4 million in 2007-08 (3.6 per cent decrease). The reduced level of Commonwealth funding, in present value terms, over the period of the new CSHA may contribute to budgetary pressures on the State's public housing programs.

  Paras 4.5 to 4.11

- Under the new Australian Health Care Agreement **(**AHCA), the level of funding to be provided by the Australian Government to the State is dependent on Victoria increasing its own-source funding of public hospitals at a rate which at least matches the estimated growth of Commonwealth funding. Given the tightening financial condition of the State, the introduction of the matching conditions in the new AHCA in 2003-04 will pose budgetary challenges over the life of the new agreement.

  Paras 4.12 to 4.18

- Two of the major contributors to the increase in taxation revenue during the year were higher stamp duty collections on property transfers ($222 million), reflecting the continued strength of the property market, especially house prices; and land tax collections ($165 million) due to increases in property values, marginally offset by an increase in the threshold at which land tax is payable.

  Paras 4.19 to 4.21

- State revenues from gambling activities in 2002-03 amounted to $1 326 million, a decrease of $44 million on the previous year. This decrease is attributed to the introduction of smoking bans in gaming venues from September 2002.

  Paras 4.22 to 4.24

REVENUE - *continued* **Page 39**

- Revenue from fines totalled $376.3 million in 2002-03, an increase of $104.7 million or 39 per cent over the amount collected in the previous year.

Paras 4.32 to 4.37

- Investment revenue contributed $1 101 million to the State's operating result in 2002-03, an increase of $672 million from the previous year. The increased revenue is largely attributable to a lower level of losses incurred on equity investments and a partial re-allocation of the investment portfolio into higher yielding holdings.

Paras 4.38 to 4.46

- Government Business Enterprises, such as water bodies and public financial corporations, paid dividends of $580 million into the Consolidated Fund during 2002-03, some $174 million higher than the budget estimate for the year. These additional dividends were a major contributor to the net surplus of $236 million achieved by the General Government Sector.

Paras 4.47 to 4.53

EXPENDITURE Page 59

- The operating expenses of the State totalled $31 962 million during 2002-03, some $1 973 million (6.6 per cent) higher than in the previous year.

Paras 5.1 to 5.3

- Costs associated with employee benefits, including salaries, wages and related on-costs totalled $10 122 million in 2002-03, an increase of 7.4 per cent on the previous year.

Para 5.4

- The net additional cost in 2002-03 of major public sector industrial settlements and additional permanent staffing decisions made since 2000-01 is estimated at $1 482 million, an increase of $519 million from the previous year.

Paras 5.5 to 5.8

- The Government currently faces negotiations of a number of significant industrial agreements expiring in 2003-04. These negotiations, particularly in the health and education sectors, which represent a large proportion of the total public sector workforce, will require careful management to ensure that employment costs do not adversely impact on the State's finances.

Para 5.12

- The Government has incurred significant additional net costs above the original contractual obligations, estimated at around $196 million, under the public transport franchise arrangements. Further additional costs will be borne by the Government following the re-structuring of these arrangements.

Paras 5.35 to 5.65

- The State's contribution to the cost of hosting the Commonwealth Games in the period up to 2006 is estimated at $474 million. The State will also contribute an estimated $228 million towards Games infrastructure. These amounts do not include other costs that will be incurred by public sector agencies in staging the Games, which are to be accommodated within their existing budget allocations.

Paras 5.66 to 5.85

- An updated economic impact study on the Commonwealth Games had not been prepared since the impact study undertaken at the time of the bid in 1996.

Para 5.77

ASSETS Page 81

- The State's assets mainly comprise physical assets, receivables, cash and investments with an aggregate value of $102 218 million at 30 June 2003 - an increase of $5 103 million on the previous year.

Para 6.1

- The major factors contributing to the higher value of assets held were an increase in the value of physical assets, mainly due to revaluation adjustments and net asset additions in the year, and increased cash holdings, mainly by public financial corporations.

Paras 6.2 to 6.3

- During 2002-03, the Government approved additional capital funding of $35 million for the regional fast rail project, bringing the revised capital budget for this project to $617 million.

Paras 6.25 to 6.30

- A number of delays have been experienced in the delivery of the regional fast rail project. While the budget for this project contains a contingency sum to cover unexpected expenditures, a number of risks need to be carefully managed for the project to remain within the revised budget and timelines.

Paras 6.28 to 6.30

LIABILITIES, COMMITMENTS AND CONTINGENCIES Page 91

- The liabilities of the State totalled $49 362 million at 30 June 2003, an increase of $1 674 million on last year.

  Para 7.1

- The increase in liabilities is mainly due to higher outstanding insurance claims and increased interest-bearing liabilities resulting from a higher level of deposits lodged and the assumption of debt relating to V/Line Passenger rolling stock. This was partly offset by a reduction in payables mainly for the maturity of derivative transactions (financial instruments) and lower gas sale payables.

  Paras 7.2 to 7.5

- At 30 June 2003, the Department of Treasury and Finance estimated that aggregate losses for vehicle disposals under the Budget Sector vehicle fleet leasing arrangements, to be funded in future periods, were $57.5 million. During 2002-03, the State funded previous losses of $17.5 million for these arrangements.

  Paras 7.10 to 7.13

- The State's unfunded superannuation liability increased only marginally by $55 million in 2002-03, mainly reflecting the impact of additional Government contributions of $1 605 million off-setting the negative impact of poor investment markets on superannuation scheme earnings and asset values, and members' salary growth.

  Paras 7.14 to 7.21

- The State's net obligations under the flexible electricity tariff arrangements associated with the Portland and Point Henry aluminium smelters may be impacted by the outcome of a recent legal action initiated by an electricity market participant. The State is defending this legal challenge. An adverse outcome may lead to further claims by other parties and may have significant financial ramifications for the State.

  Paras 7.37 to 7.44

- At 30 June 2003, the State's operating, capital and other commitments totalled $15 416 million, an overall increase of $2 282 million on the previous year. The major reasons for this increase were the establishment of new contractual arrangements in the year, including those for the Spencer Street redevelopment, Berwick Community Hospital, prison facilities and various office accommodation arrangements.

  Paras 7.45 to 7.46

Part 2

Opinion on the Government's Annual Financial Report

AUDIT OF THE ANNUAL FINANCIAL REPORT FOR THE STATE OF VICTORIA

2.1 A key obligation of the Government, under the *Financial Management Act* 1994, is to annually prepare and table in Parliament a consolidated financial report for the State of Victoria, referred to as the Annual Financial Report, which must be audited by the Auditor-General.

2.2 The Annual Financial Report for the State provides comprehensive information on the operating results and financial position of the State by consolidating the financial transactions and balances of approximately 320 controlled entities. Under the Act, the Report must present fairly the financial position of the State and the Victorian General Government (Budget) Sector at the end of the financial year and the results of their operations and cashflows for the financial year, and the transactions of the Public Account, which comprise the Consolidated Fund and the Trust Fund. Consistent with the reporting requirements of the Act, the Minister for Finance has determined that the Annual Financial Report be presented in accordance with the relevant Australian Accounting Standards.

2.3 Figure 2A sets out the elements of the State of Victoria reporting entity.

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

General Government (Budget) Sector	*Public non-financial corporations*	*Public financial corporations*
Comprises government departments and bodies engaged in providing services free of charge or at prices significantly below their cost of production.	Comprises agencies which provide goods and services within a competitive market, which are non-regulatory and non-financial in nature.	Comprises agencies which 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.
Comprises 203 entities, including: • all government departments; • administrative units, such as the Office of the Chief Commissioner of Police and the Office of Public Employment; and • other entities that provide services that are mainly non-commercial in nature and are for the collective benefit of the community.	Comprises 109 entities, including: • Water sector authorities; • Australian Grand Prix Corporation; • Urban Land Corporation; and • Alpine Resort Management Boards.	Comprises 8 entities, including: • Transport Accident Commission; • Treasury Corporation of Victoria; • Victorian Funds Management Corporation; • Victorian WorkCover Authority; and • State Trustees Ltd.

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

2.4 The composition of agencies forming part of the State of Victoria economic entity remained relatively stable during 2002-03. The key changes mainly related to the establishment and/or acquisition of a number of new companies and related subsidiaries associated with the restructuring of public transport franchising.

AUDIT OPINION ON THE ANNUAL FINANCIAL REPORT

2.5 The Annual Financial Report for the financial year ended 30 June 2003 has been audited as required by the *Audit Act* 1994. My audit opinion on the Annual Financial Report, issued on 20 October 2003, reads as follows:

AUDITOR GENERAL
VICTORIA

AUDITOR-GENERAL'S REPORT

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

Matters relating to the electronic presentation of the Audited Financial Report

This audit report relates to the Annual Financial Report for the State of Victoria (excluding local government bodies and universities) for the year ended 30 June 2003 included on the Department of Treasury and Finance's web site. The Secretary to the Department of Treasury and Finance is responsible for the integrity of the Department of Treasury and Finance's web site. I have not been engaged to report on the integrity of the Department's web site. The audit report refers only to the Annual Financial Report named below. It does not provide an opinion on any other information which may have been hyperlinked to or from the Annual Financial Report. If users of this report are concerned with the inherent risks arising from electronic data communications they are advised to refer to the hard copy of the audited financial report to confirm the information included in the audited financial report presented on this web site.

Audit Scope

The accompanying Annual Financial Report for the State of Victoria (excluding local government bodies and universities) for the year ended 30 June 2003, comprising the consolidated statement of financial performance, consolidated statement of financial position, consolidated statement of cash flows and the accompanying notes contained in Chapter 2 of the Annual Financial Report, has been audited. The 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 Secretary to the Department of Treasury and Finance as required by the *Audit 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 applicable Accounting Standards and other mandatory professional reporting requirements in Australia, and the financial reporting 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 General Government (Budget) Sector and their financial performance and 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 in accordance with applicable Accounting Standards and other mandatory professional reporting requirements in Australia, and the financial reporting requirements of the *Financial Management Act* 1994, the financial position of the State of Victoria and the Victorian General Government (Budget) Sector as at 30 June 2003 and their financial performance and cash flows for the year then ended.

MELBOURNE
20 October 2003

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

Understanding the audit opinion on the Annual Financial Report

2.6 The broad purpose of my audit opinion (also known as the audit report) on the Annual Financial Report is to enhance the credibility of the information presented in that Report, relating to the financial performance, financial position and cash flows of the State. The audit report is structured to clearly explain the scope of the audit and present my opinion on the financial report.

2.7 It is important to recognise that the audit report relates only to the financial report and the related notes, which are contained in chapter 2 of the Annual Financial Report. It does not extend to the information presented in chapters 1, 3 and 4 of that Report, or in the associated appendices.

Extent or scope of the audit

2.8 The audit 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 to the Members of Parliament and the responsible Ministers.

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

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

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

Impact of materiality and audit procedures on the audit opinion

2.12 Australian Auditing Standards require that the audit work provide "reasonable assurance" that any misstatements aggregating to more than a pre-determined level of materiality will be revealed in the audit opinion. Before commencing the audit, a judgement is made based on the total revenues, expenditures, assets, liabilities and the net result as to what dollar magnitude (materiality) of misstatements in the financial report 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 of the financial report.

2.13 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. However, in order to reduce this risk to an acceptable level, detailed audit procedures are performed.

Audit opinion

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

2.15 My audit opinion on the 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 2003.

What the audit opinion does not provide

2.16 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 Annual Financial Report.

2.17 Finally, our audit work on the 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. Where significant, these will be reported to Parliament in separate reports.

MY REPORT ON THE FINANCES OF THE STATE OF VICTORIA

2.18 The Annual Financial Report is complex and serves a general accountability purpose. In preparing the Report, the Government summarises a great deal of information, including information relating to significant transactions which can substantially impact on the State's finances. In this context, my *Report on the Finances of the State of Victoria* complements the Annual Financial Report by providing an independent assessment of the financial performance and position of the State. Where considered necessary, more detailed explanations and analysis of significant transactions are also provided to assist the readers of the Annual Financial Report to better understand the State's finances and the role that these transactions have played in shaping the financial position and performance of the State for the 2002-03 financial year, and into the future.

2.19 Comments are provided in my Report on developments in financial reporting and management, together with certain observations arising from the review of the Government's estimated financial statements. My report makes recommendations, where relevant, for the more effective and efficient management of public resources, and for the keeping of proper accounts and records of the transactions relating to public resources.

ANNUAL FINANCIAL REPORT PREPARATION AND DISCLOSURES

2.20 In this part of the report, we comment on the Annual Financial Report preparation process and the quality of disclosures therein. The compilation of the Annual Financial Report is a complex process involving the electronic collation of financial and non-financial data from approximately 320 reporting entities. The necessary data for these entities is required to be submitted to the Department of Treasury and Finance (DTF), as the central agency responsible for the preparation of the Annual Financial Report, within 8 weeks of the end of the financial year through an internet-based data exchange facility.

2.21 The timely completion of the Annual Financial Report is, therefore, dependent on the timely completion of the financial reports of all these agencies. In preparing the Annual Financial Report, particular focus is placed on around 45 material entities, which account for over 95 per cent of the transactions and balances of the State.

2.22 In 2002-03, we found the processes within DTF associated with the consolidation of entity information and the preparation of the Annual Financial Report to be generally sound. However, a significant number of the material entities experienced substantial delays in finalising their 2002-03 financial reports (including 7 departments), which impacted on the timeliness and accuracy of the information provided to DTF and, consequently, the timely completion of the Annual Financial Report.

2.23 The delays in the completion of departmental financial reports and the finalisation of information provided to DTF were mainly attributed to:

- delays in the implementation of machinery of government changes which took effect from 1 January 2003, with certain issues such as the transfer values of assets and liabilities between departments remaining unresolved until October 2003;
- non-finalisation until early September 2003 of the appropriation certification process, which confirms the major revenue source for departments;
- certain asset valuations and actuarial assessments not finalised in a timely manner;
- complexities associated with public transport developments within the infrastructure sector; and
- certain departments appeared unaware of specific details and disclosure requirements concerning major lease arrangements.

2.24 While delays were experienced by a number of material agencies, there was a significant improvement in the timeliness of completion of financial statements across the broader public sector groups for 2002-03.

2.25 **It is important that DTF, in close liaison with the departments, other public sector agencies and my Office, continue to explore avenues that will result in a more efficient and timely financial reporting process.**

Quality of disclosures within the Annual Financial Report

2.26 Since the inaugural Annual Financial Report in 1996-97, there has been a focus by both DTF and my Office on the continuous improvement of the presentation and disclosures of the Report. Consistent with this focus, further minor changes were made during 2002-03 and, in my opinion, the document is of a high standard.

2.27 However, a number of opportunities remain to enhance the quality of the information contained in the Annual Financial Report. These mainly relate to:

Improved disclosures

- *Restricted assets of the State* - Restrictions may be imposed on the manner in which government agencies can utilise certain assets under their control. Examples of restricted assets include heritage assets, cultural assets, parkland and infrastructure assets relating to such things as roads, schools, public hospitals, police stations and courts. Restricted assets are currently not separately identified in the Annual Financial Report. To assist users in better understanding the extent of these types of assets, consideration should be given to their separate disclosure in the notes to the Annual Financial Report.
- *Insurance claims expense* – These expenses represent a major component of State expenditure and are currently not separately identified in the Annual Financial Report. Given their significance, and their impact on the reported results for the State, insurance claims expenses should be separately disclosed in the notes to the Annual Financial Report.
- *Trust Fund operations* – Trust Fund operations form a substantial element of the Public Account, with related expenditures not forming part of the parliamentary appropriation process. As highlighted in my April 2003 *Report on Parliamentary Control and Management of Appropriations*, there is scope for improved disclosures of the transactions and balances of the Trust Fund, including major trust accounts, within the Annual Financial Report.

Recognition of State assets

- *Murray-Darling Basin Commission* - Under the provisions of the Murray-Darling Basin Agreement, the State, together with a number of other jurisdictions, is required to contribute funds towards the activities of the Murray-Darling Basin Commission. However, the State does not recognise its interest in the Commission's assets as the value of these assets could not be reliably determined due to the Commission's major assets not being valued. The valuation and recognition of the State's interest in the Commission's assets would enhance the comprehensiveness of information provided in the Annual Financial Report.

2.28 **We will continue to work closely with the Department of Treasury and Finance in the coming year to further improve the quality of disclosures of the Annual Financial Report.**

Harmonisation of accounting standards

2.29 Over the past 18 months, there have been 2 significant developments in, and proposals to reform, the future direction of financial reporting in Australia which will impact on the public sector.

2.30 The Financial Reporting Council, which is responsible for the broad oversight of the accounting standard setting process in Australia, announced in December 2002 that the Australian Accounting Standards Board (AASB) would pursue the harmonisation of the Government Finance Statistics (GFS) and the Australian Generally Accepted Accounting Principles (GAAP) reporting frameworks. The differences between GFS and GAAP can yield quite different reporting outcomes in terms of operating results and government sector net worth.

2.31 The objective of the convergence process is to develop an Australian Accounting Standard for a single set of Government reports which will be comparable between jurisdictions and in which the outcome statements will be directly comparable with the relevant budget statements. The AASB has advised its intention to issue an accounting standard exposure draft in May 2004 reflecting the convergence process.

2.32 The other major development occurred in July 2002 when the Financial Reporting Council announced that the AASB would work towards adoption of international accounting standards for reporting periods commencing on or after 1 January 2005.

2.33 While the AASB will continue to issue Australian Accounting Standards, its approach will be to formulate Australian equivalents of international accounting standards by adopting the content and wording of the International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB). The new standards are intended to be sector neutral and will, therefore, apply to all reporting entities (i.e. both the public and private sector). They will, therefore, incorporate the standards issued by the public sector committee of the International Federation of Accountants Committee. The AASB will retain or develop additional standards when required to cater for purely domestic issues.

2.34 The adoption and the harmonisation of GFS and GAAP have wide-ranging implications for reporting by the public sector agencies and whole-of-government reporting. DTF has established a project team with responsibility for the identification of significant issues arising from these changes and the development of appropriate communication and implementation strategies.

2.35 **It is our intention to work closely with DTF and all public sector agencies in facilitating the effective implementation of the major accounting changes ahead.**

Part 3

Operating result and financial condition

SUMMARY OF OPERATING RESULT AND FINANCIAL POSITION

3.1 The Annual Financial Report for the State of Victoria discloses the financial outcomes for the 2002-03 financial year on 3 levels, namely:

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

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

State of Victoria

Operating result

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

3.4 Figure 3A presents a summary of the operating result achieved by the State for the financial year ended 30 June 2003, as disclosed in the Annual Financial Report.

FIGURE 3A
STATE OF VICTORIA, OPERATING RESULT
($million)

Item	***2002-03***	*2001-02*	*Movement*
Revenues	**32 016**	30 596	1 420
Expenses	**31 962**	29 989	1 973
Operating surplus for the year	**54**	607	**(553)**

3.5 **The State achieved an operating surplus of $54 million in 2002-03 - some $553 million lower than the result achieved in 2001-02. While State revenues increased by $1 420 million in the year, expenditure increased at a higher rate, or $1 973 million.**

3.6 The major sources of increased revenues were taxation ($484 million) mainly reflecting the continuing impact of favourable property market conditions, investment income ($672 million), grants from the Commonwealth Government ($214 million) and revenues from fees and fines ($140 million).

3.7 These positive influences were offset by reduced gas sales revenues resulting from the introduction of retail gas contestability ($340 million) and increased expenditure on employee entitlements ($701 million), WorkCover claims ($440 million) and general supplies and services ($506 million).

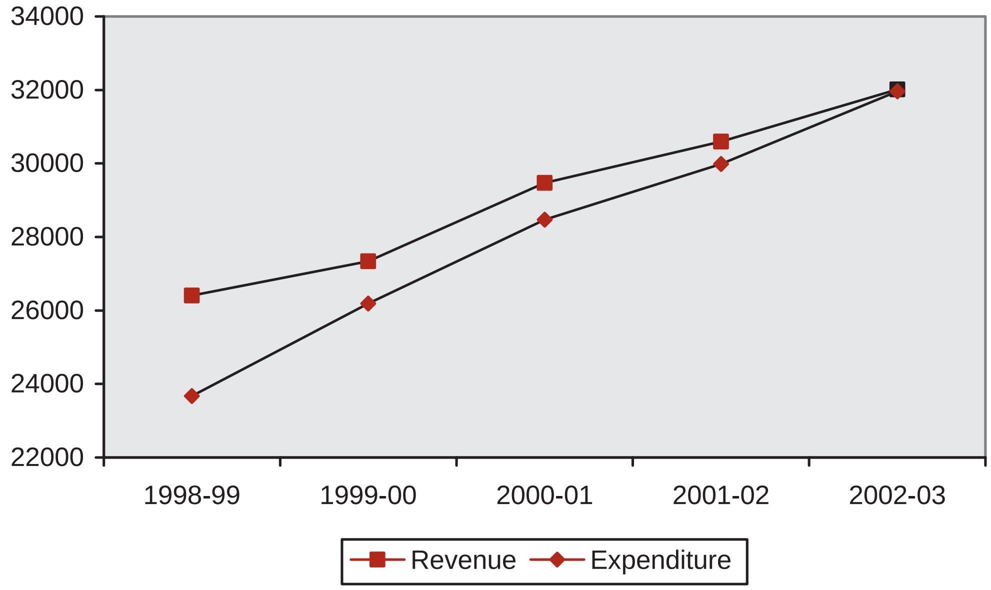
3.8 Figure 3B outlines the contribution of each of the key factors to the reduction in the operating surplus compared with the previous year.

