VICTORIA

Auditor General

Victoria

Report of the Auditor-General on the Finances of the State of Victoria, 2003-04

November 2004

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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 16AB of the *Audit Act 1994*, I transmit my *Report on the Finances of the State of Victoria, 2003-04.*

Yours faithfully

JW CAMERON
Auditor-General

18 November 2004

Contents

1. Executive summary

Overview

This report sets out the results of my audit and analysis of the Annual Financial Report for the State of Victoria for the year ended 30 June 2004. A clear audit opinion was provided on the *2003-04 Annual Financial Report*.

The state reported a substantial operating surplus for the year - a significant improvement on the previous year's result. This improvement was mainly due to the impact of improvements in equity markets on investment revenues and superannuation costs. Returns from equity investment markets have improved from an average of negative 7 per cent in 2002-03 to an average of 21 per cent in the year under review.

My analysis of the state's financial performance over a 5-year period shows that state revenue growth has outpaced the rate of inflation by 17.5 per cent while growth in state spending has outpaced the rate of inflation by 9 per cent.

The volatility of revenue from investment and property markets, combined with the growing costs of increased service delivery, industrial settlements and commitments associated with "off-balance sheet" financing arrangements, will require the government to be constantly vigilant to ensure that public sector activity and program levels remain sustainable over the long-term.

The transition to International Financial Reporting Standards (IFRS) and the outcome of the current review of public sector-specific accounting standards will impact on results reported from 2005 onwards. These impacts will require careful management and communication by government.

The government has identified a number of changes needed to its accounting policies as a result of implementing the standards developed as part of IFRS harmonisation. These may have a material impact on the state's financial position and financial performance. We will continue to work closely with all public sector agencies in implementing and monitoring the impact of the new standards.

1.1 Summary of major findings

1.1.1 Opinion on the government's Annual Financial Report

- Both my Office and the Department of Treasury and Finance, over several years, have endeavoured to improve the presentation of, and the level of disclosure in, the Annual Financial Report. It is, in my opinion, a high standard document. Its credibility is enhanced because it is prepared applying the full range of Australian Accounting Standards. Any step away from this important financial reporting foundation would represent a backward step.
- Even though the presentation and disclosure of information is of a high standard, there remain opportunities to enhance the information included in the Annual Financial Report.

1.1.2 Operating result and financial position

- The state reported an operating surplus of $3 766 million in 2003-04, an increase of $3 712 million from the previous year.
- The increase in the operating result was attributable to an increase in revenue of $3 258 million and a decrease in expenditure of $454 million.
- The major sources of increased revenues were investment income ($1 430 million), taxation ($800 million), grants from the Commonwealth Government ($533 million) and the fair value of assets received free of charge ($410 million). These positive influences were offset by reduced revenue from the sale of goods and services ($124 million), and fines and regulatory fees ($58 million).
- The improvement in the net result for the year was further enhanced by reduced expenditures. The major source of decreased expenditure were superannuation ($2 313 million), and supplies and services ($304 million). These reductions were offset by increases in expenditure mainly relating to the write-off of the smelter reduction levy receivable ($1 140 million), employee benefits ($499 million), and grants and transfer payments ($225 million).
- The financial position of Victoria continued to be sound. At June 2004, the state had net assets of $60 945 million, an increase of $8 088 million for the financial year.

- The general government sector reported an operating surplus in 2003-04 of $990 million, $754 million more than in 2002-03. This result was substantially greater than the government's target of a general government sector surplus of at least $100 million and that originally estimated in the 2003-04 *Budget Papers*.
- The difference between the Generally Accepted Accounting Principles operating result and the Government Financial Statistics (GFS) result in 2003-04 is $17 million. However, an expense of $1 232 million relating to the assumption of an amount equivalent to the State Electricity Commission of Victoria's (SECV) obligation relating to the flexible electricity tariff arrangements has been treated as a prior period adjustment and not recognised in the GFS result.

1.1.3 The state's financial condition

- The state's financial condition improved in 2003-04 and remained resilient and sound but continues to be significantly influenced by external factors, including the performance of equity markets and the property market. The government will need to continue to monitor revenue trends and carefully manage the rate of expenditure and commitment growth.

1.1.4 Revenue trends

- Operating revenues of the state totalled $35 274 million in 2003-04, an increase of $3 258 million from the previous year.
- A funding condition of the Commonwealth Government for all new specific purpose grants for capital purposes is the need to comply with the National Code of Practice for the Construction Industry and the associated guidelines. Unless the Victorian Government can reach agreement about these funding requirements, it risks forgoing the full amount of capital funding available from the Commonwealth Government.
- Stamp duty on conveyancing was $2 446 million, an increase of $339 million from the previous year. However, the state is forecasting a decrease in conveyancing taxation revenue from 2004-05, largely due to a predicted lower number of property sales.
- Revenue collected from gambling fees and taxes remained static. This is attributed to the continued impact of smoking bans on gaming venues.
- Revenue received from investments was $1 430 million higher than that received in the prior year. The increase was due mainly to the impact of stronger local and international equity markets.
- Revenue from fines and regulatory fees was $58 million less than the prior year. This was mainly due to a decrease in fines revenue brought about by problems with speed cameras.

- At June 2004, the state's uncollected fines totalled $554 million. Around 75 per cent of this amount represented fines outstanding in excess of 12 months.

1.1.5 Expenditure trends

- The operating expenses of the state totalled $31 508 million in 2003-04, a decrease of $454 million from the previous year.
- Employee benefit expenditure increased by $499 million compared with the prior period due to the ongoing impact of policy decisions and enterprise bargaining agreements.
- The total cost of the enterprise bargaining agreements entered into in 2003-04 above the government's benchmark of 3 per cent is estimated at $420 million over the 4 years of the agreements.
- The government needs to carefully monitor productivity improvements and attrition-related savings to ensure that additional funding does not have to be provided in the future to finance these elements of the enterprise bargaining agreements.
- Following the public transport restructure, the state will spend $265 million a year more than it spent in 2003-04 in franchisee subsidies and to operate V/Line Passenger Service. This will increase the total annual operating subsidy to around $654 million from 2004-05.
- Following a re-examination of the new rolling stock arrangements, the new rolling stock leases have been reclassified from an "off-balance sheet" transaction to a finance lease for 3 of the 4 existing franchise arrangements. Accordingly, an asset and liability of around $453 million, respectively, has been recognised for the first time.
- To facilitate the sale of Loy Yang A, the government and the new owners agreed that the net inflow to the state on the transaction would not exceed $40 million. The assessed stamp duty resulting from the sale was $84.8 million. Of this amount, $40 million was paid on settlement with the balance, including interest, to be paid over a 4 and half-year period. As an offset, the state agreed to pay the new owners an ex-gratia payment of $48.8 million over a similar time frame.
- The Commonwealth Government in late June 2004 provided $40 million to the state towards the cost of the 2006 Commonwealth Games. This amount was on-passed to the Melbourne 2006 Commonwealth Games Corporation (an agency outside the general government sector) on 30 June 2004 in advance of need.

- An agreement was entered into by the state with a developer to construct the Commonwealth Games village in December 2003. The state will contribute cash of around $52 million and land valued at $11.7 million to the development in return for its use as an athletes' village, and for a portion of the proceeds from the subsequent property sales estimated at $62 million. The state will also fund the public housing construction component of the project, which will be retained in state ownership, estimated at $35 million, and contribute $15.6 million to fund environmental works.

1.1.6 Asset trends

- The state's asset base increased by $6 896 million from the previous year.
- The increase in the year in the asset base was mainly due to asset revaluations, net additions to physical assets and increases in investment holdings. These increases were partially offset by a decrease in receivables mainly resulting from the write-off of a receivable following the cessation of the smelter reduction levy.
- At June 2004, a total of $35.7 million in new claims for compensation in relation to the Spencer Street Station redevelopment, had been lodged by the developer with the state. At August 2004, the completion of the main interchange facility was around 8 months behind schedule.

1.1.7 Liabilities, commitments and contingencies trends

- The state's liabilities decreased by $1 192 million from the previous period.
- Unfunded superannuation liabilities decreased by $1 729 million, resulting from improvements in investment returns and changes in actuarial assumptions.
- Outstanding claims liabilities increased by $527 million mainly due to the growth in the liability for common law claims to be paid by the Victorian WorkCover Authority and the higher cost of compensation claims for major injuries against the Transport Accident Commission.
- During the year, the state decided to abolish the smelter reduction levy which contributed to the funding of the flexible electricity tariff arrangements' liabilities, and wrote-off a related receivable for $1 140 million. The Department of Treasury and Finance assumed an amount equivalent to the SECV's exposures under the arrangement of $ 1 232 million. During the year, the state made land tax payable on transmission companies' electricity easements which will assist in funding this obligation.
- At June 2004, the state's operating, capital and other commitments totalled $15 906 million, an overall increase of $490 million. This increase is largely attributable to the establishment of 3 new public-private sector partnership arrangements for 2 correctional facilities and the metropolitan mobile radio network.

2. Opinion on the government's 2003-04 Annual Financial Report

2.1 Audit opinion on 2003-04 Annual Financial Report

Under the *Financial Management Act 1994*, I am required to examine, and issue an audit report (also known as an audit opinion) to parliament on Victoria's Annual Financial Report.

The *Financial Report for the State of Victoria 2003-04*[1] consolidates the financial reports of 326 agencies in 3 sectors, being:

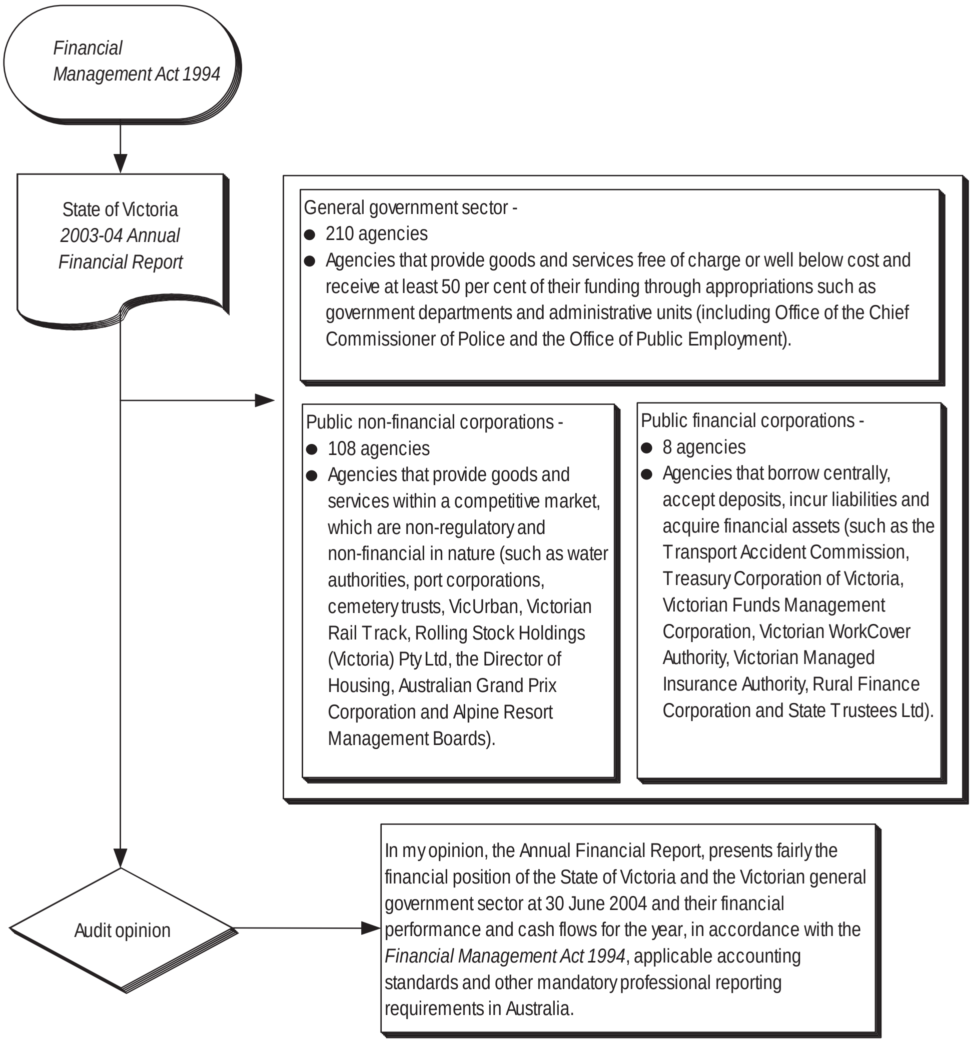
- the general government (budget) sector
- public non-financial corporations
- public corporations.

The Annual Financial Report outlines the 2003-04 operating result (essentially, revenue and expenditure), and financial position (assets and liabilities) for Victoria, and the general government sector. The Annual Financial Report also provides financial results for the Public Account (comprising the Consolidated Fund and the Trust Fund).

Figure 2A provides further details about which agencies were included in the *2003-04 Annual Financial Report*.

[1] Throughout this report we refer to this document by its popular title, *2003-04 Annual Financial Report*.

FIGURE 2A: AGENCIES COVERED BY 2003-04 ANNUAL FINANCIAL REPORT



Source: Victorian Auditor-General's Office.

We issued a clear audit opinion on the *2003-04 Annual Financial Report* on 5 October 2004. The scope of the opinion is detailed on page 62 of the *2003-04 Annual Financial Report*.

This report complements the *2003-04 Annual Financial Report* by providing an independent assessment of the state's financial performance and position. Where we consider it necessary, we have provided more detailed explanations and analysis of significant transactions and financial trends. We have done this to help readers of the Annual Financial Report to better understand the state's finances and the role of significant transactions in shaping the state's financial position and performance both in 2003-04 and into the future.

2.2 Preparation of the 2003-04 Annual Financial Report

To prepare the *2003-04 Annual Financial Report*, the Department of Treasury and Finance (DTF) electronically collated financial and non-financial data from 326 public sector agencies. These agencies were required to send data from their annual financial report to DTF through an internet-based data exchange facility.

The timely completion of an Annual Financial Report, therefore, depends on all agencies completing their financial reports within the required time.

When preparing the *2003-04 Annual Financial Report*, DTF placed particular focus on 44 "material entities" (the largest agencies), which account for over 95 per cent of the state's transactions and balances. To improve the timeliness and reliability of the information, these agencies were required to have their financial statements completed and audited by the time their financial data was required to be submitted to DTF on 20 August 2004.

We found DTF's processes to consolidate agency information and prepare the *2003-04 Annual Financial Report* to be generally sound. However, a significant number of material entities experienced substantial delays in finalising their 2003-04 financial reports. This affected the timeliness and accuracy of the information they provided to DTF and, consequently, the timely completion of the *2003-04 Annual Financial Report*.

Delays in material entities preparing their financial reports and finalising the information they sent to DTF were mainly due to:

- complexities with public transport developments in the infrastructure sector
- some asset valuations not being promptly finalised
- incomplete and inaccurate contingency and commitment data.

We consider that DTF (working closely with departments, other public sector agencies and my Office) should continue to explore ways to make agencies' reporting processes more efficient and timely.

2.2.1 Quality of disclosures in the Annual Financial Report

Both DTF and my Office have, over several years, endeavoured to improve the presentation of, and the level of disclosure in, the Annual Financial Report. It is, in my opinion, a high-standard document. Its credibility is enhanced because it is prepared applying the full range of Australian Accounting Standards. Any step away from this important financial reporting foundation would represent a backward step. However, there are still things to do to improve the quality of the information in the report.

Outstanding insurance claims liability assumptions

The *2003-04 Annual Financial Report* does not disclose all the financial assumptions used by actuaries to calculate these liabilities. These assumptions including prudential margins form the basis for the calculation of the liabilities, and should be disclosed.

"Build own and operate" (BOO) and "build own operate and transfer" (BOOT) arrangements

A large portion of the state's commitments relate to these arrangements (such as the Spencer Street Station redevelopment and the new Ravenhall prison facilities). The state's use of BOO and BOOT arrangements has continued to increase in recent years. Currently, these arrangements are included in "other commitments" in the Annual Financial Report. As these arrangements are often for 20 years or more, by including them in "other commitments", readers of the Annual Financial Report may be unable to ascertain the nature of these commitments. DTF should consider reporting commitments for BOO and BOOT arrangements in a separate note.

Restricted assets of the state

Restrictions are sometimes imposed on the use to which agencies can put the assets they control. The use of heritage assets, cultural assets, parkland and infrastructure assets (such as roads, schools, public hospitals, police stations and courts) can all be restricted. Restricted assets are not separately identified in the Annual Financial Report. To help users to better understand the extent of restricted assets, DTF should consider clearly identifying these assets in the notes to the Annual Financial Report.

Insurance claims expenses

These expenses are a major component of state expenditure and are not separately identified in the Annual Financial Report. Given their significance, and their impact on the state's reported results, 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, however, Trust Fund expenditures do not need to be approved through the appropriation process. There is scope for greater disclosure of the transactions and balances of the Trust Fund, including major trust accounts, in the Annual Financial Report.

Recognition of Murray-Darling Basin Commission assets

Under the Murray-Darling Basin Agreement, the state is required (as are other jurisdictions) to contribute funds to the Murray-Darling Basin Commission. However, the state cannot recognise its interest in the commission's assets because they have not been valued. Steps should be taken to have the state's interest in the commission's assets valued.