FIGURE 3B
CHANGES IN FINANCIAL PERFORMANCE SINCE THE PREVIOUS YEAR

Item	*Major contributing factors*	*$million*
Revenue changes -		
Taxation	Increased conveyancing duty revenue	222
	Increased land tax revenue	173
	Increased insurance levies revenue	103
	Decreased gambling revenue	(44)
	Other net movements	46
Investment revenue	Lower level of losses incurred on equity investments	672
Fines and Fees	Impact of road safety package initiatives	140
Grants	Increased Commonwealth grants for health and non-government schools	187
	Other net movements	27
Sales of goods and services	Decreased gas sales revenue	(340)
	Increased Transport Accident Commission and Victorian WorkCover Authority premium revenue	83
	Spencer Street Station commercial development payment	66
	Other net movements	90
Loss on disposal of physical assets	Mainly due to the transfer of responsibility for City Link assets to the City Link operator	(228)
Other revenue	Settlement of public transport franchise performance bonds	135
	Increased smelter levy receivables from electricity distributors	103
	Other net movements	(15)
		1 420
Less		
Expenditure changes -		
Employee benefits	Increase mainly due to the additional cost of major public sector industrial settlements and higher staffing levels	701
Supplies and services	Mainly due to -	
	Higher WorkCover claims expenditure	440
	Increased hospital service provider payments	151
	Additional fire suppression activities associated with bushfires	114
	Litigation and disputation settlements	78
	Costs associated with wind-up of Latrobe Hospital Pty Ltd	61
	Other net movements	102
Depreciation	Impact of asset acquisitions and upward asset revaluations	108
Other expenses	Miscellaneous net movements	218
		(1 973)
Change in net result		**(553)**

3.9 My previous reports on the State's finances have drawn attention to a number of emerging cost pressures (such as wage growth) and revenue vulnerabilities (such as property and investment market volatility) which require careful management to ensure the sustainability of the State's overall financial position. **Figure 3C shows that while there has been a 21 per cent growth in revenue over the 5 year period 1989-99 to 2002-03, expenditure has increased at a greater rate, at 35 per cent.**

FIGURE 3C
STATE REVENUE/EXPENDITURE ANALYSIS
($million)



		1998-99	*1999-00*	*2000-01*	*2001-02*	*2002-03*
Revenue	($m)	26 406	27 340	29 474	30 596	32 016
Expenditure	($m)	23 673	26 190	28 471	29 989	31 962

3.10 **The trend over the past 5 years demonstrates a continuing need for management strategies by the Government to ensure that public sector activity and program levels remain sustainable in the longer-term.**

Financial position

3.11 The Statement of Financial Position discloses information on the level and composition of assets and liabilities held by the State as at 30 June 2003. Figure 3D presents a summary of the State's financial position.

FIGURE 3D
STATE OF VICTORIA, FINANCIAL POSITION, AT 30 JUNE
($million)

Item	***2002-03***	*2001-02*	*Movement*
Assets	**102 218**	97 115	5 103
Liabilities	**49 362**	47 688	1 674
Net assets	**52 856**	49 427	**3 429**

3.12 **The financial position of the State of Victoria continues to remain sound, with net assets of $52 856 million – an increase of $3 429 million since the previous year.**

3.13 Overall, the State's assets have increased by $5 103 million, mainly attributable to revaluation adjustments ($3 553 million) and net additions to physical assets ($1 399 million). These increases were partially offset by a higher level of outstanding insurance claims liabilities ($1 287 million) and interest-bearing liabilities ($824 million). Figure 3E shows the key movements since the previous year.

FIGURE 3E
CHANGES IN FINANCIAL POSITION SINCE THE PREVIOUS YEAR

Item	*Major contributing factors*	*$million*
Asset changes -		
Physical assets	Revaluations in the year	3 553
	Net asset additions	3 019
	Depreciation/amortisation in the year	(1 620)
Receivables	Decrease mainly due to the maturity of derivatives and reduced gas revenue receivables	(859)
Cash assets	Increase in cash deposits held	741
Other asset movements		269
		5 103
Liability changes -		
Interest-bearing liabilities	Increase mainly due to the assumption of V/Line Passenger new rolling stock debt and a higher level of third party deposits lodged	(824)
Payables	Decrease due to lower gas sale payables and the maturity of derivatives	958
Outstanding insurance claims	Increase attributable to higher claims combined with the impact of adjustments to actuarial assumptions and the recognition, for the first time, of certain health sector claims incurred but not reported	(1 287)
Employee benefits	Increase mainly due to the impact of wage growth	(263)
Other liability movements		(257)
		1 673
Change in net assets		**3 430**

General Government Sector

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

Operating result

3.15 A summary of the operating result for the General Government Sector for the year ended 30 June 2003, as disclosed in the Annual Financial Report, is presented in Figure 3F.

FIGURE 3F
VICTORIAN GENERAL GOVERNMENT SECTOR, OPERATING RESULT
($million)

Item	*2002-03 Estimate*	***2002-03 Actual***	*2001-02 Actual*
Revenues	25 282	**26 631**	25 363
Expenses	*(a)* 24 760	**26 395**	25 090
Operating surplus for the year	**522**	**236**	273

(a) Budget Estimates included $257 million for housing, water and roads capital spending. Due to changes in accounting treatment, spending on these items was treated not as part of expenses but as contributed capital.

3.16 **The Consolidated Statement of Financial Performance discloses that the General Government Sector achieved an operating surplus of $236 million for the 2002-03 financial year - a decrease of $37 million on the previous year.** This result is above the Government's target of maintaining a budget sector surplus of at least $100 million.

3.17 The General Government Sector result for the year was $286 million below the original budget estimate mainly due to higher:

- superannuation costs ($899 million);
- employee benefits ($501 million);
- supplies and services ($166 million); and
- other expenditure ($128 million).

3.18 These increases were offset by increased revenues from:

- taxation ($548 million);
- investments ($144 million);
- Commonwealth grants ($350 million);
- dividends from Government business enterprises ($174 million); and
- other sources ($217 million).

Financial position

3.19 Figure 3G presents a summary of the financial position of the General Government Sector as at 30 June 2003.

FIGURE 3G
VICTORIAN GENERAL GOVERNMENT SECTOR, FINANCIAL POSITION
($million)

Item	*2002-03 Estimate*	***2002-03 Actual***	*2001-02 Actual*
Assets	44 931	**48 742**	46 503
Liabilities	23 821	**25 134**	24 658
Net assets	**21 110**	**23 608**	21 845

3.20 The net assets of the General Government Sector at 30 June 2003 were $2 498 million higher than initially forecast in the Budget Papers. The key factors contributing to this outcome were higher than expected physical asset balances ($3 811 million) mainly due to revaluation, cash and investment balances ($607 million), and receivables ($324 million). These movements were offset by higher than anticipated unfunded superannuation liabilities ($676 million) and payables ($512 million).

The Public Account

3.21 The Public Account is the Government's central bank account. It records the transactions 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. Money can only be appropriated and issued from the Consolidated Fund by standing authority (Special Appropriation) or annually through annual Appropriation Acts (Annual Appropriation).

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

3.23 Figure 3H shows the Consolidated Fund cash flows for the year (prior to borrowing transactions).

FIGURE 3H
CONSOLIDATED FUND CASH RESULT FOR THE FINANCIAL YEAR
($million)

Item	***2002-03***	*2001-02*	*Movement*
Receipts -			
Operating activities	**23 361**	22 188	1 173
Investing and financing activities	**84**	134	(50)
Total receipts, excluding borrowing transactions	**23 445**	22 322	1 123
Less – Payments (operating and capital transactions) -			
Special Appropriations	**3 180**	2 003	1 177
Annual Appropriations	**21 082**	19 192	1 890
Total payments, excluding borrowing transactions	**24 262**	21 195	3 067
Overall Consolidated Fund deficit for year, excluding borrowing transactions	**(817)**	1 127	(1 944)
Borrowing repayments	*(a)* -	*(a)* -	-
Cash deficit for the year	**(817)**	1 127	(1 944)

(a) Borrowing repayments during 2002-03 totalled $695 000 (2001-02, $638 000).

3.24 **The figure discloses that the Consolidated Fund had a cash deficit of $817 million for 2002-03, compared with a surplus of $1 127 million in the prior year.** The negative movement in the year was mainly due to additional contributions of $1 355 million made by the Government towards the reduction of unfunded superannuation liabilities, combined with a general growth in departmental expenditures.

KEY INDICATORS OF THE STATE'S FINANCIAL CONDITION

3.25 Over many years, we have provided independent assessments to Parliament of the State's financial condition, as measured by a number of key indicators which seek to express aspects of financial sustainability, vulnerability and flexibility. These terms can be broadly defined as follows:

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

3.26 Below we present an analysis of the State's financial condition, reflecting the position of the Government over a 5 year period to 30 June 2003. The analysis[1] draws on the financial indicators provided below. We have re-assessed the indicators used in previous years and have modified the basket of indicators to ensure that our analysis is better able to capture the key drivers which impact on the State's financial condition.

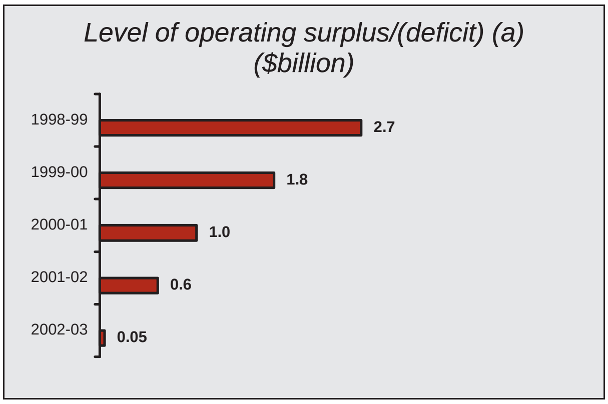
3.27 The analysis provides a useful insight into the Government's finances and aims to assist Members of Parliament and the community to better understand and interpret the financial information contained in the State's Annual Financial Report.

3.28 While the unaudited part of the Annual Financial Report includes a range of indicators of financial condition, limited commentary and assessment is provided to help interpret the indicators included. **Accordingly, we recommend that the Government provide further supporting analysis specifically in relation to the indicators included to assist in informing Parliament and taxpayers of the State's finances and condition, and trends therein.**

[1] All data used in the analysis is sourced from the audited Annual Financial Reports, except for Victoria's Gross State Product (GSP), which is sourced from the Australian Bureau of Statistics for financial years up to 2001-02. Estimates of the Gross State Product for the 2002-03 financial year are sourced from the Victorian Department of Treasury and Finance.

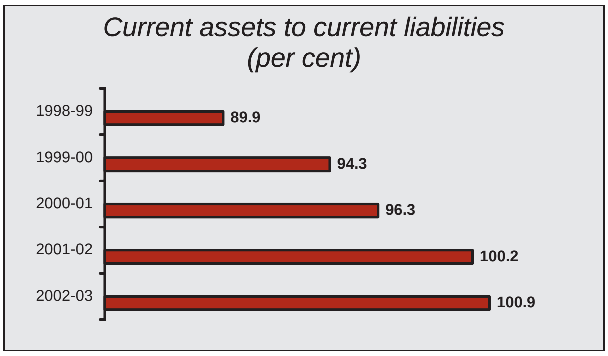
Sustainability

3.29 **Indicators of financial sustainability seek to express whether the Government's capacity to maintain existing programs and operations, and pay creditors without increasing the debt burden on the State, has improved or deteriorated over the period of the assessment**. We have utilised the following 4 indicators for this assessment:

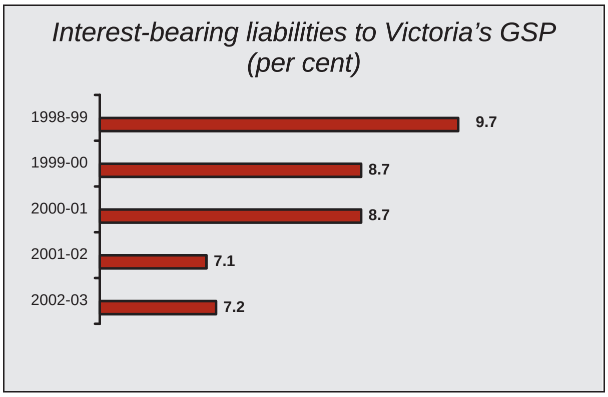


(a) Figures relating to periods prior to 2000-01 do not include abnormal items, which in the main relate to the impact of privatisations.

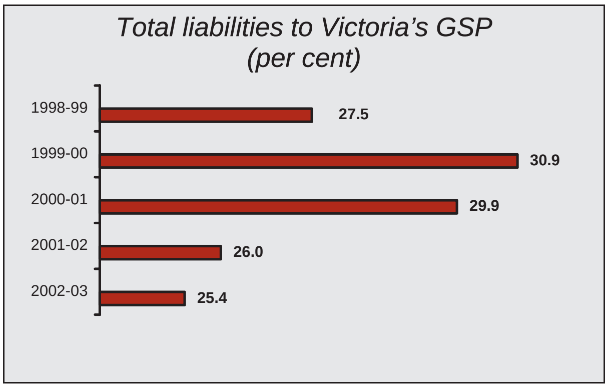
The annual surplus or deficit is an indicator of whether the Government has managed annual operating expenditures to levels supported by State revenues. This indicator shows that the State has achieved operating surpluses over the past 5 years, however, the level of such surpluses has declined over this period. The key factors impacting on the 2002-03 result are outlined earlier in this part of the Report.



Current assets to current liabilities (generally known as the working capital ratio) measures the ability of the State to meet its short-term obligations. The State's working capital ratio has improved over the 5 year period, with current assets now sufficient to meet current liabilities.



The ratio of interest-bearing liabilities to GSP measures the level of debt relative to the size of the State's economy. While the State has not substantially altered its interest-bearing debt levels over the past 5 years, GSP has grown significantly and, as a result, the ratio of State debt to GSP has improved. In 2002-03, there was a marginal reversal of this trend, mainly attributable to the assumption by the State of debt associated with public transport restructuring and higher third party deposits lodged with the Treasury Corporation of Victoria for investment purposes.



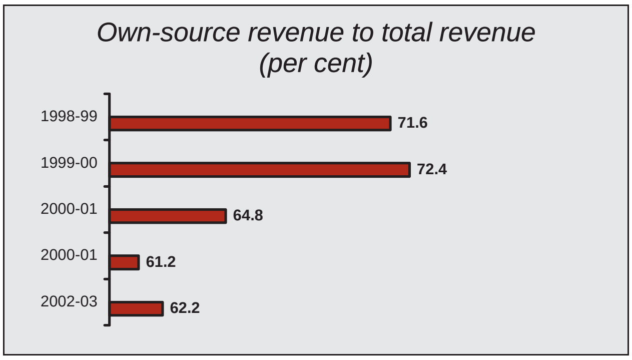
The ratio of total liabilities to GSP measures the level of State liabilities relative to the size of the economy. The marginal improvement in this ratio in 2002-03 mainly reflects the GSP growth being at a higher rate than the growth in the State's total liabilities.

Conclusion on sustainability

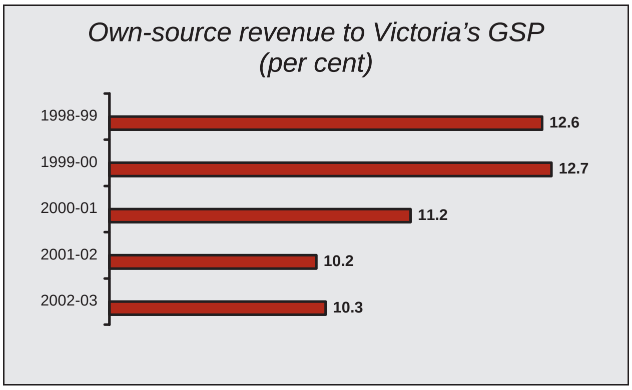
3.30 **The level of State liabilities relative to the size of the Victorian economy has remained generally stable, together with the State's capacity to meet its short-term obligations. However, the annual operating surpluses have continued to decline, notwithstanding the State's strong economic activity. Accordingly, any downturn in the economic cycle and further expenditure pressures, including wage growth, beyond those anticipated, will place pressures on the State's finances.**

Flexibility

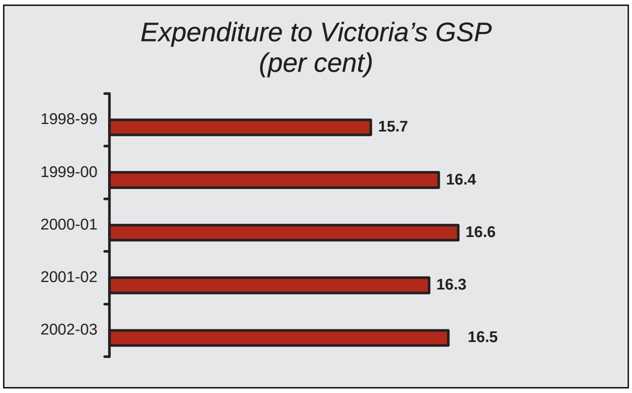
3.31 Indicators of financial flexibility seek to assess whether the Government's capacity to increase its financial resources to respond to rising commitments, by either expanding its revenues or increasing its debt burden, has improved or deteriorated over the period of assessment. We have used the following 5 indicators for this assessment:



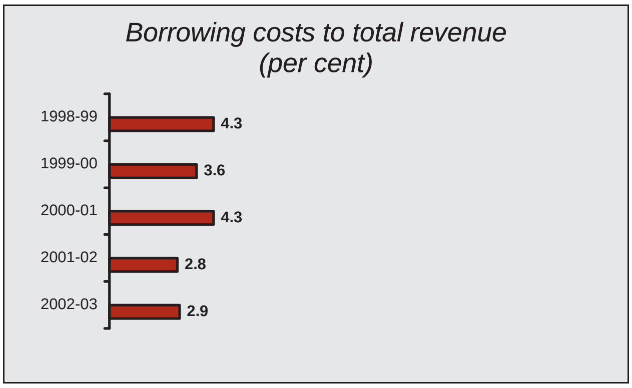
Own-source revenue represents total State revenues, excluding grants provided to the State. In recent years, own-source revenue has decreased due to the introduction in 2000-01 of National Tax Reforms, which required States and Territories to abolish a number of taxes, which were replaced by Commonwealth grants, thereby reducing the flexibility in raising own-source revenues. The reversal of the trend in this ratio in 2002-03 was largely attributable to strong growth in property - related transactions and one-off revenue items.



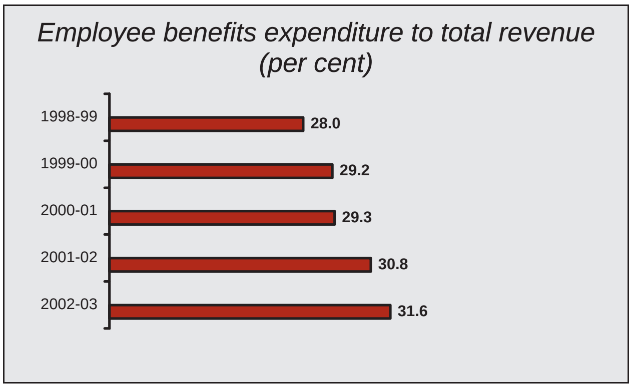
The ratio of own-source revenue to GSP is a measure of the economy's capacity to withstand increased State taxes and charges. As the ratio increases, the Government's flexibility decreases, due to the increasing impact of such raising on the community. Overall, this ratio has decreased over the past 5 years largely as a result of the impact of the National Tax Reforms. The marginal reversal of this trend in 2002-03 was largely attributable to strong growth in property-related transactions, in particular, stamp duty on conveyancing and one-off revenue items.



The ratio of expenditure to GSP highlights the relationship between State expenditure levels and the size of the economy. The State has experienced strong economic growth in recent years. In 2001-02, the Victorian economy grew at a marginally faster rate than State expenditure, however in 2002-03 this trend was reversed.



The ratio of borrowing costs to total revenue measures the proportion of revenues consumed by interest costs. The more the Government pays in interest costs on its debt, the less funds it has available to support its programs. As debt levels have remained relatively stable in recent years so have borrowing costs. This has occurred in an environment influenced by growth in total revenues and a period of low interest rates.



The ratio of employee benefits expenditure to total revenue measures the proportion of revenues consumed by employee-related costs. The substantial increase in this ratio over the past 5 years reflects the impact of government policy decisions to increase service delivery in key portfolios, plus the impact of industrial settlements.

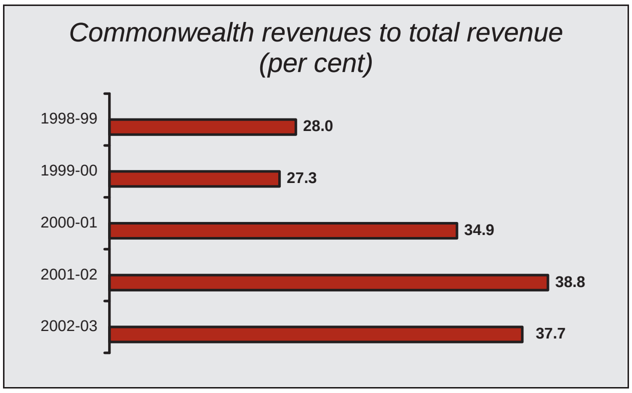
Conclusion on flexibility

3.32 **In 2002-03, the Government's flexibility to respond to future opportunities requiring increased financial resources has, on balance, been maintained. However, the level of Government expenditure is not only growing in nominal terms but, in the last financial year, it increased at a marginally faster rate than the growth in the Victorian economy.**

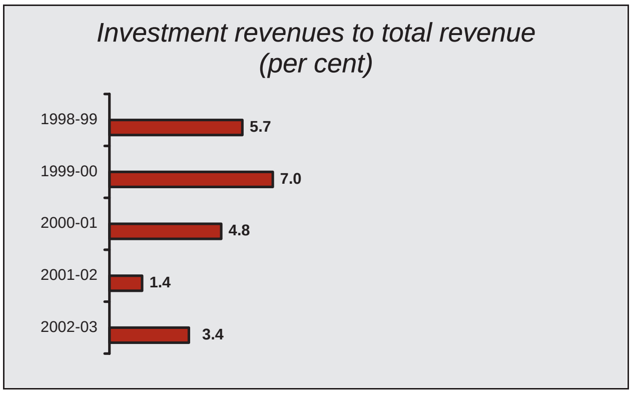
3.33 **This growth in expenditure, to some extent, reflects the impact of Government decisions to increase service delivery in key areas, such as health, education and community safety, and the impact of industrial settlements.**

Vulnerability

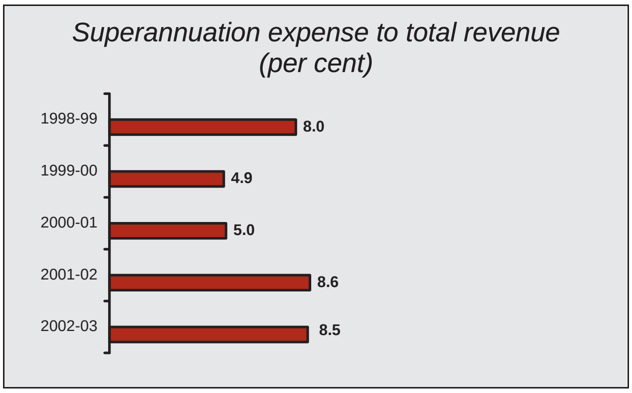
3.34 **Indicators of vulnerability seek to assess the Government's dependency on, and therefore vulnerability to, sources of funding outside its control or influence, both domestic and international.** We have utilised the following 4 indicators for this assessment:



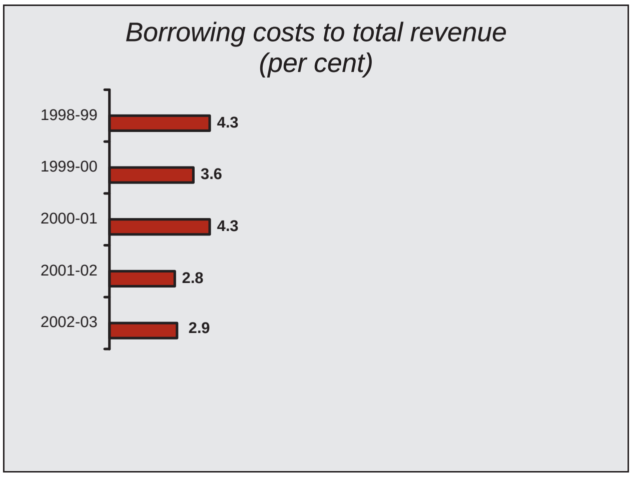
The ratio of Commonwealth revenue to total revenues highlights the dependency of the Government on Commonwealth funding. This ratio has increased over the 5 year period largely due to the impact of the National Tax Reforms, which required the State to abolish some of its own-source taxes in return for increased Commonwealth funding. The reversal of this trend in 2002-03 is largely attributable to strong growth in property-related transactions and one-off revenue items.



The ratio of investment revenues to total revenues highlights the extent to which the State relies on investment income which, to an extent, is influenced by external market conditions. The ratio has declined over the past 5 years, with the most significant decline occurring in 2001-02 mainly due to a downturn in equity markets. However, during 2002-03 equity markets strengthened, contributing to higher equity returns during the year.



Superannuation expense as a ratio to total revenue measures the proportion of State revenues consumed by superannuation costs. Such expenses are in part influenced by economic and investment market conditions, and contribution requirements set by the Commonwealth Government. The increase in such expenses in recent years mainly reflects the impact of a decline in the value of superannuation fund investments, due to the impact of equity markets which, in turn, has impacted on the net liabilities of the superannuation funds and the costs to the State.



The ratio of borrowing costs to total revenue measures the proportion of revenues consumed by interest costs. The more the Government pays in interest costs on its debt, the less funds it has available to support its programs. The cost of debt, to an extent, is influenced by external financial market conditions. As debt levels have remained relatively stable in recent years so have borrowing costs. This has occurred in an environment influenced by growth in total revenues and a period of low interest rates.

Conclusion on vulnerability

3.35 **The variability in investment returns and superannuation costs highlights the State's vulnerability to movements in financial markets. In addition, while the strong property market has positively contributed to the State's operating result, the unpredictability of this market presents a risk to future State revenue levels.**

3.36 **While these risks have been considered as part of the Government's budgetary processes, there is a continuing need for vigilance by the Government to ensure any adverse impacts are effectively managed so that public sector activity and program levels remain sustainable in the longer-term.**

RESPONSE *provided by Minister for Finance and Treasurer*

General comments

The financial performance and position of the State of Victoria continues to remain strong. This is evidenced by the significant surplus results in the General Government (Budget) Sector and the State of Victoria for the 2002-03 financial year.

The Government has a strong commitment to a sound financial strategy, through delivering on its long and short term financial objectives, including maintaining a substantial budget operating surplus and delivery of world class infrastructure to maximise economic, social and environmental benefits for Victorians.

The strong financial result was achieved despite total expenses being heavily influenced by poor returns on investment markets particularly in relation to assets held by the superannuation funds ($764 million) and a reduction in revenue as a result of retail gas contestability ($347 million).

The State Budget is formulated to take into account economic risks and pressures. Policy decisions are made in the context of a managed and balanced risk strategy. The Government will continue to meet its key performance objective to maintain a minimum $100 million surplus, together with the principles of pursuing expenditure and taxation policies that allow reasonable stability and predictability in tax burden levels.

***RESPONSE** provided by Minister for Finance and Treasurer - continued*

Sustainability (para. 3.29)

The disclosure of the Level of operating surplus/(deficit) does not provide a reasonable analysis for the reasons of the movement in the State's financial results over time. The Report does not provide adequate information on the components of the measures, in particular, the influence of factors that impact on the operating result which are outside the control of the Government (primarily movements in investment markets).

Key Indicators of the State's Financial Position (paras 3.25 to 3.36)

State Governments have no influence over movements in domestic and world equity markets, or interest rates which affect returns on fixed interest investments. The returns on superannuation funds and other financial assets are volatile in the short-term.

To assist in determining performance, the Government has developed the standardised operating surplus, which excludes the difference between the actual rates of return and the expected rates of return on superannuation fund and other financial assets. This alternate surplus measure excludes the volatility of financial asset swings, and in this respect differs from the AAS 31 surplus as presented in the Report.

The standardised operating surplus is another measure of the operating result which removes both the 'down-side' and 'up-side' associated with the volatility of financial asset returns. For example, when there is strong equity price growth, the actual return on financial assets would be greater than expected and the AAS 31 operating surplus would increase. This increase, however, would not be reflected in the standardised operating surplus measure.

GENERAL GOVERNMENT SECTOR STANDARDISED OPERATING SURPLUS
($million)

	1998-99	*1999-00*	*2000-01*	*2001-02*	*2002-02*
Operating surplus	1 806	1 167	1 216	273	236
Standardised operating surplus	1 598	649	1 164	1 263	1 040

Source: Department of Treasury and Finance.

As the table illustrates, excluding the volatility of financial asset returns strengthens the Government's financial accountability, as it provides an additional measure of the State's fiscal performance which assists in analysing the sustainability of the State's financial position.

Removing the effect of actual returns on financial assets relative to expected returns is also broadly consistent with the approach underlying the Government Finance Statistics (GFS) framework of the Australian Bureau of Statistics.

Sustainability (para. 3.30), Flexibility (paras 3.32 to 3.33) and Vulnerability (paras 3.35 to 3.36)

The Government does not agree with the revised selection of measures (graphs) used to assess the State's Sustainability, Flexibility and Vulnerability. The measures selected in the Report have been significantly changed from those used in previous Reports and therefore does not allow for a comparable assessment of the State's financial performance and position. The scale used in the graphs should also be consistent for each measure and should also be disclosed. The absence of similar comparative data (six-year) to previous Reports also makes for limited comparison and therefore usability of the information by readers.

Part 4

Revenue

SUMMARY OF STATE REVENUES

State's operating result ($million)	***2002-03***	*2001-02*	*Movement*
Revenues	**32 016**	30 596	1 420
Expenses	**31 962**	29 989	1 973
Operating result	**54**	607	(553)

4.1 **The operating revenues of the State in 2002-03 totalled $32 016 million, some $1 420 million (4.6 per cent) higher than 2001-02.**

AT A GLANCE

			Movement	
State revenues ($million)	***2002-03***	*2001-02*	*Amount*	*%*
Grants	**12 088**	11 874	214	1.8
Taxation	**9 275**	8 792	483	5.5
Sale of goods and services	**7 822**	7 880	(58)	(0.7)
Investment revenue	**1 101**	429	672	156.6
Other revenue	**1 730**	1 621	109	6.7
Operating revenue	**32 016**	30 596	1 420	4.6

4.2 The key factors contributing to the increase in State revenues in the year were improved investment returns and increased taxation collections, in particular, stamp duty on property transactions.

GRANT REVENUES

State revenues	2002-03	2001-02	Movement
Grants ($million)	**12 088**	11 874	214

4.3 Grant revenues mainly represent Commonwealth funding provided to the State and account for 38 per cent of total State revenues. In 2002-03, grants received by the State increased by $214 million, mainly as a result of growth and indexation factors associated with the Commonwealth-State Health Care Agreement and an increase in grants for non-government schools. General purpose grants remained generally consistent with the prior year ($6 774 million).

4.4 Of the grants received in the year, $5 314 million (44 per cent) were provided for specific purposes. Two of the major specific purpose funding agreements impacting on the financial outcomes for current and forward years include the Commonwealth–State Housing Agreement and the Commonwealth–State Health Care Agreement.

Commonwealth-State Housing Agreement

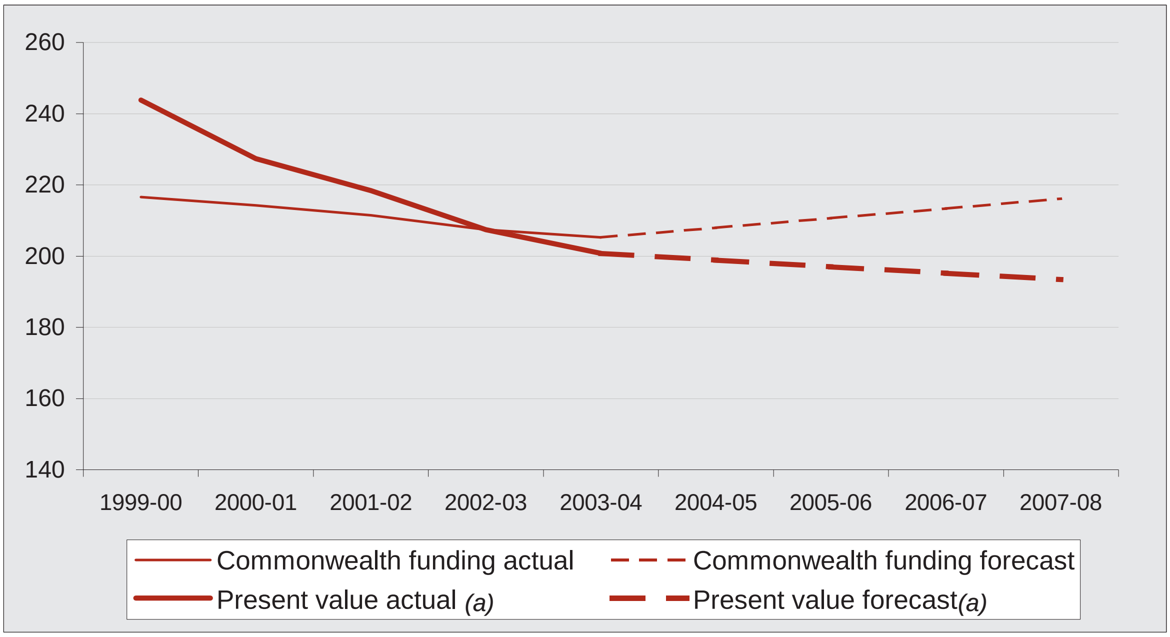
4.5 Under the Commonwealth-State Housing Agreement (CSHA), the State receives grants from the Commonwealth Government for public housing assistance.

4.6 In August 2003, the Commonwealth and the State entered into a new CSHA, covering the 5 year period from 1 July 2003 to 30 June 2008. The new CSHA follows the previous agreement which expired on 30 June 2003.

4.7 During 2002-03, Victoria received total housing assistance grants of $207.4 million from the Commonwealth, some $4 million less than the prior year. In accordance with the funding arrangements established under the new CSHA, the State will receive $205.2 million in 2003-04, a marginal decrease of $2.2 million.

4.8 Figure 4A reports grants received by the State under the previous CSHA and the estimated funding agreed with the Commonwealth under the new CSHA, in nominal and constant 2002-03 (present value) dollars.

FIGURE 4A
TRENDS IN COMMONWEALTH GOVERNMENT FUNDING (STATE HOUSING GRANTS)
($million)



(a) CPI annual average, Melbourne (in 2002-03 dollars).
Source: Department of Human Services – Housing Division.

Commonwealth funding	*Actual*				*Forecast*				
	1999-00	*2000-01*	*2001-02*	*2002-03*	*2003-04*	*2004-05*	*2005-06*	*2006-07*	*2007-08*
Nominal value ($million)	216.6	214.2	211.5	207.4	205.2	207.9	210.6	213.4	216.1
Present value ($million)	243.84	227.4	218.4	207.4	200.7	198.9	197.0	195.2	193.4

4.9 Figure 4A shows that, expressed in constant 2002-03 dollars, funding to the State under the CSHA has declined by 15 per cent over the past 4 years.

4.10 Under the terms of the new CSHA, the State expects to receive funding increases in nominal terms each year primarily because Commonwealth financial assistance will be indexed in line with wage cost movements from 2004-05. However, as illustrated above, funding is expected to decline in present value terms from $200.7 million in 2003-04 to $193.4 million in 2007-08 (3.6 per cent decrease). The previous CSHA provided an additional amount of $15 million annually to the State as compensation for the introduction of the goods and services tax (GST). Under the new CSHA, compensation for GST will no longer be provided.

4.11 **The reduced level of Commonwealth funding, in present value terms, over the period of the new CSHA may contribute to budgetary pressures for the State's public housing programs.**

Commonwealth-State Health Care Agreement

4.12 Australian Health Care Agreements (AHCA) establish the basis and value of funding to be received by the State from the Commonwealth Government for health programs. Commonwealth financial assistance is provided in the form of annual Health Care Grants determined after applying set formulae established in the AHCA.

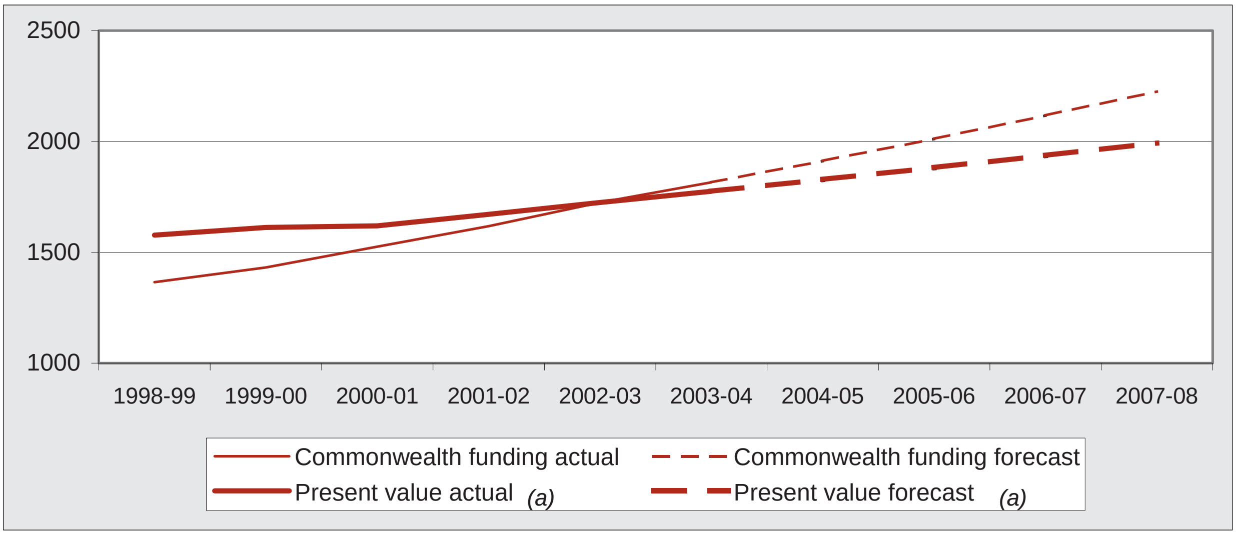
4.13 Following the completion of the previous AHCA in 2002-03, the Commonwealth and all State and Territory Governments entered into a new AHCA in August 2003, which became effective as from 1 July 2003 and will continue until 30 June 2008.

4.14 In 2002-03, Victoria received total health care grants of $1 725 million, an increase of $107 million over the prior year. In accordance with the funding arrangements established under the new AHCA, the State is to receive $1 815 million in 2003-04, an increase of $90 million or 5 per cent on the previous period.

4.15 Under the new AHCA, the level of funding to be provided to the State is dependent on certain conditions being met, including a requirement for Victoria to increase its own-source funding of public hospitals at a rate which at least matches the estimated growth of Commonwealth funding, and to meet agreed performance targets.

4.16 Figure 4B details the amounts received by the State under the previous AHCA and the estimated funding agreed with the Commonwealth under the new AHCA, in nominal and constant 2002-03 dollars.

FIGURE 4B
TREND IN COMMONWEALTH GOVERNMENT HEALTH CARE GRANTS
($million)



(a) CPI annual average, Melbourne (in 2002-03 dollars).
Source: Department of Human Services.

Common-wealth funding	*Actual*					*Forecast*				
	1998-99	*1999-00*	*2000-01*	*2001-02*	*2002-03*	*2003-04*	*2004-05*	*2005-06*	*2006-07*	*2007-08*
Nominal value ($m)	1 365.3	1 431.5	1 525.2	1 617.6	1 724.5	1 815.4	1 912.8	2 012.6	2 117.0	2 226.4
Present value ($m)	1 576.9	1 611.9	1 619.7	1 671.0	1 724.5	1 775.5	1 828.6	1 881.8	1 937.1	1 992.6

4.17 Figure 4B shows that the level of health care grants from the Commonwealth Government for Victoria increased steadily over the period of the previous AHCA and will continue to do so over the term of the new AHCA.