We will continue to work closely with the Department of Treasury and Finance in 2004-05 to further improve the quality of disclosures in Annual Financial Reports.

2.3 Transition to International Financial Reporting Standards

In July 2002, the Financial Reporting Council[2] announced that the Australian Accounting Standards Board (AASB) would work towards adopting International Financial Reporting Standards (IFRS)[3] for reporting periods commencing on or after 1 January 2005.

While the AASB has continued to issue Australian Accounting Standards, it has mostly formulated Australian equivalents of the international standards by adopting their content and wording. In some cases, the AASB has eliminated or reduced the accounting and reporting options available in an international standard, to improve the comparability of financial reports.

The international standards are intended to be sector-neutral and will apply to all public and private sector reporting entities. They will, therefore, incorporate the standards issued by the Public Sector Committee of the International Federation of Accountants. The AASB will retain or develop additional standards as required for purely Australian issues.

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[2] The Financial Reporting Council (FRC) is a statutory body under the *Australian Securities and Investments Commission Act 2001.* The FRC provides broad oversight of the process for setting accounting and auditing standards, and monitors the effectiveness of auditor independence requirements in Australia.

[3] Standards issued by the International Accounting Standards Committee (IASC) between 1973 and 2001 are called "international accounting standards". The International Accounting Standards Board (IASB) announced in April 2001 that its accounting standards would be designated "International Financial Reporting Standards", and that it would adopt all of the IASC's international accounting standards.

In addition to the standards recently developed, as part of the IFRS harmonisation program the AASB has commenced reviewing the 3 public sector specific standards. AAS27: *Financial Reporting by Local Governments,* AAS29: *Financial Reporting by Government Departments* and AAS31: *Financial Reporting by Governments*. The development of these standards will be very important to public sector reporting. It is initially important, therefore, that key agencies who have a leadership role in promoting and maintaining high quality financial reporting in government play an active role in the development of these standards.

The Department of Treasury and Finance has identified a number of changes needed to its accounting policies as a result of implementing the standards developed as part of IFRS harmonisation. These may have a material impact on the state's financial position and financial performance, including potentially far-reaching impacts on the valuation of non-current physical assets, the measurement of the state's unfunded superannuation liabilities, and the method for calculating outstanding insurance claim liabilities.

We will continue to work closely with the Department of Treasury and Finance and all public sector agencies in implementing and monitoring the impact of the standards.

2.4 Harmonisation of GAAP and GFS financial reporting frameworks

In Australia, the financial statements of all jurisdictions are based on a mix of the Generally Accepted Accounting Principles (GAAP) framework, and the Government Finance Statistics (GFS) framework. The Victorian Government uses GAAP to prepare accrual-based, whole-of-government, general-purpose financial statements.

In December 2002, the Financial Reporting Council announced that the Australian Accounting Standards Board would pursue harmonisation of the GFS and GAAP reporting frameworks.

While GAAP shows transactions from an accounting viewpoint, GFS shows transactions from an economic viewpoint. GFS includes only transactions over which a government has legislative or policy control. Unlike GAAP, GFS excludes from the calculation of net operating results revaluations arising from changes in market prices and changes in the volume of assets that result from the discovery or depletion of assets. Therefore, reports based on the different frameworks can give quite different operating results and government sector net worth.

Harmonisation of GAAP (which also applies to the public sector) and GFS continues to be a high priority for Australian public sector reporting. The objective of the harmonisation of the GFS and GAAP reporting frameworks is to seek to reduce the confusion that results with the publication of 2 sets of financial statements. The Australian Accounting Standards Board intends to issue an exposure draft for an accounting standard in May 2005, based on the outcome of their work in this area.

The adoption of International Financial Reporting Standards, and harmonisation of the GFS and GAAP reporting frameworks, have wide-ranging implications for reporting by public sector agencies and for whole-of-government reporting.

RESPONSE provided by Minister for Finance and Treasurer

The Financial Report for the State of Victoria 2003-04 (Financial Report) provides the reader with thorough analysis and commentary on the finances of the State. The Auditor-General has again issued an unqualified audit opinion on the finances of the State. This opinion provides assurance that the Financial Report is presented in accordance with all applicable Australian accounting standards, other mandatory professional reporting requirements, and the financial reporting requirements of the Financial Management Act 1994.

The analysis contained in the Government's Financial Report is presented in such a way to provide readers with a comprehensive understanding of the operations of the Government, and the impact of policy decisions in an open and transparent manner. In particular, the analysis enables a clear assessment to be made on the state of the Government's finances.

The unqualified Financial Report is further evidence of the Government's commitment to financial responsibility and accountability.

3. Operating results and financial position

3.1 State of Victoria's operating result and financial position

3.1.1 Operating result

The State of Victoria's consolidated financial report includes all 326 agencies, but does not include local government agencies, denominational hospitals or universities.

Figure 3A shows the State of Victoria's 2003-04 operating result, as disclosed in the *2003-04 Annual Financial Report*.

FIGURE 3A: STATE OF VICTORIA'S OPERATING RESULT 2003-04 ($M)

Item	2003-04	2002-03	Movement
Revenues	35 274	32 016	3 258
Expenses	31 508	31 962	(454)
Operating surplus for the year	3 766	54	3 712

Source: Annual Financial Report, 2003-04.

The state had an operating surplus of $3 766 million in 2003-04, $3 712 million more than in 2002-03. This was the result of a $3 258 million increase in revenues, and a $454 million decrease in expenditures.

The major sources of increased revenues were investment income ($1 430 million), taxation ($800 million), grants from the Commonwealth Government ($533 million) and the fair value of assets received free of charge ($410 million). These positive influences were offset by reduced revenue from the sales of goods and services ($124 million) and fines and regulatory fees ($58 million).

The improvement in the net result for the year was further enhanced by reduced expenditures. The major source of decreased expenditure were superannuation ($2 313 million), and supplies and services ($304 million). These reductions were offset by increases in expenditure mainly relating to the write-off of the smelter reduction levy receivable ($1 140 million), employee benefits ($499 million), and grants and transfer payments ($225 million).

Figure 3B outlines the contribution of each of the key factors to the increased operating surplus, compared with the previous year.

FIGURE 3B: OPERATING RESULT ANALYSIS ($M)

Item	Major factors contributing to the movement		Total
2002-03 revenue			32 016
Revenue movements -			
Taxation	Increased conveyancing duty revenue	344	
	Additional land tax revenue	102	
	Increased insurance levies revenue	112	
	Higher payroll tax	91	
	Increased motor vehicles taxes	122	
	Other net movements	29	800
Investment income	Mainly related to improvements in the equity markets		1 430
Fines and fees	Reduced traffic camera infringement notices	(61)	
	Other net movements	3	(58)
Commonwealth grants	Increase in GST general purpose grants due to continued strong economic performance	366	
	Increases in specific purpose grants	167	533
Sales of goods and services	Decreased gas sales revenue	(511)	
	One-off prior period transaction relating to Spencer Street Station commercial payment	(66)	
	Increased Transport Accident Commission and Victorian WorkCover Authority premium revenue	286	
	V/Line passenger revenue recognised for the first time following reversion back to the state	33	
	Other net movements	134	(124)
Loss on disposal of physical assets	One-off prior year transaction resulting from the transfer of assets to the City Link operator	257	
	Other net movements	32	289
Fair value of assets received free of charge	Rolling stock reassumed by the state for nominal consideration following franchise restructure	367	
	One-off prior period transaction associated with the state assuming the LaTrobe Hospital	(51)	
	Other net movements	94	410
Other revenue	One-off prior period transaction relating to forfeiture of National Express Group security bond	(135)	
	Doubtful debts write-back	44	
	Other net movements	69	(22)
Total revenue change			3 258
2003-04 revenue			35 274

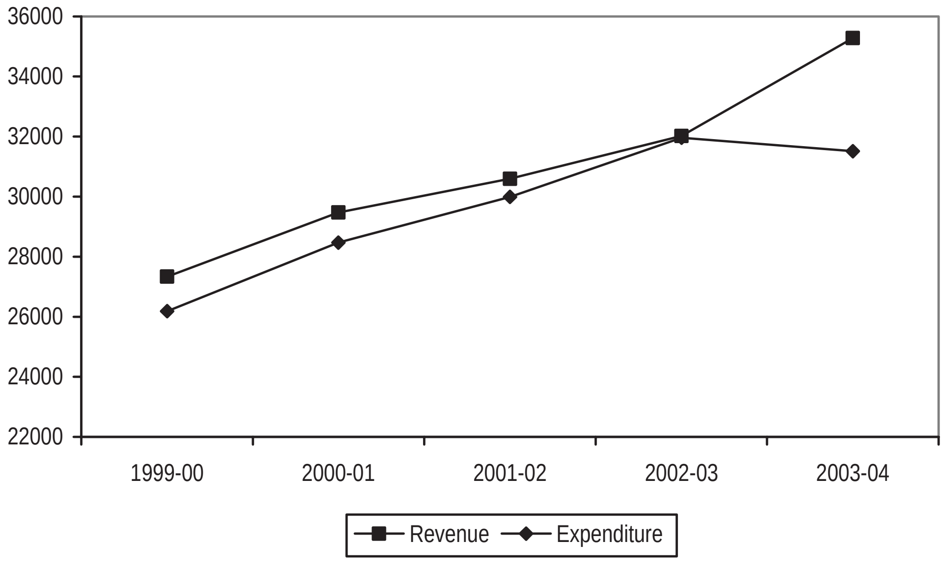
FIGURE 3B: OPERATING RESULT ANALYSIS ($M) - continued