4.18 **Given the tightening financial condition of the State, the introduction of the matching conditions in the new AHCA in 2003-04 will pose budgetary challenges over the life of the new agreement.**

TAXATION REVENUES

State revenues	2002-03	2001-02	Movement
Taxation ($million)	**9 275**	8 792	483

4.19 Taxation revenue represents the second largest source of State revenues and comprises payroll tax and various stamp duties and taxes on financial and capital transactions, gaming activities, motor vehicle fees, and other licences and levies.

4.20 **In the 2002-03 financial year, taxation collections totalled $9 275 million, an increase of $483 million on the previous year.** A summary of the State's taxation revenue over the past 2 years is provided in Figure 4C.

FIGURE 4C
TAXATION REVENUES
($million)

Taxation source	2002-03	2001-02	Movement	
			Amount	%
Payroll tax	**2 589**	2 531	58	2.3
Financial and capital transactions	**2 632**	2 436	196	8.0
Gambling	**1 326**	1 370	(44)	(3.2)
Motor vehicle	**1 110**	1 039	71	6.8
Taxes on immovable property	**723**	582	141	24.2
Other	**895**	834	61	7.3
Total taxation revenue	**9 275**	**8 792**	**483**	**5.5**

Source: Annual Financial Report for the State of Victoria, 2002-03.

4.21 Taxation revenue increased by $483 million, mainly due to higher:

- stamp duty collections on property transfers of $222 million, reflecting the continued strength of the property market, especially house prices;
- land tax collections of $165 million due to increases in property values, marginally offset by an increase in the threshold at which land tax is payable;
- motor vehicle fees and taxes of $70 million due to strong growth in vehicle sales for the period;
- payroll tax of $58 million, reflecting strong employment and wage growth partially offset by a reduction in the payroll tax rate; and
- insurance taxes of $103 million, resulting from increases in insurance premiums attributable to developments in the local and international insurance industry, world security issues and increased property values.

Gambling fees and taxes

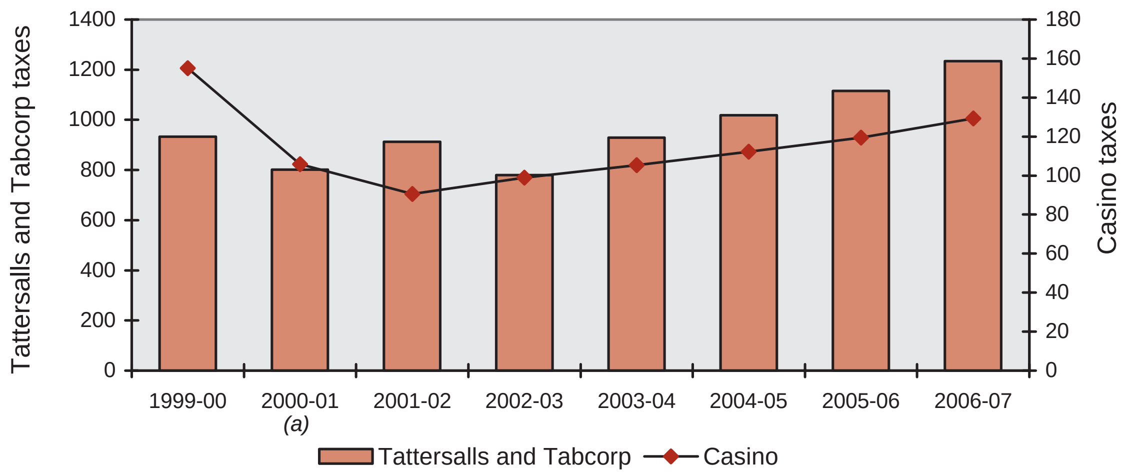
State revenues	2002-03	2001-02	Movement
Gambling ($million)	**1 326**	1 370	(44)

4.22 A major component of taxation revenues are fees and taxes levied on gambling-related activities. The major sources of gambling revenue are fees and taxes levied on electronic gaming machines (EGMs), private lotteries, casino operations and racing. **During 2002-03, State revenues from gambling activities amounted to $1 326 million, a decrease of $44 million on the previous year.**

4.23 Approximately 62 per cent of revenue from gambling activities was derived from EGMs. In 2002-03, the State collected $826 million (2001-02, $903 million) in taxation from around 27 500 electronic gaming machines located at clubs and hotels**. Revenue collected from EGMs decreased in 2002-03. This decrease is attributed to the introduction of smoking bans in the State's 538 clubs and hotels from 1 September 2002.**

4.24 Figure 4D shows the recent reduction in actual taxation revenue from EGMs compared with the recent growth in taxation revenue from casino operations. Figure 4D also shows that **the Government estimates that taxation revenue from EGMs will return to normal historical patterns and grow in future years as gaming venue patrons and gaming venue operators acclimatise to the smoking bans**.

FIGURE 4D
GAMING MACHINE TAXES
($million)



(a) Reduction in gaming machines tax revenue in 2000-01 due to lower tax rates associated with the introduction of National Tax Reform.

Source: For 1999-00 to 2002-03, amounts are sourced from the Annual Financial Reports for the State of Victoria (note 32). For 2003-04 to 2006-07, gambling estimates obtained from Department of Treasury and Finance – Forward Estimates.

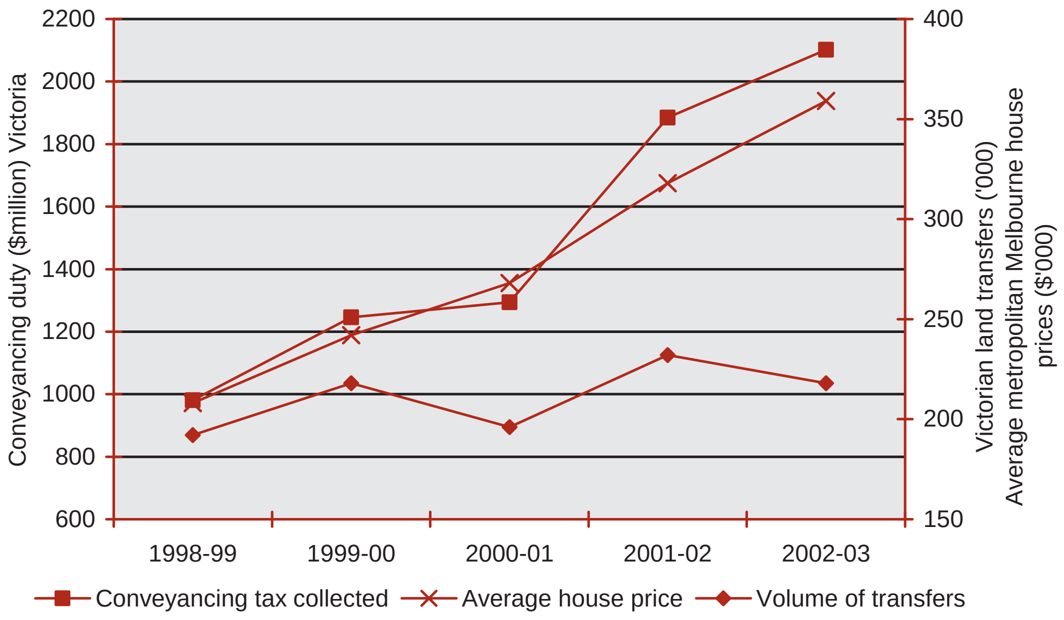
Financial and capital transaction taxes

State revenues	***2002-03***	*2001-02*	*Movement*
Financial and capital transaction taxes ($million)	**2 632**	2 436	196

4.25 Stamp duty on conveyancing represents 80 per cent of the total financial and capital transactions component of taxation revenue and is levied on a sliding scale, whereby the proportion of tax paid increases with the value of the property. **Stamp duty on conveyancing continues to be a significant source of State revenues, raising $2 107 million or 23 per cent of total taxation.**

4.26 Figure 4E shows that the increase in stamp duty on conveyancing of $196 million was largely as a result of the continued buoyant property market, characterised in particular by increasing property prices. **The median house price in metropolitan Melbourne increased by 12.8 per cent in 2002-03, offsetting a 6 per cent decrease in sales volume transfers compared with the previous year.**

FIGURE 4E
STAMP DUTY COLLECTIONS ON PROPERTY TRANSFERS



Sources: For 1998-99 to 2002-03, conveyancing tax amounts are sourced from the Annual Financial Reports for the State of Victoria. Average metropolitan Melbourne house prices sourced from Australian Bureau of Statistics. Property transfer data sourced from the Victorian State Revenue Office.

4.27 **The majority of State revenue components generally grow in line with the Gross State Product and Consumer Price Index (CPI). However, stamp duty on conveyancing has a history of being prone to substantial short-term fluctuations. Despite this volatility, revenue received from stamp duty on conveyancing in recent years has continued to increase at a faster rate than any other State taxes.**

4.28 In the past 20 years, there have only been 4 occasions when sales volumes have declined in excess of 10 per cent in one financial year. Each of these occasions was associated with increases in interest rates, or the commencement of a severe recession. From 2003-04, the Government has forecast a softening in the housing market and has factored into the forward estimates a decline in property transfer volumes, resulting in a decline in stamp duty on conveyancing revenue, and decreases across the other property-related revenue sources.

4.29 **As previously highlighted, a key risk confronting the Government remains the volatility of the transaction-based revenue sources associated with property market activities over the medium to long-term, and the impact an anticipated property market decline could have on the Government's revenue and future funding commitments. In addressing this risk, the Department of Treasury and Finance is improving its forecasting methodology to enhance its understanding of this increasingly important revenue driver and to facilitate more informed budgeting decisions.**

SALE OF GOODS AND SERVICES, AND OTHER REVENUE

State revenues ($million)	2002-03	2001-02	Movement
Sale of goods and services	**7 822**	7 880	(58)
Other revenue	**1 730**	1 621	109
Total	**9 552**	9 501	51

4.30 These categories of revenue mainly comprise insurance premiums raised by the State's statutory insurance schemes, rates and charges collected by water authorities, regulatory fees, gains (losses) on the disposal of physical assets, and miscellaneous revenues, such as contributions from developers to water authorities and collections from school fund raising activities.

4.31 While the overall level of this revenue remained stable, there were variations within a number of the major components, including:

- a decline in revenue from the sale of goods, mainly due to the reduction in gas sales revenue resulting from the introduction of full retail contestability as from October 2002;
- an increase in fines revenue, linked to road safety initiatives;
- a one-off payment of $135 million received from the National Express Group (Australia) in lieu of its performance bond associated with the transport franchise arrangements; and
- an up-front payment of $66 million received in association with the Spencer Street Station redevelopment.

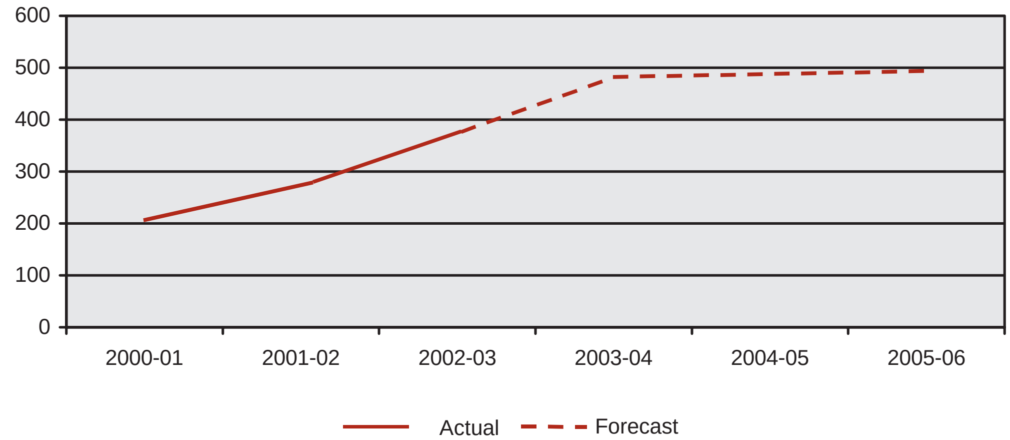
Revenue from fines

State revenues	2002-03	2001-02	Movement
Fines ($million)	**376**	271	105

4.32 Fines revenue is predominately generated from policing activities and outsourced traffic camera operations. **Revenue from this source totalled $376.3 million in 2002-03, an increase of $104.9 million or 39 per cent over the amount collected in the previous year.** A major part of fines revenue is generated from infringement notices issued by the Traffic Camera Office (TCO). In 2002-03, revenue sourced from the TCO totalled $202.5 million (2001-02, $138.6 million), representing 54 per cent of all fines raised in the year.

4.33 Figure 4F shows the level of fine revenue collections over the past 3 years and the related revenue projections over the 3-year period to 2005-06.

FIGURE 4F
FINES REVENUE
($million)



Source: Annual Financial Report for the State of Victoria, 2002-03 (General Government Sector) and Department of Treasury and Finance: Forward Estimates 2003-04.

	Actual			*Forecast*		
	2000-01	*2001-02*	*2002-03*	*2003-04*	*2004-05*	*2005-06*
Fines revenue ($million)	202.6	271.4	376.3	483.4	497.4	495.8

4.34 The figure illustrates the continuing upward trend in fines revenue over the recent years, mainly stemming from the Government's road safety initiatives.

Uncollected fines

4.35 The Department of Justice administers the majority of the State's fines revenue. At 30 June 2003, the aggregate amount of uncollected fines owing to the State was $487 million (30 June 2002, $368 million). Figure 4G quantifies the outstanding fines debt over the 3-year period to 2002-03.

FIGURE 4G
OUTSTANDING FINES DEBT
($million)

	2002-03	*2001-02*	*2000-01*
Outstanding debt	487.1	367.9	311.8
Provision for doubtful debts	303.0	266.3	187.6
Net fines debtors	**184.1**	**101.6**	**124.2**

Source: Department of Justice annual reports.

4.36 Over the past 3 years, the gross outstanding fines debt has increased from $312 million to $487 million. This rise in outstanding fines is mainly attributed to the substantial increase in infringement notices issued over the period, combined with the 20 per cent increase in 2002-03 in the face value of certain traffic fines introduced. Over the same period, in line with the increased value of outstanding debt, the Department has also increased its doubtful debts provision from $188 million to $303 million.

4.37 **Given the level of outstanding fines and the related provision for doubtful debts, the Department needs to continue to regularly review the effectiveness of its fines collection procedures and the collectability of outstanding fines.**

INVESTMENT REVENUE

State revenues	***2002-03***	*2001-02*	*Movement*
Investment revenue ($million)	**1 101**	429	672

4.38 Investment revenue mainly comprises dividends received, interest earned and investment gains and losses in the year. **In 2002-03, this source of revenue contributed $1 101 million to the operating result, an increase of $672 million from the previous year.** Figure 4H outlines the key components of investment revenue.

FIGURE 4H
INVESTMENT REVENUE
($million)

Source	*2002-03*	*2001-02*	*Movement*
Dividends	233	199	34
Interest	881	826	55
Investment gains (losses)	(168)	(747)	579
Rents	55	57	(2)
Other	100	94	6
Total investment revenue	**1 101**	**429**	**672**

Source: Annual Financial Report for the State of Victoria, 2002-03.

4.39 The increased revenue in the year is largely attributable to a lower level of losses incurred on equity investments, reflecting the impact of improved equity market conditions in the year and a partial re-allocation of the investment portfolio into higher yielding holdings.

Investment performance of major agencies

4.40 Investments held by the Treasury Corporation of Victoria, Transport Accident Commission, Victorian WorkCover Authority and the Department of Treasury and Finance made up around 98 per cent of the State's total investment portfolio. Further commentary on the investments held by the State and the impact of equity market movements is provided in the section of this report dealing with *Assets*.

4.41 The investment performance of these agencies in the 2002-03 financial year is illustrated in Figure 4I. The investment returns for each agency varies as a result of the differing investment objectives, strategies and portfolio asset mix adopted to meet the respective agencies' short-term and long-term operational requirements, and the matching of asset and liability profiles. For example, the Transport Accident Commission and the Victorian WorkCover Authority's investments are managed in the context of long-tail claims liabilities, and over a long-term horizon.

FIGURE 4I
KEY AGENCIES' INVESTMENT PERFORMANCE

Agency	***Investment return in 2002-03** (a)*	*Investment return in 2001-02 (a)*	*Investment holdings at 30 June 2003*	***Three-year average return** (a)*
	(%)	*(%)*	*($m)*	***(%)***
Department of Treasury and Finance *(b)(c)*	**8.7**	5.95	2 650	**7.40**
Treasury Corporation of Victoria *(c)(d)*	**5.22**	5.15	5 784	*(e)* ***n/a***
Transport Accident Commission *(b)*	**3.83**	(2.87)	5 499	**0.95**
Victorian WorkCover Authority *(b)*	**(0.96)**	(3.81)	5 344	**0.67**

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

(b) *Source*: Victorian Funds Management Corporation. Represents market values.

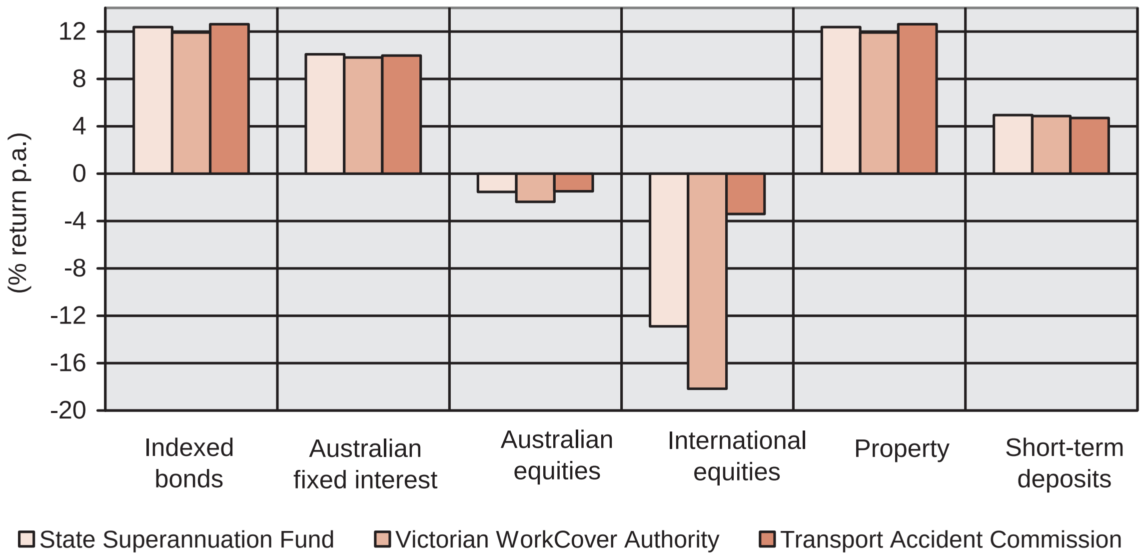
(c) These entities do not invest in equity instruments due to the nature of their investment and financing requirements.

(d) Includes the investment returns of $2.7 billion in funds deposited by the Public Account, public sector agencies and a portion of public sector superannuation funds.

(e) No data is available for this agency.

4.42 Figure 4J shows a further breakdown of 2002-03 agency returns, by investment class.

FIGURE 4J
SUMMARY OF INVESTMENT RETURNS BY MAJOR INVESTMENT CLASS *(a) (b)*



(a) Department of Treasury and Finance, and Treasury Corporation of Victoria investment holdings are only in fixed-interest securities and bonds, and are therefore excluded.

(b) While the investment returns of public sector superannuation funds are not included in the Annual Financial Report because they are not assets of the State, the investment returns impact on the State's unfunded superannuation liabilities, and are therefore included.

Source: Victorian Funds Management Corporation and respective agencies' financial reports.

4.43 Equity markets are volatile. Accordingly, agencies that have large equity holdings are expected to experience more variability in their annual investment returns than agencies investing in fixed interest investments. As illustrated in Figure 4J, all of the State's major investing agencies achieved negative returns on equity holdings. This adversely impacted on the State's overall investment returns and resulted in agencies with a substantial proportion of their investments in equities, namely Transport Accident Commission and Victorian WorkCover Authority, achieving poor overall returns on their total investments.

4.44 The Transport Accident Commission's investment strategy of hedging against foreign currency exposures was the key contributor to the achievement of a positive overall investment return of 3.83 per cent by this agency in 2002-03. The recovery of the Australian dollar against the US dollar eroded returns on overseas investments for investing agencies that did not hedge foreign currency exposures, including the Victorian WorkCover Authority and the State Superannuation Fund.

4.45 Hedging involves entering into contracts to change foreign currency back to Australian dollars at some point in the future at rates agreed today. The benefit of hedging is that it removes any risk resulting from a rising Australian dollar. However, in an environment of a reducing Australian dollar agencies that have not entered into hedging contracts benefit.