Item	Major factors contributing to the movement		Total
2002-03 expenditure			31 962
Expenditure movements -			
Employee benefits	Increase mainly due to the additional cost of major public sector industrial settlements and higher staffing levels		499
Superannuation	Decrease mainly due to improvement in performance of superannuation funds investments and changed actuarial assumptions		(2 313)
Supplies and services	Decrease in gas expenditure.	(541)	
	Decrease in Victorian WorkCover Authority expenditure due to decrease in claims and actuarial revisions	(428)	
	One-off prior period transaction relating to wind down of LaTrobe Hospital Pty Ltd	(61)	
	Additional costs associated with rail franchising	413	
	Ex-gratia payment to Loy Yang A	49	
	Other net movements	264	(304)
Grants and transfer payments	Increase in specific purpose grants received for on-passing to non-government schools	101	
	Other net movements	124	225
Depreciation and amortisation	Impact of asset acquisitions and asset revaluations		144
Other expenses	Write-off of the smelter reduction levy receivable	1 140	
	Other net movements	155	1 295
Total expenditure change			(454)
2003-04 expenditure			31 508
Difference between revenue and expenditure changes			3 712
Operating surplus			3 766

Source: Victorian Auditor-General's Office.

The state's annual operating result (the difference between revenue and expenditure) over a period provides an insight into the sustainability of government operations. Figure 3C shows that over a 5-year period, revenue has grown by 29 per cent and expenditure has increased by 20 per cent. The gap between revenue and expenditure has been significantly influenced by the impact of property and investment market volatility, cost pressures such as wage growth and one-off transactions.

FIGURE 3C: STATE REVENUE AND EXPENDITURE ($M)



Source: Victorian Auditor-General's Office.

When examining the movement in revenue and expenditure it is important to compare such movements with a suitable benchmark such as the consumer price index (CPI). Figures 3D and 3E compare growth in total state revenues and expenditures to CPI movements over the last 5 years.

FIGURE 3D: ACTUAL STATE EXPENDITURE COMPARED WITH INFLATION RATE ($B)

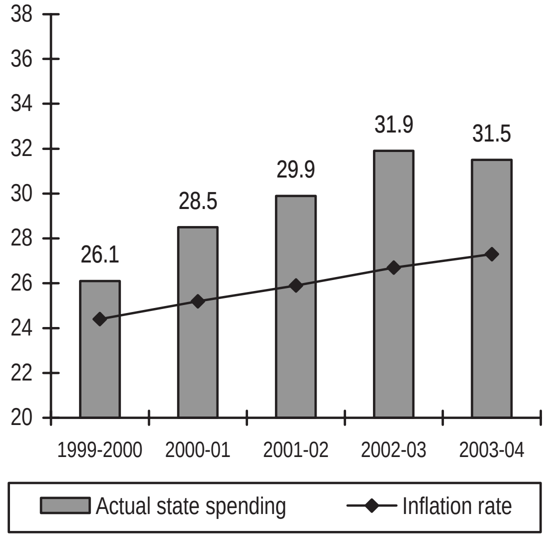
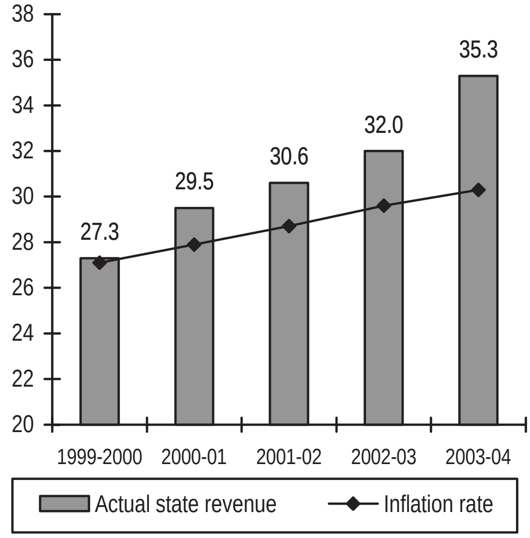


FIGURE 3E: ACTUAL STATE REVENUE COMPARED WITH INFLATION RATE ($B)



Source: Actual state revenue and expenditure obtained from the *2003-04 Annual Financial Report*. Consumer price index sourced from the ABS. Base year of 1998-99 used to arrive at inflation linked revenue and expenditure growth.

Over this 5-year period, state revenue growth has outpaced CPI movements by 17.5 per cent, while the growth in state spending has outpaced the rate of inflation by 9 per cent.

Due to the impact of property and investment market volatility and the level of expenditure growth, the government will need to be vigilant to ensure that public sector activity and program levels remain sustainable in the long-term.

3.1.2 Financial position

The Statement of Financial Position contains information about the value and composition of the state's assets and liabilities, as at 30 June 2004. Figure 3F shows the state's financial position as disclosed in the *2003-04 Annual Financial Report.*

FIGURE 3F: STATE OF VICTORIA, FINANCIAL POSITION, AT 30 JUNE ($M)

Item	2004	2003	Movement
Assets	109 114	102 218	6 896
Liabilities	48 169	49 361	(1 192)
Net assets	60 945	52 857	8 088

Source: Victorian Auditor-General's Office.

The financial position of Victoria continued to be sound. At 30 June 2004, the state had net assets of $60 945 million, an increase of $8 089 million for the financial year.

In 2003-04, the state's assets increased by $6 896 million. This was mainly due to revaluation adjustments ($4 323 million) and net additions to physical assets ($3 916 million). The net asset position was further improved by a reduction in liabilities especially in the area of unfunded superannuation ($1 729 million).

Figure 3G outlines the contribution of each of the key factors to the increase in net assets, compared with the previous year.

FIGURE 3G: FINANCIAL POSITION ANALYSIS ($M)

Item	Major contributing factors for the movement		Total
2002-03 assets			102 218
Asset movements -			
Cash	Net movements		58
Physical assets	Revaluation of rolling stock reverted back to the state	450	
	Revaluations of other physical assets	3 873	
	Recognition of leased asset - new rolling stock	453	
	Other asset additions	3 604	
	Depreciation/amortisation in the year	(1 764)	
	Other net movements	112	6 728
Receivables	Decrease mainly due to the maturity of derivatives	(686)	
	Abolition of the SECV smelter reduction levy	(1 140)	
	Stamp duty receivable associated with the sale of Loy Yang A	45	
	Other net movements	(227)	(2 008)
Other financial assets	Increase due to improved performance of the equity market		2 003
Inventories	Net movements		91
Prepayments	Net movements		24
Total changes to assets			6 896
2003-04 assets			109 114
2002-03 liabilities			49 361
Liabilities movements -			
Superannuation	Decrease due to improvements in the performance of superannuation fund investments and changes in actuarial assumptions		(1 729)
Interest-bearing liabilities	Recognition of finance lease liabilities – new rolling stock	453	
	Lower third party deposits	(370)	
	Repayment of debt	(630)	
	Other net movements	882	335
Payables	Decrease due to the maturity of derivatives	(990)	
	Payable associated with an ex-gratia payment relating to Loy Yang A sale	45	
	Reduction in gas-related payables	(66)	
	Other net movements	372	(639)
Outstanding insurance claims	Increase in the WorkCover claims	298	
	Increase in Transport Accident claims	148	
	Other net movements	81	527
Employee benefits	Increase mainly due to the impact of wage growth on entitlements for long service leave	60	
	Assumption of employee entitlements from public transport franchisees	148	208
Other liabilities	Net movements		106
Total changes to liabilities			(1 192)
2003-04 liabilities			48 169
Differences between asset and liability changes			8 088
Net assets			60 945

Source: Victorian Auditor-General's Office.

3.2 General government sector operating result and financial position

The general government sector consists of those agencies that are financed mainly through taxes and other compulsory levies, and provide public services free of charge or well below cost. 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.

3.2.1 Operating result

Figure 3H shows the general government sector's 2003-04 operating result, as disclosed in the *2003-04 Annual Financial Report*.