4.46 **Interestingly, despite differing currency exposures and investment strategies by the Transport Accident Commission and the Victorian WorkCover Authority, which both hold substantial equity investments and have reported varying rates of return on an annual basis, these agencies have averaged reasonably similar returns of 4.62 per cent and 4.99 per cent, respectively, over a 5 year period.**

Dividend payments by Government Business Enterprises

4.47 **During 2002-03, Government Business Enterprises (GBEs) paid dividends of $580 million into the Consolidated Fund, some $174 million higher than the budget estimate for the year. These additional dividends were a major contributor to the net surplus of $236 million achieved by the General Government Sector in 2002-03.**

4.48 Figure 4K provides a summary of the dividends paid by GBEs into the Consolidated Fund in the past 2 years.

FIGURE 4K
DIVIDEND PAYMENTS BY GOVERNMENT BUSINESS ENTERPRISES
($million)

Major industry	*Actual 2001-02 (a)*	***Actual 2002-03** (a)*	*Budget 2002-03 (b)*	***Variance from Budget***	***Variance from 2001-02 Actual***
Gas	66	**59**	-	**59**	**(7)**
Water	276	**355**	210	**145**	**79**
Port authorities	10	**10**	9	**1**	**-**
Public financial corporations	111	**128**	157	**(29)**	**17**
Other	39	**28**	30	**(2)**	**(11)**
Total	502	**580**	406	**174**	**78**

(a) Source: Government's Annual Financial Report.
(b) Source: 2002-03 and 2003-04 Budget Papers.

4.49 The higher dividends received from GBEs during the year compared with the 2002-03 budget forecast were largely attributable to:

- Gas sector – delayed introduction of full retail contestability, which resulted in Gascor Pty Ltd profits being higher than forecast; and
- Water sector - higher than expected profits largely attributable to the continued growth in the housing market and the associated developer contributions received by water bodies.

4.50 In addition to the annual dividend payments, 2 retail water companies, City West Water and South East Water, were directed to make further dividend payments totalling $100 million to the Consolidated Fund. The Government attributed these additional dividend payments to the strong operating performance of both GBEs over the past 5 years, assisted by buoyant land development activity.

4.51 We observed that, although the reported profits of both water companies have increased as a result of increased revenues from developer contributions, only a portion of these revenues consist of cash payments made by developers in the form of system access fees. Over the past 5 years of the $537 million revenue contributed by developers to these 2 companies, 61 per cent has represented cash payments, with the balance consisting of new water and sewer reticulation assets that will need to be maintained by the water companies into the future.

4.52 Despite the strong financial performance of the 2 GBEs over recent years, both continue to hold significant debt. As a result of the dividend payments made by South East Water and City West Water, their debt levels increased by $31.3 million and $27.5 million, respectively. In addition, both GBEs had an excess of current liabilities over current assets as at 30 June 2003.

4.53 **Given the negative impact that dividend payments have had on the 2 water companies, it will be important that their financial condition is closely monitored in the coming years.**

RESPONSE *provided by Minister for Finance and Treasurer*

Dividend Payments by Government Business Enterprises (paras 4.47 to 4.53)

The dividend payments have not had a negative impact on the financial condition of City West Water (CWW) and South East Water (SEW) as indicated in the Report.

A detailed financial analysis of the interest cover ratios (both on a cash and Earnings Before Interest and Tax (EBIT)) show that the ratios actually improved for both companies in 2002-03. Further, SEW reported increases with respect to the key indicators return on assets and return on equity in 2002-03. While CWW recorded a marginal decline in these two indicators, they remain at very strong levels. Despite debt and the gearing ratio marginally increasing in 2002-03 for both companies, CWW and SEW have low gearing levels by historical and industry standards. The levels are below that of Yarra Valley Water, the third metropolitan water retailer.

KEY FINANCIAL RATIOS: SEW AND CWW

	SEW		*CWW*	
	2001-02	*2002-03*	*2001-02*	*2002-03*
Profit before Tax ($M)	112.0	139.5	100.07	104.8
Interest Cover (cash) (times)	7.4	8.1	9.1	12.4
Interest Cover (EBIT) (times)	6.7	8.1	10.8	12.5
Return on Assets (%)	12.1	14.1	17.0	16.9
Return on Equity (%)	12.7	15.7	19.4	19.0
Gearing (%)	28.7	30.0	22.9	26.0

Source: 2002-03 and 2001-02 Annual Reports of SEW and CWW.

Dividends are set each year with reference to the established relevant benchmark and to other commercial considerations including the level of retained earnings, gearing, interest cover and cash flow projections. The views of the relevant Boards are also taken into consideration.

***RESPONSE** provided by Minister for Finance and Treasurer - continued*

While both Government Business Enterprises (GBEs) had an excess of current liabilities over current assets as at 30 June 2003, they are in a very strong position to meet short-term obligations. Across the metropolitan water sector, current liabilities have consistently exceeded current assets in recent years. Current liabilities include interest bearing debt which is usually refinanced at maturity. This has resulted in working capital ratios of less than 1 (ratio of current assets over current liabilities), which may incorrectly suggest a liquidity issue for the two GBEs.

Based on the above analysis it is difficult to conclude that the dividend payments have had a negative impact on CWW and SEW.

Part 5

Expenditure

SUMMARY OF STATE OPERATING EXPENSES

State's operating result ($million)	***2002-03***	*2001-02*	*Movement*
Revenues	**32 016**	30 596	1 420
Expenses	**31 962**	29 989	1 973
Operating result	**54**	607	(553)

5.1 **The operating expenses of the State totalled $31 962 million during 2002-03, some $1 973 million (6.6 per cent) higher than in the previous year.**

AT A GLANCE

			Movement	
State expenditures ($million)	***2002-03***	*2001-02*	*Amount*	*%*
Supplies and services	**13 115**	12 170	945	7.7
Employee benefits	**10 122**	9 421	701	7.4
Grants and other transfer payments	**3 225**	3 199	26	0.8
Superannuation	**2 677**	2 634	43	0.1
Depreciation and amortisation	**1 621**	1 491	130	8.7
Borrowing costs	**939**	863	76	8.8
Other expenses	**263**	211	52	24.6
Operating expenses	**31 962**	29 989	1 973	6.6

5.2 The key factors contributing to this increased expenditure included:

- supplies and services ($945 million) – reflecting mainly increased statutory insurance scheme claims expenses, higher health service provider payments, additional costs relating to the provision of public transport, and increased fire suppression costs associated with bushfires; and
- employee benefits ($701 million) – mainly reflecting the impact of settlements in recent years of major industrial agreements across the public sector.

5.3 An analysis of State expenditure trends over the past 5 years, as illustrated in Figure 5A, indicates that there has been a 3.1 per cent increase in State expenditure in real terms in 2002-03, representing a 1.9 per cent increase on a per capita basis. These outcomes have been influenced by the factors outlined in the following paragraphs.

FIGURE 5A
EXPENDITURE TRENDS *(a)*

Year	Total amount			Per capita		
	Nominal value	Real terms	Movement in real terms	Nominal value	Real terms	Per capita movement in real terms
	($m)	($m)	(%)	($)	($)	(%)
1998-99	23 794	23 794	n.a.	5 077	5 077	n.a.
1999-00	26 189	25 514	7.2	5 524	5 381	6.0
2000-01	28 470	26 933	5.6	5 926	5 606	4.2
2001-02	29 989	27 599	2.5	6 155	5 664	1.0
2002-03	**31 962**	**28 464**	**3.1**	**6 482**	**5 773**	**1.9**

(a) Consumer Price Index data (CPI annual average, Melbourne) sourced from Australian Bureau of Statistics publications, with 1998-99 used as the base year. CPI for 2000-01 excludes impact of GST estimated at 3 per cent. Population growth data sourced from the *Budget Papers, 2003-04*. Expenditure data (nominal value) sourced from Annual Financial Reports for the State of Victoria.

EMPLOYEE BENEFITS

State expenditures	***2002-03***	*2001-02*	*Movement*
Employee benefits ($million)	**10 122**	9 421	701

5.4 The Victorian public sector employs around 240 000 staff which account for around 10 per cent of the total Victorian work force. **Costs associated with employee benefits, including salaries, wages and related on-costs totalled $10 122 million in 2002-03 and accounted for 32 per cent of total public sector expenditure.**

5.5 Figure 5B illustrates the growth trend in employee-related costs over the past 5 years. It highlights that these costs are growing at a high rate and represent an increasing proportion of the State's total operating expenditures.

FIGURE 5B
EMPLOYEE BENEFIT COSTS

Year ended 30 June	*Employee benefit costs*	*Movement from the previous year*	*Employee costs as a percentage of total operating expenditure*
	($m)	*(%)*	*(%)*
1999	7 864	1.2	33.2
2000	7 992	1.6	30.5
2001	8 653	8.3	30.4
2002	9 421	8.9	31.4
2003	10 122	7.4	31.7

Source: Annual Financial Reports for the State of Victoria and Australian Bureau of Statistics, *Consumer Price Index* Series, Cat. no., 6401.0, ABS, Canberra.

5.6 A key factor contributing to the substantial growth in employment costs in recent years has been the additional staff employed in the education, health and justice sectors, consistent with Government policy decisions to improve service delivery in these areas. Other major factors contributing to the growth in these costs include the restructuring of career profiles and industrial wage outcomes, mainly relating to police, nursing and teaching staff. Industrial settlement outcomes for these 3 groups have had a substantial impact on the State's finances, given that they account for around 83 per cent of the State's employee benefits' costs.

5.7 Our previous reports have outlined the impact on State expenditures of major public sector industrial settlements and additional permanent staffing decisions by the Government. In 2002-03, the Government concluded a number of industrial agreements within the emergency services, human services and education sectors. In addition, a number of policy decisions were made, as part of the 2003-04 State Budget development process, which will result in the employment of additional staff within various sectors. Given the continuing significance of these industrial settlements and policy decisions, we have updated our analysis of the associated impacts on State expenditures in Figure 5C.

5.8 **As outlined in Figure 5C, the net additional cost of major public sector industrial settlements and additional permanent staffing decisions made since 2000-01 is estimated at $1 482 million for the 2002-03 year, an increase of $519 million on the previous year.**

FIGURE 5C
ESTIMATED COST OUTCOMES OF MAJOR PUBLIC SECTOR INDUSTRIAL AGREEMENTS AND POLICY INITIATIVES RESULTING IN ADDITIONAL STAFF *(a)*
($'000)

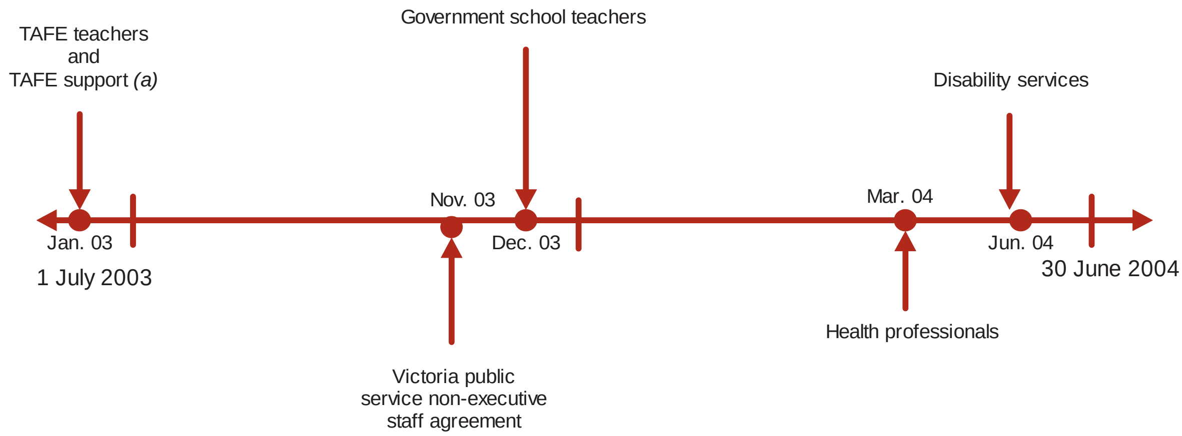
Salaries and on-costs	*2000-01*	*2001-02*	*2002-03*	*2003-04*	*2004-05*	*2005-06*
Agreements cost -						
Impact of major prior year agreements *(b) (c) (f)*	389 240	809 974	1 056 913	1 179 186	1 212 236	1 249 966
Impact of major agreements entered in 2002-03 -						
Country Fire Authority/Melbourne Metropolitan Fire and Emergency Services Board	-	-	16 154	34 544	46 896	46 896
Health services sector *(b) (d)*	-	-	129 206	188 225	247 019	277 957
Education sector	-	-	21 800	27 600	27 600	27 600
Total estimated cost of major agreements	**389 240**	**809 974**	**1 224 073**	**1 429 555**	**1 533 751**	**1 602 419**
Less redirection of existing funding towards agreements -						
Redirection requirements for prior year agreements *(c)*	33 850	74 780	72 610	74 700	72 700	72 700
Total redirection of existing funding	**33 850**	**74 780**	**72 610**	**74 700**	**72 700**	**72 700**
Total net cost to the State of new agreements excluding impact of policy decisions *(e)*	**355 390**	**735 194**	**1 151 463**	**1 354 855**	**1 461 051**	**1 529 719**
Major policy decisions – Additional permanent staff -						
Prior year decisions *(c)*	136 000	227 240	330 180	371 780	371 780	371 780
Major new funding decisions arising from 2003-04 Budget initiatives -						
DE&T - Additional 450 secondary school teachers *(g)*	-	-	-	4 000	14 000	28 000
DE&T - Additional 256 student welfare co-ordinators *(g)*	-	-	-	4 200	12 500	16 400
DHS - Additional 900 nurses/health staff	-	-	-	54 000	54 000	54 000
DOJ - Additional 600 police	-	-	-	12 500	22 600	33 000
DOJ - Additional 125 firefighters	-	-	-	7 320	15 290	18 130
Total estimated cost of new budget initiatives	-	-	-	82 020	118 390	149 530
Total estimated cost of policy decisions	**136 000**	**227 240**	**330 180**	**453 800**	**490 170**	**521 310**
Total net cost Including additional staff *(e)*	**491 390**	**962 434**	**1 481 643**	**1 808 655**	**1 951 221**	**2 051 029**
Net Increase on prior year	**-**	**471 044**	**519 209**	**327 012**	**142 566**	**99 808**

(a) Data extracted from estimates provided by Department of Treasury and Finance, Department of Human Services (DHS), Department of Education and Training (DE&T), Department of Justice (DOJ) and Victoria Police. Data covers new major agreements entered into from the 2000-01 financial year and policy initiatives announced subsequent to, and including, the 2000-01 Budget for each of the key sectors.
(b) Excludes adjustments to grants paid to non-government agencies relating to safety net adjustment, non-government parity and award simplification outcomes.
(c) Refer to my *Report on the Finances of the State of Victoria, 2001-02*, for further details (page 58).
(d) Does not include the cost of the additional 400 equivalent full-time staff to be employed by the end of the enterprise bargaining period agreement in 2005-06 as we were unable to ascertain in which years the additional staff will be engaged.
(e) The total cost does not include the consequential impact on unfunded superannuation liability.
(f) An assumption is made that the Victorian Police Sworn Officers industrial agreement option to extend the period of the agreement will be exercised by the parties.
(g) Excludes the impact of DE&T staff reductions resulting from head office restructure announced in August 2003, as we were unable to ascertain the financial impact of these reductions.

5.9 **As emphasised in my previous reports on the State's finances, given the significant impact of these industrial settlements and staffing decisions on the State's finances, it will be important that their implementation continues to be carefully managed and monitored to mitigate against the risk of further cost increases.**

5.10 A number of significant industrial agreements expired during 2002-03 or will expire in the course of the 2003-04 financial year, as illustrated in Figure 5D.

FIGURE 5D
EXPIRATION OF MAJOR AGREEMENTS FOR MAJOR PUBLIC SECTOR EMPLOYEE GROUPS



(a) Renegotiation of these agreements had not been finalised at the date of preparation of this report.

5.11 **Given that employee costs represent the most significant driver of the unit cost of government services, one of the most important risks faced by the Government in meeting budget forecasts is that future wage settlements may exceed expectations. It is important to recognise that wage settlements also impact on employer obligations relating to employee superannuation costs.**

5.12 **The Government currently faces negotiations of a number of significant industrial agreements expiring in the 2003-04 financial year, as outlined above. These negotiations, particularly in the health and education sectors, which represent a large proportion of the total public sector work force, will require careful management to ensure that employment costs do not adversely impact on the State's capacity to deliver services to the community.**

Revised departmental funding arrangements

5.13 As part of the 2003-04 State Budget development process, the Government endorsed a new departmental funding model to be implemented for the 2004-05 budget cycle. This model will replace the previous centrally managed wage contingency regime, with departments assuming direct responsibility for the management of employee entitlements.

5.14 **Under the new funding model, departments will be required to manage costs within the output prices determined by the Government. This is designed to place greater responsibility and accountability for cost control, in particular wages growth, on managers within departments which, in turn, should assist in a more focused management of these costs.**

Key individual settlements and 2003-04 budget initiatives

Health sector

5.15 Further to the major awards settled in previous years in the health sector, a number of additional enterprise bargaining agreements were settled during the year. Overall, these settlements have increased the Department of Human Services' (DHS') funding requirements for wage costs by $129 million in 2002-03, increasing to $278 million by 2005-06. A 2003-04 budget initiative to recruit an additional 900 nurses/health staff is estimated to cost a further $54 million per annum. Furthermore, wage parity and safety net adjustments have resulted in increased grant payments to non-government sector organisations of $32 million in 2002-03, increasing to $36 million by 2005-06.

Emergency services sector

5.16 In 2002-03, the Government concluded the negotiation of a certified agreement covering the operational staff of the Melbourne Metropolitan Fire and Emergency Services Board and the Country Fire Authority. Under the agreements, these staff received a 6 per cent increase plus a 0.5 per cent advanced skill allowance per annum over the life of the agreement. The additional cost of the agreement is estimated at $16.1 million in 2002-03, increasing to $46.9 million by 2005-06. This cost is to be partially funded by increased revenues from stamp duty levied on insurance premiums, which is estimated to generate $4.4 million in 2002-03, increasing to $13.8 million in 2005-06.

5.17 Also arising from the industrial negotiations and policy decisions was a commitment by the Government to the employment of an additional 125 firefighters and 600 police officers. This commitment is estimated to cost $19.8 million in 2003-04, increasing to a full year cost of $51.1 million by 2005-06.

Education sector

5.18 The phased implementation of the School Support Officer Enterprise Bargaining Agreement, which was negotiated in October 2001, resulted in additional costs of $21.8 million in 2002-03, increasing to $27.6 million in 2003-04 and in subsequent years.

5.19 In addition, the 2003-04 budget initiatives to recruit an additional 450 secondary school teachers and 256 student welfare co-ordinators is estimated to cost $8.2 million in 2003-04 increasing to $44.4 million in 2005-06.

5.20 In August 2003, the Government announced a re-structure of the head office of the Department of Education and Training. The restructure is expected to result in staff reductions. At the time of preparation of this report, we are unable to ascertain the financial impact of these reductions.

SUPPLIES AND SERVICES EXPENDITURE

State expenditures	**2002-03**	2001-02	Movement
Supplies and services ($million)	**13 115**	12 170	945

5.21 Supplies and services expenditure consists of costs incurred for the purchase of goods and the provision of services, including payments made under outsourcing arrangements, statutory insurance-related claims, operating lease payments and maintenance expenses. **In 2002-03, supplies and services expenditure totalled $13 115 million, an increase of $945 million from the previous year.**

5.22 Commentary follows on a number of the more significant transactions impacting on the expenditure outcomes achieved in the 2002-03 financial year and in forward years.

Bushfire and drought relief

5.23 In 2002-03, $114 million was spent on the bushfire recovery strategy, including $96 million for fire suppression costs relating to the summer bushfires which impacted on Gippsland and the State's north-east region. These costs were incurred by a number of government agencies including the Department of Sustainability and Environment, Department of Primary Industries, Department of Infrastructure, Department of Justice and the Country Fire Authority.

5.24 In October 2002, the Government announced a $27.7 million Drought Relief Package to assist farmers impacted by the drought. In December 2002, a further $52.3 million was made available for drought relief. The grants under this package were administered by the Rural Finance Corporation with eligibility criteria for these grants relating to hardship and long-term survival prospects of the individual farm enterprises.

5.25 The State has sought reimbursement of $30 million from the Commonwealth Government for these costs under natural disaster relief arrangements.

Seal Rocks Life Centre litigation settlement

5.26 My *Report on the Finances of the State of Victoria, 2001-02* commented on the status of arbitration between the Government and Seal Rocks Victoria (Australia) Pty Ltd (SRVA) relating to the contractual arrangements for the Seal Rocks development project.