FIGURE 3H: GENERAL GOVERNMENT SECTOR OPERATING RESULT ($M)

Item	2003-04 Estimate	2003-04 Actual	2002-03 Actual
Revenues	26 599	28 344	26 631
Expenses	26 354	27 354	26 395
Operating surplus for the year	245	990	236

Source: Victorian Auditor-General's Office.

The general government sector had an operating surplus in 2003-04 of $990 million, $754 million more than in 2002-03. This result was substantially greater than the government's target of a general government sector surplus of at least $100 million and that originally estimated in the *2003-04 Budget Papers*.

The main revenue movements from that forecast in the Budget Papers contributing to the result were increases in:

- taxation revenue ($563 million)
- Commonwealth grants ($380 million)
- investment revenue ($162 million)
- revenue from other sources ($266 million).

The main expenditure movements from that forecast that contributed to the result were increases in:

- grants and transfer payments ($1 306 million) mainly due to the assumption of an amount equivalent to the SECV's exposure under the flexible electricity tariff arrangements
- expenditure on supplies and services ($721 million)
- employee benefits ($391 million)
- other expenses ($233 million).

These increases in expenditure were offset by decreased superannuation expenses ($1 651 million).

3.2.2 Financial position

Figure 3I shows the general government sector's financial position in summary at 30 June 2004.

FIGURE 3I: GENERAL GOVERNMENT SECTOR, FINANCIAL POSITION ($M)

Item	2004 Estimate	2004 Actual	2003 Actual
Assets	49 080	51 083	48 742
Liabilities	25 761	24 804	25 134
Net assets	23 319	26 279	23 608

Source: Annual Financial Report, 2003-04.

At 30 June, the general government sector had net assets of $26 279 million. In 2003-04, the sector's net assets increased by $2 960 million compared with that initially forecast in the Budget Papers. This was mainly due to higher than expected physical asset balances ($1 385 million) - due to revaluations, cash and investment balances ($217 million), receivables ($366 million) and lower than anticipated unfunded superannuation liabilities ($2 426 million).

These movements were offset by higher than anticipated payables ($1 549 million) mainly due to the revised arrangements as a result of the abolition of the State Electricity Commission of Victoria's (SECV) smelter reduction levy and the assumption by the general government sector (the Department of Treasury and Finance) of an amount equivalent to the SECV's exposure to the flexible electricity tariff arrangements.

3.2.3 Government Financial Statistics reporting

The audited consolidated financial statements in Chapter 4 of the *2003-04 Annual Financial Report* were prepared according to the Generally Accepted Accounting Principles (GAAP) reporting framework. Chapter 5 of that report contains Government Financial Statistics (GFS) based financial statements, but we do not audit those statements.

Figure 3J shows the reconciliation of the audited GAAP operating result with unaudited GFS net operating balance for the general government sector.

FIGURE 3J: RECONCILIATION OF AUDITED GAAP OPERATING RESULT FOR THE GENERAL GOVERNMENT SECTOR WITH UNAUDITED GFS NET OPERATING BALANCE ($M)

Audited GAAP general government sector net operating result	990
Adjustments for revenues and expenses not used in the calculation of the GFS	
Add doubtful debts expense	95
Less gain/(loss) on financial asset (derivatives)	(62)
Add gains on revaluation of non-financial assets	224
Add prior period adjustment	1 232
Less change in provision for unfunded superannuation	(1 533)
Add amortisation expense	27
Unaudited GFS net operating balance	973

Source: Annual Financial Report, 2003-04.

The main differences between the 2 approaches are:

- GFS does not recognise allowances for doubtful debts and certain amortisation expenses.
- GFS does not recognise gains or losses on securities marked to market, or on revaluations or write-downs of non-financial assets.
- The assumption of an amount equivalent to the SECV's obligations relating to the flexible electricity tariff arrangements following the abolishment of the smelter reduction levy has been treated as a prior period adjustment under GFS.
- Changes in unfunded superannuation liabilities are not regarded as an expense in the GFS. However, the outstanding superannuation liability is considered to be a form of borrowing in an economic sense and, therefore, has an interest cost. The interest rate currently being used for GFS purposes is approximately equivalent to the long-term net fund earning rate. The differences represent the adjustment.

The difference between the Generally Accepted Accounting Principles operating result and the Government Financial Statistics (GFS) result in 2003-04 is $17 million. However an expense of $1 232 million relating to the assumption of an amount equivalent to the State Electricity Commission of Victoria's obligation relating to the flexible electricity tariff arrangements has been treated as a prior period adjustment and not recognised in the GFS result.

3.3 Public Account financial results

The *Financial Management Act 1994* requires the inclusion of information about the Public Account in the Annual Financial Report. The Public Account is the government's central bank account. It records the transactions of the Consolidated Fund and the Trust Fund, which is an aggregate of a number of trusts.

The Consolidated Fund is the government's main operating account, into which all the Crown's revenues must be paid. Parliamentary appropriations authorise departments to draw on this fund to conduct their activities. Appropriations from the fund are by standing authority (special appropriations) or annually through annual appropriation acts.

Figure 3K shows the Consolidated Fund's cash flows for the year (before borrowing transactions).

FIGURE 3K: CONSOLIDATED FUND CASH FLOWS ($M)

Item	2003-04	2002-03	Movement
Receipts -			
Operating activities	24 221	23 361	860
Investing and financing activities	35	84	(49)
Total receipts, excluding borrowing transactions	24 256	23 445	811
Less – Payments (operating and capital transactions) -			
Special appropriations	2 461	3 180	(719)
Annual appropriations	21 964	21 082	882
Total payments, excluding borrowing transactions	24 425	24 262	163
Consolidated Fund deficit for year, excluding borrowing transactions	(169)	(817)	648
Borrowing repayments	(793)	(a) -	(793)
Cash deficit for the year	(962)	(817)	(145)

(a) Borrowing repayments during 2002-03 totalled only $695 000.

In 2003-04, the Consolidated Fund had a cash deficit of $962 million, compared with a deficit of $817 million in 2002-03. The movement was mainly due to borrowing repayments of $793 million offset by a reduction of $595 million in top-up contributions made by the government as part of its planned reduction of unfunded superannuation liabilities.

The Trust Fund covers a range of special purpose accounts established for funds that are not necessarily subject to state appropriations.

In 2003-04, there was a net increase of $127 million in the Trust Fund cash and investment balances. This was mainly due to the receipt in the year of $78 million of investments lodged in a new trust fund in the Public Account, the Liability Claims Account. These funds were previously managed by the Victorian Managed Insurance Agency, which operates outside the Public Account.

RESPONSE provided by Minister for Finance and Treasurer

The financial performance and position of the State of Victoria has remained strong. This is evidenced by the significant surplus results in the General Government (Budget) Sector and the State of Victoria for the 2003-04 financial year, with the Government meeting its key performance objective to maintain a minimum $100 million surplus.

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

As outlined in the Auditor-General's report, the State's finances are influenced by external factors such as the performance of the property market, and the returns of both the domestic and international equity markets. The State Budget is formulated to take into account economic risks and pressures and the Government's policy decisions are made in the context of a managed and balanced risk strategy.

The Government has proved it can manage public sector activity and that program levels are sustainable over the long-term. The Government has been able to fund and deliver significant service delivery and infrastructure programs in the areas of health, education, transport and justice. This ability, together with the pursuit of expenditure and taxation policies that allow reasonable stability and predictability in tax burden levels, facilitates strong business investment, development and employment in Victoria.

The Government's record on this score is unsurpassed.

Figure 3J

The international Government Finance Statistics (GFS) framework and principles are administered in Australia by the Australian Bureau of Statistics (ABS), and are based on the statistical principles developed by the World Bank, International Monetary Fund, and the United Nations. These principles differ in their treatment of transactions as compared to Australian Generally Accepted Accounting Principles (GAAP), including by recognising transactions in the period to which they refer. The GFS tables are not subject to review or audit by the Auditor-General. They are however, reviewed and published by the ABS as part of their statistical time series.

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

The (GFS) net operating balance was a surplus of $973 million. Reconciliation table 3J lists all of the adjustment items between the audited GAAP result and the GFS result. Consistent with these principles GFS includes only transactions which occur in the current period.

The prior period adjustment to GFS has been made on the basis of advice received from the ABS as to the correct treatment for GFS reporting purposes. The Department of Treasury and Finance sought formal advice from the ABS in relation to this prior period adjustment. The ABS instructed that the appropriate treatment of this adjustment was to exclude it from the 2003-04 net operating balance, as it did not constitute a transaction of the current period.

As noted in the footnote to Table 5.5 in the Financial Report for the State of Victoria 2003-04, "The ABS expects to incorporate this revision in due course in its annual and quarterly statistics".

4. The state's financial condition

4.1 Introduction

For many years, we have provided independent assessments to parliament of the state's financial condition. These assessments use:

- ***sustainability indicators***, to examine movements in the degree to which the government can maintain existing programs and operations, and meet existing creditor requirements, without increasing debt
- ***flexibility indicators***, to examine movements in the degree to which the government can increase its financial resources to respond to rising commitments (by either expanding its revenue or increasing its debt)
- ***vulnerability indicators***, to examine movements in the degree to which the government depends on (and is therefore vulnerable to) sources of funding outside its control.

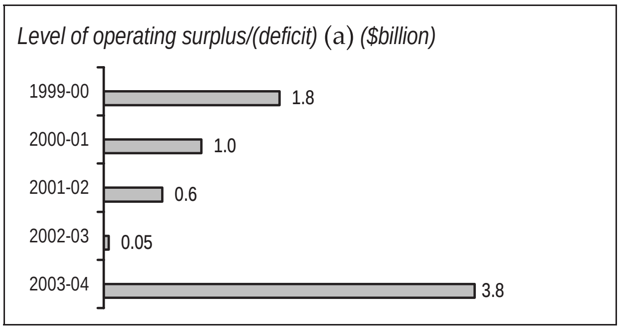
The indicators provide useful insights into the government's ability to sustain its programs, the flexibility it has to respond to economic changes, and its vulnerability to sources of outside funding. These indicators help to put the finances of government into perspective and help members of parliament and the community to understand and interpret the key financial information[1].

4.1.1 Sustainability

We use financial sustainability indicators to assess whether the government's capacity to maintain existing programs and operations, and pay creditors without increasing the state's debt, has improved or deteriorated over the period of the assessment.

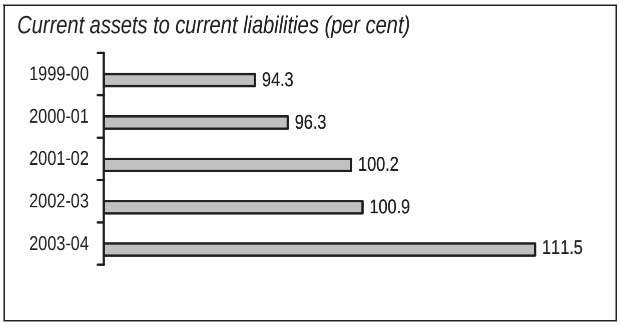
[1] All data used in the analysis is sourced from the audited annual financial reports, except for Victoria's gross state product (GSP), which is sourced from the Australian Bureau of Statistics for financial years up to 2002-03. Estimates of the GSP for 2003-04 are sourced from the Victorian Department of Treasury and Finance.

We used the following 4 indicators.

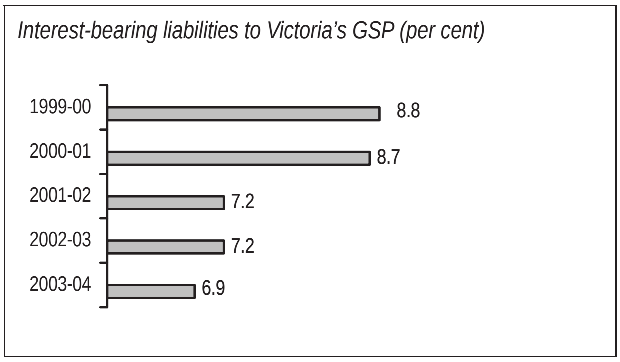


The annual operating surplus (or deficit) indicates whether the government spends more than it raises: that is, whether the government is living within its means. Since 1999-2000, the operating surplus has declined year-by-year, although this trend was reversed in 2003-04. In 2003-04, improvements in equity markets increased investment revenue and reduced the unfunded superannuation liability and accordingly the superannuation expense, increasing the operating surplus to $3.8 billion.

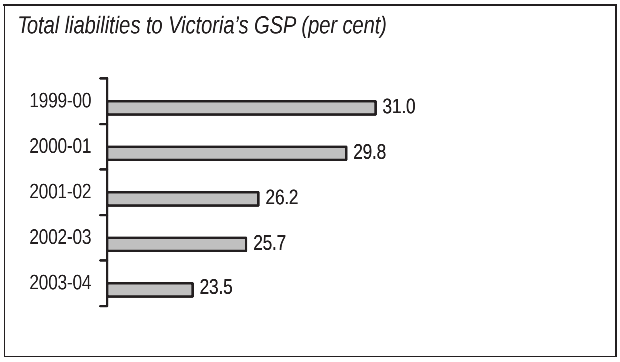
(a) Figures for periods before 2000-01 do not include abnormal items, which in the main relate to the impact of privatisations.



The ratio of current assets to current liabilities is generally known as the working capital ratio. It measures the ability of the state to meet its short-term obligations. The state's working capital ratio has continued to improve over the past 5 years, with current assets greater than current liabilities. During 2003-04, there was a change in the types of investments held which significantly increased current assets as at 30 June 2004 compared with prior periods.



The ratio of interest-bearing liabilities to gross state product (GSP) measures the level of debt relative to the size of the state's economy. The state has not substantially altered its interest-bearing debt levels over the past 5 years. Despite the net increase in interest-bearing liabilities of $335 million in 2003-04, GSP has grown at a greater rate. As a result, the ratio of state debt to GSP has continued to improve.



The ratio of total liabilities to GSP measures the level of state liabilities relative to the size of the Victorian economy. The improvement in this ratio in 2003-04 mainly reflects the reduction in the State's unfunded superannuation liability as a result of the impact of improvements in equity markets and revised actuarial assumptions.

Conclusion

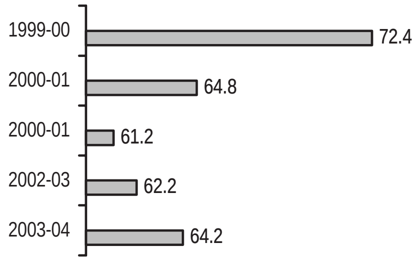
The level of state liabilities relative to the size of the Victorian economy has improved, as has the state's capacity to meet its short-term obligations. The previous 4-year trend of a declining operating surplus (in a climate of strong economic activity) sharply reversed in 2003-04. This reversal is mainly due to the positive impact of the recovery of the equity investment markets.

4.1.2 Flexibility

We use financial flexibility indicators to assess whether the government's capacity to increase its financial resources to respond to rising commitments, either by expanding its revenue or increasing its debt, has improved or deteriorated over the period of assessment.

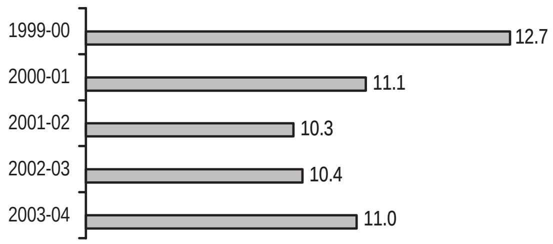
We used the following 5 indicators.

Own-source revenue to total revenue (per cent)



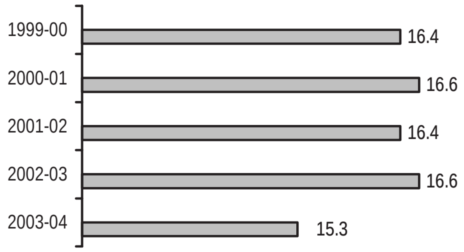
Own-source revenue is total (state) revenue, excluding grants provided to the state. Early in the 5-year period, own-source revenue decreased due to the introduction in 2000-01 of revised Commonwealth-state taxation arrangements which required states and territories to abolish a number of taxes, which were replaced by Commonwealth grants. This reduced the state's flexibility to raise own-source revenue. This trend has reversed in the past 2 years (and in particular in 2003-04), largely because of continued strong growth in property-related transactions and improved investment returns.

Own-source revenue to Victoria's GSP (per cent)



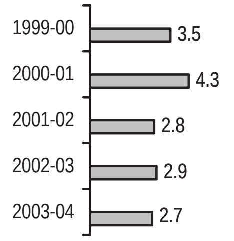
The ratio of own-source revenue to GSP is a measure of the economy's capacity to withstand increased state taxes and charges. As the ratio increases, the government's flexibility decreases, due to the increasing impact of the taxes and charges on the economy. This ratio has decreased in the past 5 years, largely as a result of the revised Commonwealth-state tax arrangements. The reversal of this trend in 2003-04 was largely due to strong growth in property-related transactions (in particular, stamp duty on conveyancing) and investment revenue.

Expenditure to Victoria's GSP (per cent)



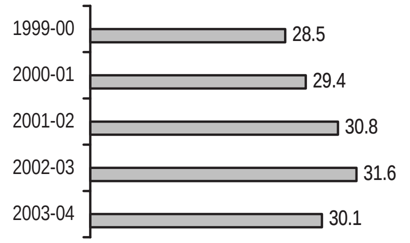
The changing ratio of expenditure to GSP shows whether government spending is becoming a bigger or smaller part of the state's economy. From 1999-00 to 2002-03 the state's expenditure grew at the same rate as the Victorian economy. In 2003-04, the ratio improved as a result of reduced superannuation expenses and the continued strong growth in the state's GSP.