5.27 Under the arrangements, SRVA agreed to construct and operate the Seal Rocks Sea Life Centre, located on Crown land at Point Grant on Phillip Island, and transfer the Centre, together with amenities, to the State at the completion of the term of the arrangements (25 years).

5.28 From the time the Centre opened in April 1998, SRVA was involved in disputes with the Government over various aspects of the contractual arrangements. This situation led to the appointment of an independent arbitrator in July 2002.

5.29 The independent arbitrator handed down an interim award in August 2002. However, the Government made application to appeal against the independent arbitrator's interim award in the Supreme Court. As a consequence of the Government's action to appeal the interim award decision, SRVA lodged an application in the Supreme Court in September 2002 seeking compensation for loss of future earnings of up to $400 million.

5.30 In November 2002, the independent arbitrator issued a final award covering the matter of damages. The Arbitrator determined that the State was liable for $37.3 million as compensation on an indemnity basis, plus costs. On 24 April 2003, the Supreme Court refused leave to appeal for both parties, thereby confirming the original decision of the Arbitrator.

5.31 At the date of preparation of this report, the overall cost to settle the dispute between the State and SRVA over the Seal Rocks development was $55.9 million, as outlined in Figure 5E.

FIGURE 5E
SEAL ROCKS - INDEMNITY AWARD AND COSTS
($million)

Expenses (excl. GST)	*Amount*
Legal settlement *(a)*	45.4
Legal fees (external)	9.3
Other related costs	1.2
Total	**55.9**

(a) Includes $42.9 million paid to SRVA in accordance with the arbitrator's award (comprising the indemnity award of $37.3 million and costs totalling $5.6 million).

Source: Financial records of the Department of Sustainability and Environment.

5.32 In August 2002, the remaining assets of SRVA, including the Seal Rocks Sea Life Centre building, were assumed by the Department of Natural Resources and Environment (now Department of Sustainability and Environment – DSE) and subsequently transferred to the Phillip Island Nature Park Board of Management. Shortly after DSE assumed these assets, significant storm damage was experienced to these assets.

5.33 Insurance works undertaken following the storm damage on the former Seal Rocks Sea Life Centre building have been completed but this area has remained closed to the public until the Government makes a decision on the future of the building. Builders completing the insurance works have identified the need for some further maintenance requirements, which were not related to the storm damage. Additional maintenance expenditure is estimated at $600 000.

5.34 Even though the building remains closed, the kiosk and souvenir shop re-opened in September 2002. At the date of preparation of this Report the future of the former Seal Rocks Sea Life Centre remained under review by the Government.

ADDITIONAL COSTS UNDER THE PUBLIC TRANSPORT FRANCHISE ARRANGEMENTS

5.35 My previous reports to Parliament have commented on the franchising of the public transport system and subsequent developments. Below we outline the major developments associated with these arrangements since their establishment, together with the resultant additional expenditure incurred by the State.

5.36 Under the arrangements entered into in mid-1999, the then 5 passenger transport businesses were awarded to 3 separate franchisees for periods up to 15 years. The State retained ownership of the infrastructure associated with the public transport system, except for the rolling stock, and transferred the responsibility for the day-to-day management and operation of the network to the franchisees.

5.37 As the projected fare revenues were forecast to be insufficient to operate the public transport businesses, the State agreed to provide subsidies to the franchisees. These subsidies were projected to reduce in value over the franchise period as the financial viability of the business improved. The aggregate cost in present value terms to the State for the delivery of these services over a 15 year period was estimated at $2.8 billion (1999 dollars).

5.38 In December 2001, the Director of Public Transport commissioned a review of the financial performance and position of the franchisees including a review of the 3 forward year business plans. The review identified a number of viability issues requiring the immediate attention of the Director. The review identified some key factors adversely impacting on the franchisee operations, including a significantly lower than forecast patronage growth across the network and consequently lower than expected growth in the revenue pool, and increases in certain costs, such as insurance and energy.

5.39 Following the completion of the above reviews the Director, in March 2002, entered into an interim agreement with the franchisees which included 2 settlement payments. The first part of the settlement involved an up-front payment by the Government of $41.6 million, together with annual payments of $2.8 million over the period of the arrangements to settle a number of claims and disputes. The second part of the settlement involved a payment of $27.2 million in recognition of a flawed passenger growth incentive system.

5.40 All the payments made under the March 2002 interim agreement were conditional upon an increase in the value of franchise performance bonds from $105 million to $210 million, with the value of the bonds decreasing back to $105 million after 30 June 2003.

5.41 The interim agreement also identified a number of outstanding claims, which would be examined by a taskforce established by the Director to review the operation of the public transport system.

December 2002 - Interim operating agreements

5.42 Under the original contractual arrangements, the risk allocation profile between the State and the franchisees included the acceptance by the franchisees of a number of key commercial risks. These key commercial risks included failure to achieve the projected levels of growth in fare revenue, and movements in the projected costs for delivery of services and procurement of new rolling stock.

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

5.44 In December 2002, with the specific objectives of ensuring the short-term viability of the franchisee operations and facilitating an orderly transition during the reorganisation of the public transport system, the State entered into interim operating agreements with Yarra Trams and Connex Trains (formerly Hillside Trains). As indicated later in this article, the National Express Group effectively withdrew from the franchising arrangement at this time. The interim operating agreements provided commercial flexibility to negotiate or tender new franchise arrangements, and provided for existing franchisees to participate in a number of new agreements. The interim operating agreements are for a 15-month period commencing from 1 October 2002. However, at the option of the Director they can be extended for an additional 12-month period to December 2004.

5.45 The key risks assumed by the State that were previously with the franchisees related to such things as:

- **Infrastructure maintenance** – Due to ongoing differences in the application of the condition survey methodology, the State waived its right to commission a survey to assess the condition of the rail infrastructure, thereby releasing the franchisees from potential infrastructure maintenance obligations;
- **Funding shortfalls** - In the initial funding period, the State will contribute on average up to 55 per cent of the projected losses arising from the franchisee operations. In the event that the funding period is extended by a further 12 months, the State will be liable for the entire funding of projected losses. In both periods, clawback arrangements are in place in the event that actual funding requirements are less than the forecast funding requirement; and
- **Insurance costs** - The State has agreed to share insurance premium cost increases on a 50/50 basis where they exceed forecast amounts. Alternatively, if costs decrease, the State will share in any benefits.

5.46 The agreements imposed certain restrictions on franchisee operations, unless otherwise approved by the Director. These restrictions included changes to employee numbers and the need to consult in relation to new employee enterprise bargaining agreements, amendments to material existing contracts and related party distributions.

5.47 The agreements also deferred or released the franchisees from certain capital works projects set out in the franchise agreement and infrastructure agreement, and re-defined events and performance targets that impact on the subsidy payment received by the franchisee, in particular the Operational Performance Regime (OPR) incentive payments. The reversion of the performance bonds of Yarra Trams and Connex Trains to original levels ($40 million) was also deferred to 31 December 2003 and remained at $80 million at 30 June 2003.

The impact of the withdrawal of the National Express Group

5.48 As indicated previously, the National Express Group (Australia) (NEGA) did not elect to enter into the December 2002 - interim operating agreement with the Director. Instead, in December 2002, NEGA's parent company withdrew its financial support for its franchisee companies, including M>Train (formerly Bayside Trains), M>Tram (formerly Swanston Trams) and V/Line Passenger.

5.49 The withdrawal of financial support and the current financial position of the franchisees effectively rendered the franchisees insolvent, triggering a termination event under the Franchise Agreements. In addition, National Express (Bayside Train Maintenance) Pty Ltd, a subsidiary company, also became insolvent. The State, whose interests were protected under a security charge over the franchisee property, elected to appoint a receiver and manager to operate the NEGA franchisees rather than to call-in the termination event under the Franchise Agreements.

5.50 To ensure the public transport service continued to operate with minimum disruption, which was achieved, a Transition Agreement was entered into between the Director and NEGA immediately following its withdrawal of financial support. The Transition Agreement recognised that a termination event had occurred and permitted the State to acquire certain head office assets of NEGA for a nominal amount. NEGA itself was not placed into receivership and continues to administer its other Australian operations, including its bus operations. Selected assets and employees of NEGA were transferred in January 2003 to a company created by the State, namely, Victorian Rail Services Pty Ltd. Ultimately, it is envisaged that the functions performed by this company will be distributed to the new franchisees.

5.51 The Transition Agreement also proposed the terms of a Deed of Company Arrangement (DOCA) to resolve claims from unsecured creditors of the franchisees, estimated at $70 million. Key provisions of the DOCA, accepted by the unsecured creditors of NEGA in July 2003, include:

- The establishment of a fund that will be shared between the franchisees' unsecured creditors on a pro-rata basis. The State and NEGA paid $20 million and $10 million, respectively, into this fund. In addition, the Government met the debts of 2 unsecured creditors to the value of $600 000;
- The assumption by the State of the employee entitlements liability of the franchisees, if a termination event occurs, estimated at $82.4 million as at 22 December 2002. The Minister for Transport at the time of withdrawal of NEGA provided an assurance to employees that all accrued entitlements and existing conditions of staff for each business would be protected; and
- The release, as from 22 December 2002, of the State and the franchisees from all claims which they have or might have against each other. Prior to signing the DOCA, the State's claim against the companies was around $906 million, after deducting the value of the performance bonds, for the period ending June 2008.

5.52 At the Director's election, NEGA is to transfer all of its shares in the franchisees to the Director or their nominees, together with all of its assets which are considered by the Director to be necessary for carrying on the business of the franchisees. At the time of preparation of this Report, the Franchise Agreements for each of the franchisees had not been terminated and no shares had been transferred, with the exception of the V/Line Passenger franchisee. We are advised that the State will elect to call a termination event at the time it implements proposed re-organisation changes to the public transport system.

5.53 **The Transition Agreement allowed the State to obtain $135 million (in lieu of the performance bonds) in cash from NEGA. The payment has been recorded as part of "other revenue" for the 2002-03 financial year in the Government's Annual Financial Report.**

5.54 **Following the signing of the DOCA in July 2003, any losses incurred since 22 December 2002 on NEGA operations (in receivership) are to be met by the State. These losses were estimated at $45.6 million for the period 22 December 2002 to 30 June 2003.**

5.55 It is my intention to examine in detail, the impact of these recent developments in the transport franchising arrangements, during the coming year.

V/Line Passenger Service

5.56 A large number of regional infrastructure projects, including regional fast rail, rail standardisation, the Spencer Street Station redevelopment and the re-opening of country lines are to be undertaken that will adversely impact on the V/Line Passenger Service operations during their respective construction periods. Following the withdrawal of financial support by NEGA, the Government elected to return the V/Line Passenger Service business to public ownership to assist in minimising disruptions during the works periods.

5.57 In May 2003, Parliament passed the *Transport (Miscellaneous Amendments) Act* 2003 establishing the V/Line Passenger Corporation. The day-to-day provision of country services is to be managed by V/Line Passenger Pty Ltd, a wholly-owned subsidiary of V/Line Passenger Corporation.

5.58 The Director called-in a termination event relating to NEGA's V/Line Passenger Service in October 2003, and transferred the shares of that company to V/Line Passenger Pty Ltd.

Revised new rolling stock arrangements – V/Line Passenger Service

5.59 Under the franchise arrangement, the franchisees are required to lease, on terms approved by the Director, a specified number of new rolling stock units and take possession of these units so that they are in regular service by specified intervals. At June 2003, 61 new rolling stock units had been brought into service by all franchisees, with the exception of V/Line Passenger. The lease costs associated with the committed new rolling stock are funded by the Director on behalf of the State through "rolling stock adjustment payments".

One of the 61 new rolling stock units in service.

5.60 NEGA had structured its new rolling stock financing through a trust. The trust issued bonds to be ultimately funded from the rolling stock subsidy revenue streams received from the State. In June 2003, the State acquired the equity interest in NEGA's V/Line Passenger special purpose vehicle companies under the financing arrangements, including the trust, for $8.3 million. This resulted in the State assuming ownership of 4 agencies under the control of Victorian Rail Track (VicTrack), including Rolling Stock Victoria–(VL) Pty Ltd (formerly GATX Rail (Victoria –VL) Pty Ltd), and its 3 wholly-owned subsidiaries.

5.61 Following the withdrawal of financial support by the NEGA parent company, the State exercised an option to acquire additional new rolling stock for country rail operations, not previously funded via the trust. Based on favourable cost-benefit considerations, rather than funding the purchase via the existing special purpose finance vehicle companies, these purchases were financed through the Treasury Corporation of Victoria. **As at 30 June 2003, the Treasury Corporation of Victoria had provided $37 million in loans to Rolling Stock Holdings (Victoria) Pty Ltd. This company was established in May 2003 to facilitate these purchases.**

5.62 **One of the effects of these arrangements is that the State has assumed the role and functions of a lessor and, accordingly, has assumed the role of meeting the repayment and financing costs associated with the bond issue. The acquisition of these special purpose financing vehicle companies has increased the State borrowings by $345 million, increased physical assets (new rolling stock works in progress) by $112 million and increased financial assets by $165 million.**

Financial impact on the State of key transactions

5.63 At the time of entering into the transport franchising arrangements in mid-1999, the Government expected annual savings of $161 million, representing total savings in real terms of around $1 760 million over the life of the arrangements.

5.64 As detailed in Figure 5F, in the years following the commencement of the franchise arrangements, **the Government has incurred significant additional net costs above the original contractual franchise agreement obligations, estimated at around $196 million at the date of preparation of this report.**

FIGURE 5F
ADDITIONAL SIGNIFICANT TRANSACTIONS SINCE COMMENCEMENT OF THE FRANCHISE AGREEMENTS
($million)

Details	*Estimated cost*
General -	
Employment of roving conductors on trams and station/customer service staff - ongoing cost *(a)*	28.3
Additional funding arising from the March 2002 Interim Agreement -	
Lump sum payments	68.8
Ongoing payments *(b)*	5.6
Additional funding arising from the December 2002 Interim Operating Agreement:	
Initial Funding Period (Oct. 2002 – Dec. 2003) *(c)*	48.0
Franchise taskforce costs *(b)*	16.6
Sub-total – General	167.3
NEGA-related costs -	
Contribution towards NEGA unsecured creditors outlined in the DOCA-one off cost *(d)*	20.6
Receiver/manager fees *(e)*	6.0
Estimated shortfall between revenue and expenditure of the franchisee businesses in receivership - ongoing until restructure of franchise *(e)*	45.6
Employee entitlement costs assumed by the State-V/Line Passenger-one off item *(f)*	24.6
Loss on acquisition of NEGA new rolling stock financing vehicle companies-one off item	66.9
Sub-total – NEGA-related costs	163.7
Total costs	331.0
Less payment of performance bond	(135.0)
Net cost	**196.0**

(a) Costs incurred from 2000-01 to 2002-03. Excludes ongoing commitments.
(b) For the period 2001-02 to 2002-03. Excludes ongoing commitments.
(c) Of the forecast expenditure of $48 million for the initial funding period, $19 million was paid up to 30 June 2003. Estimated cost excludes additional funding period (Oct. 2003 – Dec. 2004), if elected by the State (commitment of $49 million).
(d) Paid by the State in July 2003.
(e) For the period 22/12/02 to 30/06/03. Excludes ongoing commitments.
(f) V/Line Passenger Franchise Agreement terminated on 1 October 2003. Audited financial statements were not available. State has guaranteed the funding of NEGA employee entitlements which total $82.4 million. The amount included represents V/Line Passenger Corporation portion of these entitlements.

5.65 **Apart from the costs already incurred or committed as outlined in Figure 5F, further additional costs will be borne by the Government following the re-structuring of the franchise arrangements. We understand the Government is currently considering its options, including contract re-negotiation and/or re-tendering, and an appropriate structure for the public transport system.**

MELBOURNE 2006 COMMONWEALTH GAMES

5.66 The Government's major events strategy is implemented through a number of agencies; viz the Victorian Major Events Company Ltd, Australian Grand Prix Corporation, Department of Premier and Cabinet, Tourism Victoria and the Department for Victorian Communities. The overall objective of the strategy is to pursue and secure major event opportunities, which provide a substantial economic impact and/or international profile for Victoria.

5.67 These events generally raise significant financial commitments for the Government and, in most cases, the costs of hosting such events will exceed the direct revenues received from ticketing sales and sponsorships. The overall benefits are measured by way of the short and long-term economic activity, generated by the event. In essence, the major events are aimed at stimulating economic activity, with the resulting increases in tax revenues contributing towards meeting the cost of hosting the events.

5.68 My previous reports to Parliament have commented on developments associated with the State's successful bid to host the Melbourne 2006 Commonwealth Games, the subsequent establishment of an organising committee company known as Melbourne 2006 Commonwealth Games Pty Ltd and the progress of organising the Games. Major developments in 2002-03 included changes to the accountability and reporting arrangements for the Games, the approval of a revised whole-of-games budget and the selection of a preferred developer to construct the Commonwealth Games Village. Comment on each of these developments follows.

Accountability and reporting structures

5.69 In July 2000, the former Department of State and Regional Development had been assigned responsibility for the co-ordination of the Government's involvement in the Games. However, as a result of subsequent machinery of government changes in December 2002, these responsibilities were passed to the Office of Commonwealth Games Co-ordination (OCGC) within the Department of Victorian Communities.

5.70 Following the passing of the *Commonwealth Games Arrangements Act* 2003, in October 2003, the Melbourne 2006 Commonwealth Games Corporation was established to assume the role of the organising committee company. Under the provisions of the Act, the assets, liabilities, rights and obligations of the organising committee company were transferred to the new corporation, effective from 5 November 2003.

5.71 In summary, the role of the OCGC is to co-ordinate the Victorian Government's input into the Games, ensure delivery of the permanent infrastructure, manage the budget and governance arrangements, and implement a framework to maximise the benefits and positive legacies of the Games. The Corporation is responsible for the overall running of the Games, including management of ticketing, sponsorship, broadcasting and the construction of temporary infrastructure. These arrangements are designed to facilitate effective governance through the establishment of clear lines of responsibility and accountability for the delivery of the Games.

Revised budget, risk and management strategies

5.72 The development of a whole-of-games budget was undertaken over a period of 2 years and involved a number of government agencies and consultants undertaking assessments, evaluations and comparisons against other similar major events, including the 2000 Sydney Olympics Games and the Manchester 2002 Commonwealth Games.

5.73 As part of the 2003-04 State Budget process, the Government endorsed a revised budget for the Games. The whole-of-games budget is now estimated at $1.1 billion, including the cost of related capital works infrastructure. **The State's contribution to the cost of hosting the Games in the period up to 2006, excluding the cost of capital works, is estimated at $474 million. This amount does not include costs that will be incurred by public sector agencies associated with the staging of the Games, which are to be accommodated within their existing budget allocations.**

5.74 The revised State contribution is substantially higher than the original projected cost, excluding capital works, of $195 million (in 1996 dollars) as detailed in the successful bid document. The key factors contributing to the substantial increase in the Games' budget were the inclusion of the payment of licence fees, changes to the security environment, additional public transport costs and a revised project contingency sum.

5.75 The Corporation has already secured a contract for its domestic TV rights, however, a number of significant revenue streams, including international TV rights, ticketing sales, sponsorships and the Commonwealth Government contributions, are yet to be finalised. Although the Corporation has not achieved its milestone sponsorship budget target for the period ending 30 June 2003, it remains confident of achieving its ultimate budget target.

5.76 The expenditure budget also reflects the impact of a number of key assumptions, including the number of available volunteers, public transport patronage and estimates of key costs including security, information technology and transport. As indicated previously, the budget includes a contingency sum, representing around 7 per cent of the Games' projected operating expenditure. This is designed to cover cost increases (or revenue decreases) that could impact on the budget between now and 2006.

5.77 Economic impact studies are important in assessing the benefits to the State flowing from major events, notwithstanding a degree of uncertainty associated with such estimates. **We observed that the OCGC had not prepared an updated economic impact study since the impact study undertaken at the time of the bid (1996). The OCGC, instead, relied on the economic impact studies completed for the Sydney 2000 Olympic Games and the Manchester 2002 Commonwealth Games. These studies estimated an economic benefit multiplier of 2.50 and 2.40, respectively. That is, every $1 spent on the 2006 Games by the Government, would generate economic activity of around $2.50 within the State – therefore indicating a substantial net economic benefit to the State from hosting the Games.** The OCGC has advised that in 2003-04 it is proposing to conduct an assessment of the triple bottom line impact of the Games.

5.78 To minimise the financial risks and maximise economic opportunities associated with the Games, the Government has developed a number of strategies including a whole-of-games risk management strategy, sponsorship strategy and tourism marketing strategy.