Borrowing costs to total revenue (per cent)



The ratio of borrowing costs to total revenue measures the proportion of revenue spent paying interest on its debts. The more the government pays in interest, the less funds it has for its programs. In recent years, debt levels, and borrowing costs, have remained relatively stable. The period has also seen a growth in total revenues and low interest rates. The state's exposure to interest rate rises is mitigated by the majority of its borrowings being on a fixed interest basis.

Employee benefits expenditure to total revenue (per cent)



The ratio of employee benefits expenditure to total revenue measures the proportion of revenue consumed by employee-related costs. The increase in this ratio up to 2002-03 reflects the impact of government policy decisions to increase services in key portfolios, plus the impact of industrial settlements. In 2003-04, the increase in employee entitlements expenditure of $499 million was more than offset by the increase in total revenue, reversing the prior period trend.

Conclusion

In 2003-04, the government's financial flexibility improved as a result of the impact of favourable property and equity markets.

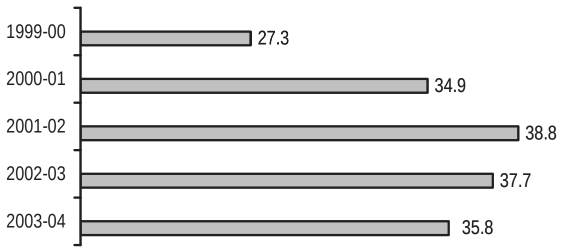
To maintain these positive trends, the government will need to manage the growing costs of increased service delivery, industrial settlements and commitments associated with "off-balance sheet" financing arrangements.

4.1.3 Vulnerability

We use financial vulnerability indicators to assess the degree to which the government is dependent on (and therefore vulnerable to) domestic and international sources of funding outside its control.

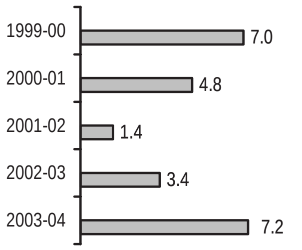
We used the following 4 indicators.

Commonwealth revenue to total revenue (per cent)



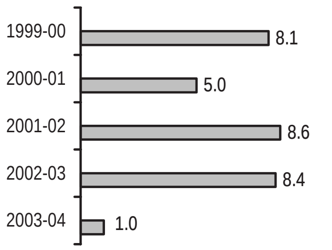
The ratio of Commonwealth revenue to total revenue indicates the dependence of the government on Commonwealth funding. This ratio had increased, largely because of the revised Commonwealth-state tax arrangements. These required the state to abolish some of its own-source taxes in return for increased Commonwealth funding. The reversal of this trend in the past 2 years is largely due to continued strong growth in property-related transactions and improved investment returns.

Investment revenue to total revenue (per cent)

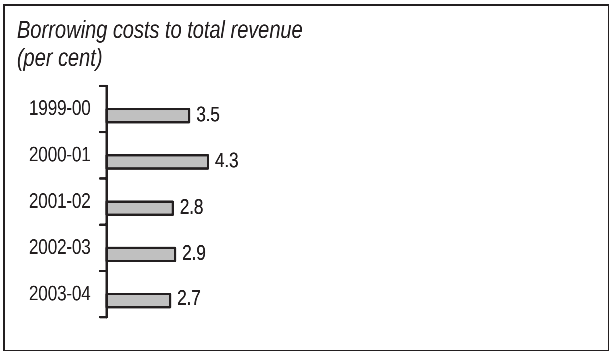


The ratio of investment revenue to total revenue indicates the extent to which the state relies on investment income (which is largely influenced by external conditions). The ratio declined significantly in 2001-02 mainly due to the downturn in equity markets. However, with equity markets strengthening, higher investment revenues are now being generated.

Superannuation expense to total revenue (per cent)



Superannuation expense as a ratio to total revenue measures the proportion of state revenue 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 significant decrease in superannuation expenditure this year reflects the impact of an increase in the value of superannuation fund investments, due to improved equity markets and revised actuarial assumptions. This, in turn, has dramatically reduced the net liabilities of the superannuation funds and the costs to the state for 2003-04.



The ratio of borrowing costs to total revenue measures the proportion of revenue spent paying interest on its debts. The more the government pays in interest, the less funds it has for its programs. In recent years, debt levels, and borrowing costs, have remained relatively stable. The period has also seen a growth in total revenues and low interest rates. The state's exposure to interest rate rises is mitigated by the majority of its borrowings being on a fixed interest basis.

Conclusion

The significant variations in investment revenue and superannuation costs highlights the state's vulnerability to movements in financial markets. Returns from equity investment markets have improved from an average of negative 7 per cent in 2002-03 to an average of 21 per cent in 2003-04. Short-term volatility of investments (in particular equities) may continue to have a significant impact on the operating result.

While the State's financial position is strong, any property market slowdown and variation in investment returns beyond what is currently anticipated remains a budgetary risk for the government.

4.1.4 Overall conclusion on financial condition

Using the indicators of sustainability, flexibility and vulnerability, the state's financial condition improved in 2003-04 and remained resilient and sound, but continues to be significantly influenced by external factors including the performance of equity markets and the property market. The government will need to continue to monitor revenue trends and carefully manage the rate of expenditure and commitment growth.

5. Revenue trends

5.1 Revenue trends

State's operating result ($million)	2003-04	2002-03	Movement
Revenues	35 274	32 016	3 258
Expenses	31 508	31 962	(454)
Operating result	3 766	54	3 712

Source: Victorian Auditor-General's Office.

In 2003-04, state revenue totalled $35 274 million. Figure 5A shows the major variations in revenue from 2002-03.

FIGURE 5A: STATE REVENUE MOVEMENTS ($M)

Revenue item	2003-04	2002-03	Movement
Grants	12 621	12 088	533
Taxation	10 075	9 275	800
Sale of goods and services	7 698	7 822	(124)
Investment revenue	2 531	1 101	1 430
Fair value of assets received free of charge or for nominal consideration	610	200	410
Fines and regulatory fees	513	571	(58)
Gain (loss) on disposal of physical assets	(45)	(334)	289
Other revenue	1 271	1 293	(22)
Total	35 274	32 016	3 258

Source: 2003-04 Annual Financial Report.

5.1.1 Grants

State revenues	2003-04	2002-03	Movement
Grants ($million)	12 621	12 088	533

Source: Victorian Auditor-General's Office.

In 2003-04, grants received by the state from the Commonwealth Government, were $533 million higher than that received in the prior year. This was due to:

- increases in general-purpose grants ($366 million)
- increases in specific-purpose grants ($167 million, including $40 million for the 2006 Commonwealth Games and $101 million for non-government schools).

In 2003-04, the main specific purpose grants negotiated were for the AusLink Package and for vocational education and training funding. At the time of preparing this report, the 2004-06 Government and Non government Schools Funding Agreement incorporated in the Schools Assistance Bill 2004 had not been passed by the Commonwealth Parliament.

AusLink

In June 2004, the Commonwealth Government released its *AusLink White Paper*. AusLink is a national plan for the land transport network and allocates $11 800 million to the states and territories over 5 years starting from 1 July 2004. Victoria's share of this funding is $575 million over the 5-year period. This is in addition to $643 million in pre-existing commitments under former agreements (but excludes the Commonwealth Government's funding offer for the Scoresby Freeway).

AusLink replaces the Commonwealth's National Highway, Roads of National Importance, National Blackspot and Roads to Recovery road funding packages. With the exception of Roads to Recovery funding (which was provided directly to local governments), all AusLink funding will be made available through the state government.

Under AusLink, the state government is required to submit an updated 5-year plan each year. The state government's submission to the Commonwealth Government in March 2004 formed the basis of the projects considered under AusLink.

The following issues affecting the state's finances arise from the AusLink funding arrangements:

- The Commonwealth will no longer pay the full construction costs of designated national highways and 50 per cent of roads of national importance. The state will be required to make an agreed contribution to all new projects, including national highways. No project will be fully funded by the Commonwealth.
- The agreement will provide rail network funding of $85 million over 5 years. Previously, the Commonwealth did not directly provide funds to the state for rail projects. All rail project funding was previously allocated to the Australian Rail Track Corporation, a Commonwealth Government body. The rail network funding is for interstate rail track infrastructure and freight rail requirements. Funding of metropolitan public transport remains a state responsibility.
- In 2005-06, Auslink will phase-in a new funding formula for road maintenance, which will have effect until 2007-08. The formula takes into account lane length, total vehicle distance travelled and total heavy vehicle distance travelled. Under AusLink, the Commonwealth will only make a contribution to maintaining the AusLink National Network, rather than fund all maintenance on National Highways as it did previously. In 2003-04, the state government received $30.7 million for maintenance of national highways, increasing to $35 million in 2004-05. The financial impact of the new funding formula compared with the current maintenance allowance received by the state is not clear.
- The majority of Commonwealth funding for Victorian projects (of about 65 per cent), will not be made available until the later years of the 5-year plan (from 2007-08 and beyond).
- The Auslink agreement provides for the extension of the National Code of Practice for the Construction Industry and the code's implementation and industry guidelines. The code and the guidelines will apply to all Commonwealth Government-funded construction projects.