5.79 Although the Government has imposed a cap on its contribution towards the Games, under the endorsement contract the Government has underwritten any shortfall between revenue and expenditure of the Corporation established to run the event. As outlined in our October 2002 *Report on the Finances of the State of Victoria, 2001-02*, the State has also provided a range of guarantees and indemnities associated with the redevelopment of the Melbourne Cricket Ground Northern Stand and a loan facility to the Melbourne Cricket Club via the Treasury Corporation of Victoria. As at 30 June 2003, the Melbourne Cricket Club had drawn-down $52.5 million against the loan facility for the redevelopment.

5.80 The State has further agreed to provide project support in the form of a $77 million grant to the Melbourne Cricket Club (to be provided in equal instalments in 2003-04 and 2004-05), and to provide compensation to the Australian Football League for the loss of seating capacity for AFL grand finals during the project construction period, to be calculated in accordance with an agreed formula. As outlined in the Annual Financial Report, the base compensation has been agreed at $5.7 million and is to be paid in equal instalments in November 2003 and 2004, subject to possible future adjustment if seating capacity targets are unable to be met.

5.81 **As the State is the ultimate guarantor of the Games and given the significant associated logistical and financial commitment, it is important that Parliament be progressively informed on the progress against the whole-of-games budget. It is especially pleasing to note that a summary of the whole-of-games cost has been presented for the first time, in the unaudited section of the *Department for Victorian Communities 2002-03 Annual Report*, as a "Special Purpose Report". We understand this practice will be repeated over the life of the games. We welcome this development.**

Infrastructure budget

5.82 One of the key financial commitments confronting governments in hosting major international events is funding the required infrastructure and the subsequent utilisation of the facilities following the event. From this perspective, the financial impact and risks to the State have been minimised given that the majority of the required infrastructure is already in place and is being used for local, national and international events.

5.83 The additional facilities identified by OCGC requiring development or redevelopment for the Games are shown in Figure 5G.

FIGURE 5G
STATE CONTRIBUTION TO COMMONWEALTH GAMES INFRASTRUCTURE
($million)

Works funded from the infrastructure budget	*Estimated contribution by the State*	*Actual contribution to 30 June 2003*
MCG Northern Stand redevelopment	77.0	-
Melbourne Sports and Aquatic Centre	51.0	3.2
State Lawn Bowls Centre	2.5	2.5
Commonwealth Games Village *(a)*	35.1	-
Yarra Precinct Infrastructure, including Jolimont station improvements	31.1	-
Works at miscellaneous Games venues, including MCG temporary athletics track	25.9	-
Total	**222.6**	**5.7**

(a) Includes the social housing component of the Games Village.

5.84 **As indicated above, the State is to contribute an estimated $222.6 million towards the Games' infrastructure**. At 30 June 2003, the majority of planned works had not substantially progressed.

5.85 At the time of the preparation of this report, the final development agreement for the Commonwealth Games Village was being negotiated with the successful bidder.

***RESPONSE** provided by Minister for Finance and Treasurer*

Figure 5C Estimate Cost Outcomes of Major Public Sector Industrial Agreements and Policy Initiatives Resulting in Additional Staff

In its first term, the Government worked hard to improve the quality of services such as health, education and police, partly the result of neglect under the previous Government. This achievement, which resulted in greater numbers of nurses, teachers, police and emergency services workers, is reflected in higher employee costs.

The Government will continue to ensure that wages growth is fiscally responsible, and anticipates that, without productivity gains, wages funding will grow at the same rate as inflation, forecast at 2.25 per cent in the 2003-04 Budget. Any additional growth in employee costs will need to be funded through productivity gains and/or improved service delivery outcomes.

Part 6

Assets

SUMMARY OF STATE ASSETS

State's financial position ($million)	2002-03	2001-02	Movement
Assets	**102 218**	97 115	5 103
Liabilities	**49 362**	47 688	1 674
Net assets	**52 856**	49 427	**3 429**

6.1 **The State's assets mainly comprise physical assets, receivables, cash and investments with an aggregate value of $102 218 million as at 30 June 2003 - an increase of $5 103 million on the previous year.**

AT A GLANCE

			Movement	
State assets ($million)	2002-03	2001-02	Amount	%
Financial and other non-physical assets -				
Investments	**20 098**	19 937	161	0.8
Receivables	**6 360**	7 218	(858)	(11.8)
Cash	**2 319**	1 578	741	46.9
Other assets	**692**	585	107	18.3
	29 469	29 318	151	0.5
Physical assets -				
Land and buildings	**35 178**	31 521	3 657	11.6
Plant, equipment and infrastructure systems	**17 514**	17 018	496	2.9
Roads and earthworks	**16 749**	16 132	617	3.8
Other	**3 308**	3 126	182	5.8
	72 749	67 797	4 952	7.3
Total State assets	**102 218**	97 115	5 103	5.2

6.2 The major factors contributing to the higher level of assets held were:

- an increase in the value of physical assets of $4 952 million, mainly due to revaluation adjustments and net asset additions in the year; and
- increased cash holdings of $741 million, mainly by public financial corporations.

6.3 These increases were offset by a reduction in receivables of $858 million, largely due to the maturity of various derivative transactions (financial instruments) and lower gas sales debtors due to the impact of the introduction of full contestability for retail gas customers during the year.

INVESTMENTS

State assets	***2002-03***	*2001-02*	*Movement*
Investments ($million)	**20 098**	19 937	161

6.4 **At 30 June 2003, the State's investment holdings were valued at $20 098 million, an increase of $161 million since the previous year.** These assets represent the largest component of the State's financial assets and comprise domestic and international equities, investment property, fixed interest securities, bonds and term deposits.

6.5 The majority of the State's investments are held by 5 agencies, namely:

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

6.6 Figure 6A details the investment holdings of these major agencies at 30 June 2003 and movements in these holdings from the previous year.

FIGURE 6A
MAJOR INVESTMENT HOLDINGS *(a)*
($million)

Agency (a)	*Investments 30 June 2003*	*Investments 30 June 2002*	*Movement*
Department of Treasury and Finance	2 650	2 438	212
Treasury Corporation of Victoria *(b)*	5 784	5 970	(186)
Transport Accident Commission	5 499	5 224	275
Victorian WorkCover Authority	5 344	4 935	409
Victorian Managed Insurance Authority	415	411	4

(a) Investments are valued at net market values.
(b) Excludes cash at bank and on hand, and deposits with the Futures Exchange. The Treasury Corporation of Victoria investments include $2.7 billion ($2.3 billion, 30 June 2002) of funds deposited by public sector agencies, public sector superannuation funds and Budget Sector trust funds.

6.7 The movements in investment balances during the year reflect the changes in the market value of investment assets, and the impact of decisions about the placement and redemption of funds throughout the year.

Impact of equity market movements

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

6.9 The State and its major investing agencies hold diversified investment portfolios, which include substantial holdings of domestic and international equities. As shown in Figure 6B, investment portfolio allocations remained relatively stable during 2002-03.

FIGURE 6B
INVESTMENTS HELD BY MAJOR AGENCIES,
AT 30 JUNE 2003 *(a)*

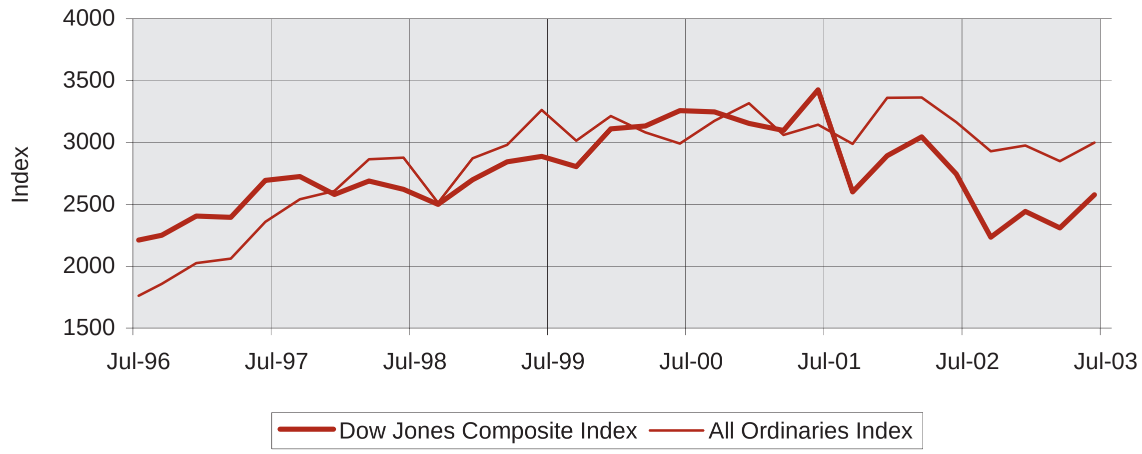
Type of investment	*Transport Accident Commission*	*Victorian WorkCover Authority*	*Victorian Managed Insurance Authority*	*Department of Treasury and Finance*	*Treasury Corporation of Victoria*	*State Super Fund*	*Overall fund allocation* ***2003***	*2002*
	($m)	*($m)*	*($m)*	*($m)*	*($m)*	*($m)*	***(%)***	*(%)*
Domestic equities	1 198	1 703	112	-	-	2 041	**19**	20
International equities	*(b)* 1 353	990	128	-	-	1 235	**14**	13
Total equities	2 551	2 693	240	-		3 276	**33**	34
Fixed interest	2 032	1 764	127	2 650	5 129	1 346	**48**	50
Bonds - indexed	277	572	47	-	655	340	**7**	7
Property	503	166	-	-	-	526	**4**	5
Short-term deposits	136	149	1	-	-	1 734	**8**	4
Total investments	**5 499**	**5 344**	**415**	**2 650**	**5 784**	**7 222**	**100**	**100**

(a) All investments are shown at their market values.
(b) The Transport Accident Commission fully hedges its exposure to foreign currency movements.
Source: Financial investment reports of the respective agencies.

6.10 Of the total investments held by the major agencies, 33 per cent were held in equities. The value of these investments is subject to substantial volatility in the short to medium-term, which can significantly impact on the reported investment values and the financial performance of the respective investing agencies, and consequently the State, in any one financial year.

6.11 Notwithstanding this volatility, over the longer-term, equity values have generally increased and have provided strong returns to the State's investing agencies. This is illustrated in Figure 6C which outlines the performance of the Australian and the United States of America equity markets over a 7 year period from July 1996 to July 2003, as reflected in the movements of the All Ordinaries Index and the Dow Jones Composite Index, respectively.

FIGURE 6C
MOVEMENT IN THE ALL ORDINARIES AND DOW JONES COMPOSITE INDEX



Source: Dow Jones Composite Index and Australian Stock Exchange.

6.12 **Figure 6C shows that for 2002-03 the Dow Jones Composite and the Australian All Ordinaries indices have fallen over the year by 6.1 per cent and 5.2 per cent, respectively, which has again adversely impacted on investment values and the returns achieved by the State's investing agencies in the year.**

6.13 The substantial movements in equity markets have also had a significant impact on the value of investments held by public sector superannuation funds. While these investments are not recorded in the Annual Financial Report because they are not the assets of the State, the movement in the valuation of the investment portfolio has directly impacted on the State's reported liability for unfunded superannuation obligations. The impact of the market movements on the State's unfunded superannuation liabilities is discussed later in this report.

6.14 **Equity investments are generally held to fund longer-term liabilities, such as insurance claims and superannuation obligations, with the ultimate value of these investments not crystallising until they are realised. In this context, some caution is required when assessing the impact of short-term market conditions on the financial standing and longer-term financial performance of the respective investing agencies and the State.**

PHYSICAL ASSETS

State assets	2002-03	2001-02	Movement
Physical assets ($million)	**72 749**	67 797	4 952

6.15 The State's physical assets mainly comprise Crown and freehold land, buildings, roads and other infrastructure, plant and equipment, and cultural assets. Figure 6D outlines the major movements during 2002-03 in the value of the State's physical assets.

FIGURE 6D
STATE'S PHYSICAL ASSETS,
SUMMARY OF 2002-03 MOVEMENTS
($million)

Opening balance – 1 July 2002	**67 797**
Revaluations	3 553
Disposals and write-downs	(627)
Additions	3 019
Depreciation and amortisation	(1 620)
Other	627
Closing balance – 30 June 2003	**72 749**

Source: Annual Financial Report for the State of Victoria, 2002-03.

6.16 Major asset revaluations undertaken in 2002-03 that have significantly impacted on the asset base include:

- Office of Housing - public housing properties ($874 million);
- Department of Education and Training - school sites ($637 million) and TAFE sites ($114 million);
- VicRoads - roads ($789 million);
- Department of Sustainability and Environment – conservation reserves ($445 million); and
- State Library of Victoria – library collection ($150 million).

6.17 The State's infrastructure consists of a complex network of public works, including roads, bridges, dams, utilities and education and health facilities, which significantly impact on our quality of life and are a key driver of economic growth.

6.18 The process of managing the planning, financing, construction and upkeep of infrastructure assets is complex. For example, capital programs result in the creation of public assets, which provide benefits over many years. Moreover, capital projects often involve large sums of money with long-term financial commitments that after commencement, cannot easily be changed without incurring serious delays and irretrievable costs.

6.19 State Government spending on capital investment was $3 019 million in 2002-03. Past management problems and reduced discretionary revenue sources have led to an increased focus by government on strengthening capital decision-making and project management processes.

6.20 A number of large infrastructure projects currently underway, or before the market, pose a financial risk to the Government. My previous reports to the Parliament have highlighted the difficulties associated in completing significant capital projects on time and within budget. This risk, in some cases, has been mitigated by the transfer of the risk of cost overruns to the private sector, in return for a premium under partnering arrangements.

6.21 To address these risks and improve the asset management process, the Department of Treasury and Finance has developed an Asset Investment Allocation Model. The model is designed to assist the Government in making decisions during the budget cycle, taking into account whole-of-asset-life principles. In addition, as from 2003-04, the Government will implement a mandatory review process to be conducted by experienced independent officers at the critical stages of major projects. The broad objective of this process is to identify any issues that may impact on the delivery of projects and ensure that they are effectively managed.

6.22 Based on the Government's *Budget Information Paper 1, 2002-03*, there were around 1 700 capital works projects in progress, or planned to be commenced across the Victorian public sector during 2002-03, with a combined value of $11 057 million.

6.23 A summary of the major individual capital works projects with an approved total budget in excess of $20 million and actual capital outlays in 2002-03 of at least $10 million at variance from those forecast for the year, is outlined in Figure 6E.

FIGURE 6E
MAJOR 2002-03 CAPITAL WORKS - BUDGET TO ACTUAL VARIANCES
($'000)

Project	*Original budget*	*Revised budget (a)*	*Forecast capital outlay in 2002-03*	*Actual capital outlay in 2002-03*	*Variance*
Regional Fast Rail Project	*(b)* 582 000	*(c)* 617 000	147 670	111 469	(36 201)
Showgrounds Redevelopment	100 700	100 700	25 200	4 021	(21 179)
Wodonga Rail Freight and Urban Redevelopment	30 000	30 000	20 149	777	(19 372)
State Library Redevelopment	187 000	190 600	42 199	25 205	(16 994)
Standardisation of Regional Freight Lines	*(d)* 96 000	67 500	24 671	8 021	(16 650)
Australian Synchrotron Project	100 000	157 300	13 500	2 174	(11 326)
Federation Square Development	110 000	436 400	49 000	38 231	(10 769)
Total	**1 205 700**	**1 599 500**	**322 389**	**189 898**	**(132 491)**

(a) Revised budget as per *Budget Information Paper 1, 2003-04.*
(b) Original budget of $550 million was later revised to $557 million. The budget is net of forecast net operational savings of $25 million, making the capital budget $582 million.
(c) Revisions to the budget were not included in *Budget Information Paper 1, 2003-04*. We were advised by the Department of Treasury and Finance that the revision to the budget was not included so as not to prejudice negotiations which were in progress with counterparties.
(d) Of this amount, $28.5 million was subsequently re-allocated to other regional freight projects.

6.24 While the majority of the variations against forecast for 2002-03 have been broadly attributed by the responsible agencies to planning, design, health and safety, access, contractual and financial issues, we examined one of the major projects, namely, the Regional Fast Rail Project, to identify the specific reasons for such variances.

REGIONAL FAST RAIL PROJECT

6.25 As outlined in our October 2002 *Report on the Finances of the State of Victoria, 2001-02,* the Government approved 4 contracts in June 2002 for the design and construction of the Regional Fast Rail Project (RFRP), at an approved project budget of $557 million (net of expected operating cost savings of $25 million, making the capital budget - $582 million). The principal aim of the RFRP was to reduce passenger journey times between Melbourne and the regional centres of Ballarat, Bendigo, Geelong and the Latrobe Valley by undertaking infrastructure works that will allow trains to run at higher speeds. The infrastructure works will involve the upgrading of 500 kilometres of existing track, construction of new sections of track and installation of new signalling equipment.

6.26 Following a detailed risk assessment subsequent to establishing the project budget, the Department of Infrastructure identified a number of potential risks, which formed the basis of its submission for additional funding for this project during the 2003-04 budget cycle. We were advised that **the Government approved additional capital funding of $35 million bringing the revised capital budget for the regional fast rail project to $617 million.**

6.27 At 30 June 2003, a total of $111.5 million had been expended on this project, mainly relating to its design, procurement of materials and site mobilisation. This compares with a forecast for the year of $147.7 million. The under-expenditure of $36.2 million resulted from a number of delays experienced on the project, including:

- the failure of the contractors to complete the required design and accreditation documentation by the required dates;
- operational issues between V/Line Passenger and Freight Australia; and
- land acquisition difficulties.

6.28 These issues have resulted in delays for the development of the 4 rail corridors, ranging from 4 to 18 weeks as at 30 June 2003. Despite these delays, with remedial action, including the closure of lines for extended periods of time, the department believes that it will achieve its original completion dates for construction of the Ballarat (June 2005) and Geelong (February 2005) corridors. The expected completion date for the Bendigo corridor has been revised from October 2004 to June 2005, with the Latrobe corridor completion date extended from March 2004 to February 2005.

6.29 **At October 2003, the department had received 120 Notices of Delay from the contractors. The department has rejected all such claims.**

6.30 **While the budget for this project contains a contingency sum to cover unexpected expenditures, a number of issues and risks need to be carefully managed for the project to remain within the revised budget and timelines.**

Part 7

Liabilities, commitments and contingencies

AGGREGATE LIABILITIES OF THE STATE

State's financial position ($million)	2002-03	2001-02	Movement
Assets	**102 218**	97 115	5 103
Liabilities	**49 362**	47 688	1 674
Net assets	**52 856**	49 427	3 429

7.1 **The Annual Financial Report shows liabilities of the State totalling $49 362 million at 30 June 2003, an increase of $1 674 million on the previous year.**

AT A GLANCE

State liabilities ($million)	2002-03	2001-02	Movement	
			Amount	%
Interest-bearing liabilities	**13 891**	13 067	824	6.3
Unfunded superannuation liabilities	**13 490**	13 435	55	0.4
Outstanding claims liabilities	**11 945**	10 658	1 287	12.1
Payables	**4 291**	5 249	(958)	18.3
Employee entitlements	**2 976**	2 713	263	9.7
Other liabilities	**2 769**	2 566	203	7.9
Total State liabilities	**49 362**	47 688	1 674	3.5

7.2 **The increase in State liabilities is mainly due to higher outstanding insurance claims and increased interest-bearing liabilities resulting from a higher level of deposits lodged and the assumption of debt relating to V/Line Passenger rolling stock. This was offset by a reduction in payables mainly relating to the maturity of derivative transactions (financial instruments) and lower gas sale payables.**

7.3 In addition to the liabilities outlined in Figure 7A, 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 $1 750 million at 30 June 2003 ($1 786 million, 30 June 2002).**

7.4 The most significant quantifiable contingent liabilities relate to the value of lease payments on new rail rolling stock if early termination of public transport rail franchise agreements were to eventuate. The major non-quantifiable contingent liabilities include those associated with contracts and agreements for the Melbourne 2006 Commonwealth Games, the provision of public transport services by private sector operators, the redevelopment of the Melbourne Cricket Ground and litigation claims against the State.

7.5 The State has also entered into various arrangements giving rise to operating, capital and other commitments. These also do not form part of the liabilities included in the Consolidated Statement of Financial Position as the relevant goods or services had not been received or consumed at balance date. **The State's operating, capital and other commitments totalled $15 416 million at 30 June 2003 ($13 134 million, 30 June 2002).** The major reasons for the increase in commitments between the 2 years were the establishment of new contractual arrangements, including those for the Spencer Street Station redevelopment, the Berwick Community Hospital, prison facilities and various office accommodation arrangements.

INTEREST-BEARING LIABILITIES

State liabilities	***2002-03***	*2001-02*	*Movement*
Interest-bearing liabilities ($million)	**13 891**	13 067	824

7.6 Interest-bearing liabilities of the State predominantly comprise public sector debt raised domestically and overseas, loans and advances from the Commonwealth Government, and finance leases entered into by various public sector agencies. **At 30 June 2003, the State's interest-bearing liabilities totalled $13 891 million, an increase of $824 million on the previous year.** Figure 7A summarises the composition of interest-bearing liabilities at 30 June 2003 and the movement from the previous year.

FIGURE 7A
INTEREST BEARING LIABILITIES
($million)

Interest-bearing liabilities	***2002-03***	*2001-02*	*Movement*
Domestic borrowings	12 620.9	11 372.9	1 248.0
Foreign currency borrowings	964.9	1 429.9	(465.0)
Finance lease liabilities	304.9	264.3	40.6
Total interest-bearing liabilities	**13 890.7**	**13 067.1**	**823.6**

Source: *Annual Financial Report for the State of Victoria, 2002-03*.

7.7 Key transactions impacting on the overall movement in interest-bearing liabilities include:

- Acquisition by the State of the former National Express Group's special purpose financing vehicle companies utilised to obtain new rolling stock. These companies raised funds from a bond issue valued at $340 million to finance the acquisition of new rolling stock for the provision of public transport. The State is now responsible for this debt; and
- Increase in deposits held by the Treasury Corporation of Victoria, mainly on behalf of the State Superannuation Fund.

7.8 The State holds various debt instruments with terms to maturity ranging up to 30 years. The State's exposure to risk arising from the repayment and/or refinancing of matured debt is mitigated by maintaining a spread of debt along the maturity spectrum. In 2002-03, the State issued $1 100 million of term debt to replace matured borrowings and manage its liquidity. Matured foreign borrowings in the year have substantially been funded from new domestic borrowings.

7.9 **Debt with a face value of approximately $1 886 million will fall due for repayment in 2003-04 (excluding short-term deposits lodged with the State).**

Car fleet financing arrangements

7.10 My previous *Reports on the Finances of the State* have commented on a 7 year Master Lease Agreement (MLA) entered into in 1997 between the Government and the Commonwealth Bank of Australia (CBA), involving the sale and leaseback of the Budget Sector vehicle fleet.

7.11 Under the terms of the agreement, the State is required to fund any shortfall between the value of motor vehicles sold at the end of the lease term and the previously agreed residual value of the motor vehicles via increased rentals on new leases. These transactions are recorded in a "Profit and Loss Adjustment Account" (PLAA) maintained by the Department of Treasury and Finance. **At 30 June 2003, the department estimated the aggregate losses associated with vehicle disposals under the leasing arrangements to be funded in future periods at $57.5 million. During 2002-03, the department funded previous losses of $17.5 million associated with the arrangement.**

7.12 **During the year, the lease liability under the arrangement increased by $45.5 million to $211.5 million**. This increase was due to revisions in the model used to calculate the lease liability. The model was originally developed when the residual values for motor vehicles were considerably higher than those currently obtainable, resulting in the lease liability being significantly understated.

7.13 **At the time of preparing this report, the Government was in the process of completing a review of the future of the current Budget Sector vehicle fleet arrangements.**

UNFUNDED SUPERANNUATION

State liabilities	2002-03	2001-02	Movement
Unfunded superannuation liabilities ($million)	**13 490**	13 435	55

7.14 **At 30 June 2003, the State's unfunded superannuation liabilities totalled $13 490 million, an increase of $55 million on the previous year.**

7.15 This liability represents one of the largest components of State liabilities and is a legacy of decisions taken by successive Governments before 1994 not to fund public sector superannuation costs in the periods that they accrued. Rather, previous Governments elected to meet superannuation costs as and when member benefits became due and payable – on an emerging cost basis.

7.16 The Government's current strategy is to fully fund the superannuation liability by 2035 and, to this end, it annually makes additional contributions to the respective superannuation funds (mainly the State Superannuation Fund). **In 2002-03, total contributions of $1 605 million, which were $750 million above forecast, were made by the Government towards the reduction of the State's unfunded superannuation liabilities.**

7.17 In estimating the value of unfunded superannuation liabilities, a range of variables are taken into account by the fund actuaries. Among these are assumptions relating to salary earnings, investment earnings on superannuation assets, inflation and demographic changes such as the life expectancy of members. These assumptions have not materially changed for this year's actuarial assessments.

Performance of unfunded superannuation schemes

7.18 Of the 2 main types of superannuation schemes (defined benefits and accumulation schemes), it is only the defined benefits schemes which have unfunded superannuation liabilities. The State's main defined benefits scheme is the State Superannuation Fund. Under the defined benefits schemes, most of which have been closed to new members for some years, members are entitled to levels of benefits which are not impacted by the investment earning rates of the schemes. Accordingly, when investment returns are low, the Government is generally required to contribute more to fund the benefits payable by the scheme. However, in the case of accumulation schemes, the Government contributes a percentage of salary and members carry the risk of poor or negative investment earnings on funds invested by these schemes.

7.19 **As previously mentioned the State's unfunded superannuation liability increased only marginally by $55 million in 2002-03, mainly reflecting the impact of additional Government contributions of $1 605 million which substantially off-set the negative impact of poor equity markets on superannuation scheme earnings and assets, and members' salary growth.**

7.20 While the investment returns achieved by the State's major defined benefits schemes substantially improved in 2002-03 when compared with the previous year, they still remained low mainly due to continued depressed equity markets. In particular, the investment return achieved by the State Superannuation Fund in 2002-03 was 0.4 per cent (2001-02, negative 5.03 per cent), while the return achieved by the Emergency Services Superannuation Scheme in the year was 2.10 per cent (2001-02, negative 2.98 per cent).

7.21 **In addition, the State's share of the unfunded liabilities of Health Super (formerly known as the Hospitals Superannuation Fund) and the Local Authorities Superannuation Fund were recognised as part of the State's liabilities in the Annual Financial Report in 2002-03. This occurred because each of these funds had an excess of liabilities over assets and the State became obliged to recognise its share of the unfunded liability.**

OUTSTANDING CLAIMS LIABILITIES

State liabilities	***2002-03***	*2001-02*	*Movement*
Outstanding claim liabilities ($million)	**11 945**	10 658	1 287

7.22 **The State's outstanding claims liabilities totalled $11 945 million at 30 June 2003, an increase of $1 287 million (12 per cent).**

7.23 The majority of these liabilities are managed by the Victorian WorkCover Authority (personal workplace injury), Transport Accident Commission (motor vehicle and public transport personal injury) and the Victorian Managed Insurance Authority (participating public sector agencies insurance cover).

7.24 The liabilities for outstanding claims for each of these insurance entities, along with those recorded by other agencies at 30 June 2003, are detailed in Figure 7B.

FIGURE 7B
COMPOSITION OF OUTSTANDING CLAIMS LIABILITIES, AT 30 JUNE
($million)

			Total		
Entity	*Current*	*Non-current*	***2003***	*2002*	*Movement*
Victorian WorkCover Authority	963	5 581	**6 544**	5 874	670
Transport Accident Commission	596	4 082	**4 678**	4 290	388
Victorian Managed Insurance Authority	83	442	**525**	452	73
Other agencies	11	187	**198**	42	156
Total outstanding claims liabilities	1 653	**10 292**	**11 945**	**10 658**	1 287

Source: Annual Financial Report.

7.25 Over the past 5 years, these liabilities have increased by around 33 per cent. This has been mainly due to:

- increasing number of claims reflecting the maturing nature of these schemes;
- rising claims costs for medical, legal, rehabilitation and settlement expenditure;
- higher number of motor vehicle and workplace accidents resulting in serious injury that have led to costly claims; and
- changes in the economic assumptions, such as inflation and investment earning rates, used to determine the future claims costs.

7.26 **The 12 per cent increase in the value of the outstanding claims liabilities in 2002-03 was largely due to the increase in medical claims as a result of increasing health costs, the recognition for the first time of claims "incurred but not reported" in the health sector, and changes in economic assumptions used by the individual scheme actuaries in calculating the value of the liabilities. The negative impact of the above factors was partially offset by the positive impact of various case management initiatives at the Victorian WorkCover Authority and the Transport Accident Commission.**

7.27 Following an operating loss of $316 million for 2002-03 (loss of $98 million in 2001-02), the Victorian WorkCover Authority's financial position further deteriorated in the year, with the excess of liabilities over assets held increasing from $781 million at 30 June 2002 to $1 097 million at 30 June 2003. The Transport Accident Commission and the Victorian Managed Insurance Authority still had positive net asset positions at that date.

7.28 The methodology used to determine the value of outstanding claims liabilities is broadly 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. **Consequently, the value of calculated outstanding claims liabilities may change periodically as assumptions and claims experience change.**

7.29 The actuarial assessments cover claims reported but not paid, and claims incurred but not reported. In estimating the outstanding claims liability, a range of assumptions are made, including the projected inflation rate over future periods, and cashflows are discounted to bring future cash flows back to today's values. In 2002-03, the decline in domestic bond yields, and actual inflation experience led to a change in the economic assumptions made by the actuaries of the 3 schemes. The actuaries estimated that these changed assumptions accounted for $638 million of the increase in the total outstanding claims liability.

7.30 The extent of the "tail" for the State's insurance obligations is indicated by the "weighted average expected term to settlement" for claims. The Australian Prudential Regulation Authority has advocated the use of "prudential margins" where there is a significant level of uncertainty in actuarial estimates, as is experienced with "long tail" insurers such as the State's insurance authorities. The Department of Treasury and Finance has been considering for some time the adoption of prudential guidelines for the State's public sector insurance entities along similar lines to those promoted by the general insurance regulator.

7.31 In the meantime, the decision on whether to incorporate a prudential margin when valuing outstanding insurance claims and the quantum of such a margin, is made by each insurance entity's governing board. The prudential margin for the Transport Accident Commission and the Victorian Managed Insurance Authority at 30 June 2003 totalled $690 million, and effectively represented 13.7 per cent of their combined outstanding claims liabilities. For the Victorian WorkCover Authority, no prudential margin is included in the actuarial assessment and reliance is placed on the "central" or "best" estimate arrived at by their actuary to adequately reflect the inherent uncertainty in the estimation process.

Public Healthcare insurance claims

7.32 The Victorian Managed Insurance Authority has historically managed the Public Healthcare Insurance Program on behalf of the Department of Human Services on a "claims made" basis - that is, when a claim is made by a party.

7.33 As a result of changes in professional accounting requirements, the department was required in 2002-03 to account for the Public Healthcare claims on a "claims incurred" basis and to, therefore, also recognise claims "incurred but not reported" (IBNR). These claims are annually assessed by an actuary, based on incidents that have taken place in the year, rather than waiting until claims are made.

7.34 **In accordance with the new accounting requirement, the State recognised as liabilities, for the first time, IBNR claims associated with the Public Healthcare insurance scheme amounting to $164.4 million at 30 June 2003.**

PAYABLES AND OTHER LIABILITIES

State liabilities ($million)	2002-03	2002-01	Movement
Payables	**4 291**	5 249	(958)
Other liabilities	**2 769**	2 566	203

7.35 **At 30 June 2003, payables and other liabilities totalled $7 060 million, an overall decrease of $755 million compared with the previous year.** This decrease was mainly attributable to the reduction in gas sale payables due to revision of the gas supply arrangements and the maturity of certain derivative transactions (financial instruments)**.**

7.36 Comment follows on one of the major transactions forming part of the above balances.

Flexible electricity tariff arrangements

7.37 My previous *Reports on the Finances of the State of Victoria* have outlined the flexible electricity tariff arrangements established by the Government in 1984 in relation to the Portland and Point Henry aluminium smelters. Under the arrangements, the State Electricity Commission of Victoria (SECV) is responsible for meeting the Government's obligation to subsidise electricity generators for the lower prices charged to the smelters when prices fall under a stipulated level.

7.38 To reduce the State's exposure under the smelter contracts, the SECV entered into a hedge arrangement. In addition, from 1 July 1997, wholesale electricity market participants are obliged to pay the SECV "smelter reduction amounts" which would be applied by the SECV towards the funding of future expected losses under the flexible electricity tariff arrangements.

7.39 **Net payments made by the SECV under the smelter contracts during 2002-03 totalled $111.7 million (2001-02, $104.4 million) inclusive of "smelter reduction amounts".**

7.40 The SECV's obligations and rights arising from the smelter contract and associated "smelter reduction amounts" are assessed each year by the SECV taking into account amounts received and paid, developments in the electricity market and changes to underlying assumptions, in particular future aluminium and electricity prices, renewable energy obligations and consumer price index forecasts. **This re-assessment resulted in an increase in the provision for future contract payments by $76 million, and an increase in the receivables for future smelter reduction amounts payable to the State, by $53 million.**

7.41 The estimated future liabilities and receivables arising from these arrangements at 30 June 2003 are outlined in Figure 7C.

FIGURE 7C
SMELTER CONTRACT (LIABILITY) AND "SMELTER REDUCTION AMOUNT" (ASSET), AS AT 30 JUNE 2003 *(a)*
($million)

	2003	*2002*
Smelter contract (liability)	1 326.8	1 251.0
Smelter reduction amount (asset)	1 246.3	1 193.6
Net liability	**80.5**	**57.4**

(a) Net present values.
Source: State Electricity Commission of Victoria.

7.42 As indicated above, it is expected that the State will incur a loss of $80.5 million (2001-02, $57.4 million) for the remaining duration of these arrangements. Under current projections of future cash flows, the State will have net cash outflows in each year up to 2014, but is expected to have net cash inflows thereafter.

7.43 **The State's net obligations under these arrangements may be impacted by the outcome of a recent legal action in which the SECV was the first defendant in a matter before the High Court of Australia initiated by an electricity market participant as plaintiff. The plaintiff is seeking reimbursement of the "smelter reduction amounts" previously paid, together with interest and costs on the basis that the smelter levy is invalid. The existence of this action has been disclosed in the Annual Financial Report as a contingent liability.**

7.44 **The State is defending this legal challenge. An adverse outcome may lead to further claims by other parties and have significant financial ramifications for the State.**

COMMITMENTS

State commitments ($million)	2002-03	2001-02	Movement
Capital	2 083	1 957	126
Operating lease	8 824	9 397	(573)
Other	4 509	1 780	2 729
Total commitments	**15 416**	**13 134**	**2 282**

7.45 **At 30 June 2003, the State's operating, capital and other commitments totalled $15 416 million, an overall increase of $2 282 million compared with the previous year.**

7.46 The movement from the previous year was mainly attributable to the recognition of the commitments for the Spencer Street Station redevelopment, the Berwick Community Hospital, prison facilities, the Echuca/Rochester Wastewater Treatment Plant, the Mobile Data Network and various office accommodation arrangements.

7.47 Comment follows on a number of new major transactions impacting on commitments during 2002-03 and future years.

Berwick Community Hospital Project

7.48 The Berwick Community Hospital (now known as the Casey Hospital) was the first public hospital to be procured under the Government's *Partnerships Victoria* Policy. The project will be delivered through a partnering arrangement between the private sector (responsible for the design, construction, financing and maintenance of the facility), and the public sector (which will operate the facility).

7.49 Upon its completion in mid-2004, the hospital will provide 229 public hospital beds, surgical and obstetric services, ambulatory and emergency care, mental health and sub-acute services to the community. The hospital will be leased to the State for 25 years. At the end of that period, the hospital facility will be transferred to the State for nil consideration.

Tender evaluation and selection process

7.50 Following a 12 month tender evaluation and selection process, Progress Health Pty Ltd was selected in October 2002 as the preferred tenderer for the development of the hospital. Progress Health is a consortium comprising ABN Amro, Multiplex Constructions and Multiplex Asset Management.

7.51 Progress Health's bid was assessed to conform with the project scope, provided the lowest tendered price and compared favourably with the public sector comparator (The public sector comparator is used as a benchmark to demonstrate the likely value of a project if it were financed, owned and implemented by the State.)

7.52 **The probity auditor appointed to oversee the tender and selection process concluded that the tender evaluation process was conducted fairly and impartially, and all bidders were evaluated in accordance with agreed selection criteria. Our review of the tender process also confirmed that it was appropriately conducted.**

Key rights and obligations under the project agreement

7.53 The key rights and obligations of the parties to the arrangement are outlined in Figure 7D.

FIGURE 7D
KEY RIGHTS AND OBLIGATIONS OF PARTIES

Type of risk	*Private sector developer*	*The State*
Design and construction risk	Assumes the design and construction risks, including cost overruns, construction delays and design or construction flaws. Liable for liquidated damages of up to $75 000 per day if final completion does not occur by the required date.	Grant to the developer a non-exclusive construction licence until the end of the agreement. Issue to the developer a 25 year lease over the land. Upon issuing the completion certificate, must promptly procure the execution of a facility lease.
Obsolescence, including the effect of change in technology	Facility to have a design life of 40 years. Provide equipment as per the design brief that must be maintained and replaced as detailed in the Asset Management Plan.	Pay a pre-determined amount into an escrow account to meet the maintenance and refurbishment costs.
Potential changes in relevant costs	Meet the costs of any proposed modification not requested by the State before final completion. The risk of maintenance and refurbishment costs exceeding the amount paid in the escrow account. Maintain all prudent insurances over the facility and the plant and equipment. The risk of loss, damage or destruction of the facility.	Quarterly service payment adjusted for movements in the consumer price index. Costs associated with any modifications requested by the State before final completion. Contribute towards insurance costs in the event the actual insurance costs exceed predetermined levels. Meet potential costs associated with changes in legislation, impacting on the construction and operation of the facility. Meet potential costs associated with a renegotiated scope of the security contracts (5 yearly intervals).
Penalties for non-availability	Quarterly service payment subject to an abatement regime if the facility, associated security and upkeep services do not meet specifications.	Nil
Third party revenues	Able to raise third party revenue from the public hospital car park.	Nil
Asset residual value	Developer has not accepted any residual value risk, and has therefore assigned a nil residual value to the property in pricing the lease.	Facility reverts back to the State at end of the 25 year lease term. Assumes the risks and costs associated with the remaining economic life (estimated at 15 years) following the end of the lease period.

FIGURE 7D
KEY RIGHTS AND OBLIGATIONS OF PARTIES - *continued*

Type of risk	*Private sector developer*	*The State*
Demand risk	Developer remains liable for all repairs, maintenance and refurbishment, even if hospital demand exceeds forecasts.	Quarterly service payments are not dependent upon the number of patients serviced. The risk of utilisation rate of the facility is the responsibility of the State.

7.54 The project agreement includes extensive provisions relating to default events. If the default event is not cured, the State may terminate the agreement. Upon termination, the State is required to pay to the developer the market value of the project as at the termination date. If the termination occurs during the design and construction phase, the termination payment is equivalent to the capital costs expended by the developer up until the termination date plus any associated financing costs.

Commencement of the construction of the Berwick Community Hospital (now known as Casey Hospital).

Reporting of the arrangement

7.55 The total payments to be made by the State over the life of the agreement, in net present value terms, at the time of entering into the contract equates to $118.9 million. Based on our assessment of the risk profile of the contractual arrangements detailed previously, we conclude that the key risks associated with the project remain with the State.

7.56 **Accordingly, we concur with the proposed accounting and financial disclosure for this project, which will entail its future recognition as a financing arrangement. On this basis, upon its completion in 2004, the hospital is to be recorded as an asset of the State with a corresponding liability to be recognised reflecting the State's obligations to finance the capital cost of the facility. In the interim, the nominal commitments associated with the project are disclosed as part of commitments in the Annual Financial Report.**

Index

Accounting standards, harmonisation of 20

Annual Financial Report, audit of 13

Annual Financial Report, preparation and disclosures 17

Assets, State, summary of 83

Audit opinion on the Annual Financial Report 14

Berwick Community Hospital Project....... 104

Car fleet financing arrangements................. 96

Claims liabilities, outstanding 99

Commitments 104

Commonwealth-State Health Care Agreement 44

Employee benefits 62

Equity market movements, impact of.......... 85

Gambling fees and taxes............................. 47

Goods and services, sale of, and other revenue 50

Government Business Enterprises, dividend payments.................................... 55

Grant revenues.. 42

Interest-bearing liabilities 95

Investment performance of major agencies .53

Investment revenue 52

Investments 84

Liabilities, aggregate, of the State................93

Melbourne 2006 Commonwealth Games.....76

Operating result and financial condition, summary of 21

Payables and other liabilities......................102

Physical assets...87

Public transport franchise arrangements, additional costs..69

Regional Fast Rail Project...........................89

Revenues, State, summary of.......................41

Seal Rocks Life Centre litigation settlement 67

State operating expenses, summary of 61

State's financial condition, key indicators of 30

Superannuation, unfunded 97

Supplies and services expenditure 67

Taxation revenues 46

AUDITOR GENERAL
VICTORIA

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