Commonwealth funding of vocational education and training

The Commonwealth Government provides the majority of funding for vocational education and training under the *Australian National Training Authority Act 1992*. The Act established the Australian National Training Authority (ANTA) and the funding and policy framework, which is known as the ANTA agreement.

ANTA allocates funds provided by the Commonwealth to state and territory training authorities on the basis of guidelines determined by the ANTA Ministerial Council. Funds are allocated (generally speaking) on an historical basis to reflect each state and territory's vocational education and training funding in the early 1990s (when ANTA was established). ANTA also administers Commonwealth Government vocational education and training budget initiatives not covered by the Act, such as New Apprenticeships.

In May 2003, the Commonwealth Government announced its funding offer for the 2004 to 2006 ANTA Agreement across all Australian states and territories. Figure 5B shows details of the Commonwealth's proposal of $3 600 million over 3 years.

FIGURE 5B: CURRENT AND PROPOSED ANTA AGREEMENT FUNDING ESTIMATES (CALENDER YEAR) ($'000)

Funding component	2003	2004	2005	2006
Base	975 368	997 501	1 020 049	1 042 720
Supplementation	22 133	22 548	22 671	23 560
Australians Working Together	12 381	26 655	31 842	32 207
RICP measure (a)	4 545	8 781	9 975	10 025
ANTA growth	100 000	100 000	100 000	100 000
Growth indexation	4 025	6 325	8 525	10 699
Total	1 118 452	1 161 810	1 193 062	1 219 211
Victoria's share	264 495	275 414	283 099	289 506

(a) RICP: Recognising and Improving the Capacity of People with a disability.

Source: Department of Education and Training and the Vocational Educating and Training Funding Amendment bill 2003.

The terms of the offer were that the Commonwealth would maintain its base and growth funding at 2003 levels (indexed for inflation), and states and territories would be required to match the growth funding component.

Other conditions of the funding required the states to increase the number of apprenticeship training places. The state would also be required to implement user choice[1] and the National Code of Practice for the Construction Industry.

Of the $3 600 million offered, Victoria was to receive $848 million for the period 2004 to 2006 and was required to match the growth funding component estimated to be about $81.3 million. Victoria, along with other states and territories rejected the offer on the grounds that the growth funding component was inadequate. It also objected to the requirement that infrastructure funds could be accessed only if the code and guidelines were applied, and because of various funding implications of implementing user choice.

In the absence of a 2004 to 2006 agreement, and to obtain funding for 2004, the states and territories made a one-year agreement on the same terms and conditions as the expired 2003 agreement. However, this did not index the growth funding component. The consequence of these developments is that Victoria has forgone about $7.6 million in Commonwealth funding for 2003-04.

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[1] National user choice policy allows employers and trainees to choose their registered training organisation, with the state government funding the costs of the training flowing to the chosen organisation.

At the ANTA Ministerial Council meeting in June 2004, it was agreed to recommence negotiations for the next ANTA agreement in October 2004. However, the Commonwealth Government announced in October 2004 that the Australian National Training Authority would be wound-up.

National Code of Practice for the Construction Industry (and implementation and industry guidelines)

In July 2003, the Commonwealth Government responded to the recommendations of the Royal Commission into the Building and Construction Industry by applying the National Code of Practice for the Construction Industry and the associated implementation guidelines and industry guidelines to projects that it funds.

From January 2004, the code and guidelines have applied to all construction projects funded by the Commonwealth Government where its contribution to the project is more than $10 million, or more than $5 million if the contribution is at least 50 per cent of the total project value.

The Victorian Government has declined a $90 million Commonwealth Government grant for the redevelopment of the Melbourne Cricket Ground because of issues with implementing the code and guidelines.

Unless the Victorian Government can reach agreement about funding requirements, it risks foregoing the full amount available under specific purpose grants for capital purposes from the Commonwealth Government.

5.1.2 Taxation

State revenues	2003-04	2002-03	Movement
Taxation ($million)	10 075	9 275	800

Source: Victorian Auditor-General's Office.

In 2003-04, taxation raised was $800 million higher than that received in the prior year. This was mainly due to:

- continued strong growth in stamp duty on conveyancing ($339 million)
- continued strong growth in vehicle transfer-related taxes ($122 million), insurance levies ($112 million), land tax ($102 million) and payroll tax ($91 million).

The general growth in taxes was not reflected in gambling taxation receipts. A reason provided for no growth in this source of revenue was the continuing impact of smoking bans.

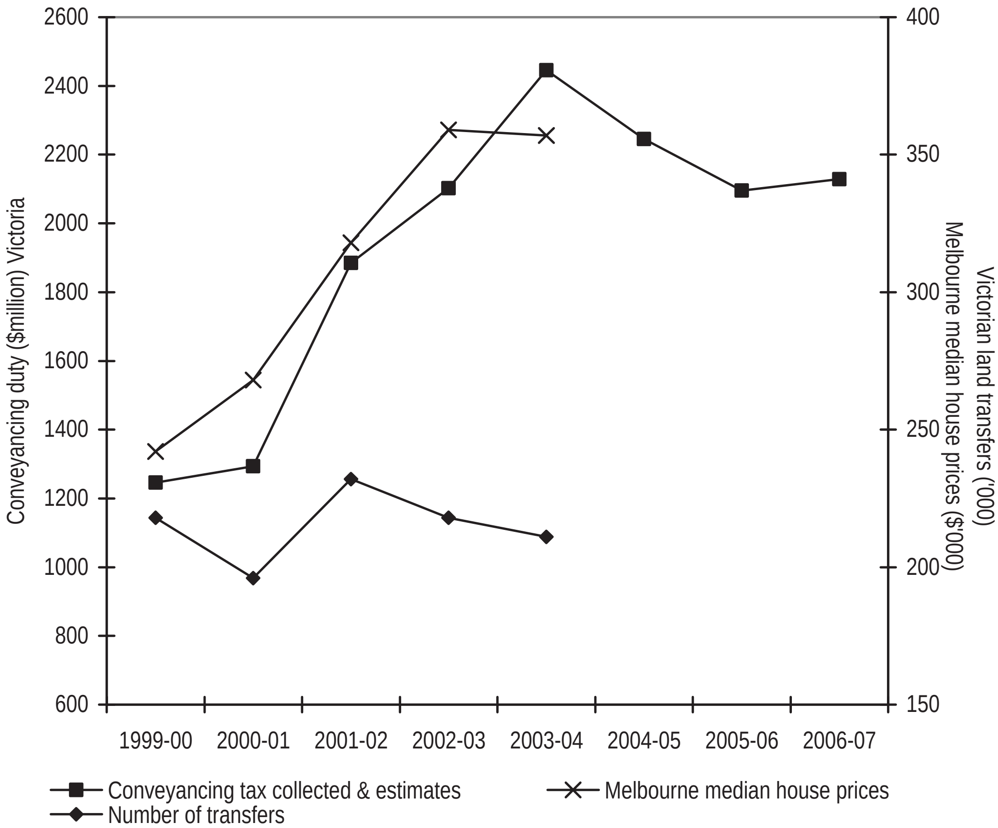
Stamp duty on conveyancing

Stamp duty on conveyancing is levied on the market value or total consideration of the land or property being transferred. In 2003-04, stamp duty on conveyancing revenue was $2 446 million. This was an increase of $339 million on 2002-03 and was about 24 per cent of total tax revenue.

As Figure 5C shows, the number of property transfer transactions continued to fall in 2003-04, and has fallen 9 per cent from its peak in 2001-02. Despite a 3 per cent decline for the year, and metropolitan median dwelling prices remaining relatively constant, stamp duty on conveyancing revenue continued to increase.

This largely reflects lags between the date of signing contracts and settling the contracts, with stamp duty being collected on the settlement date. The government also received $84.8 million in stamp duty from the sale of Loy Yang A[2].

FIGURE 5C: STAMP DUTY COLLECTIONS ON PROPERTY TRANSFERS



Sources: For 1999-00 to 2003-04, conveyancing tax amounts are sourced from the state's Annual Financial Reports. For 2004-05 to 2006-07, estimates are sourced from the budget papers. Average metropolitan residential dwelling prices are sourced from the Real Estate Institute of Victoria Ltd. Property transfer data is sourced from the Victorian State Revenue Office.

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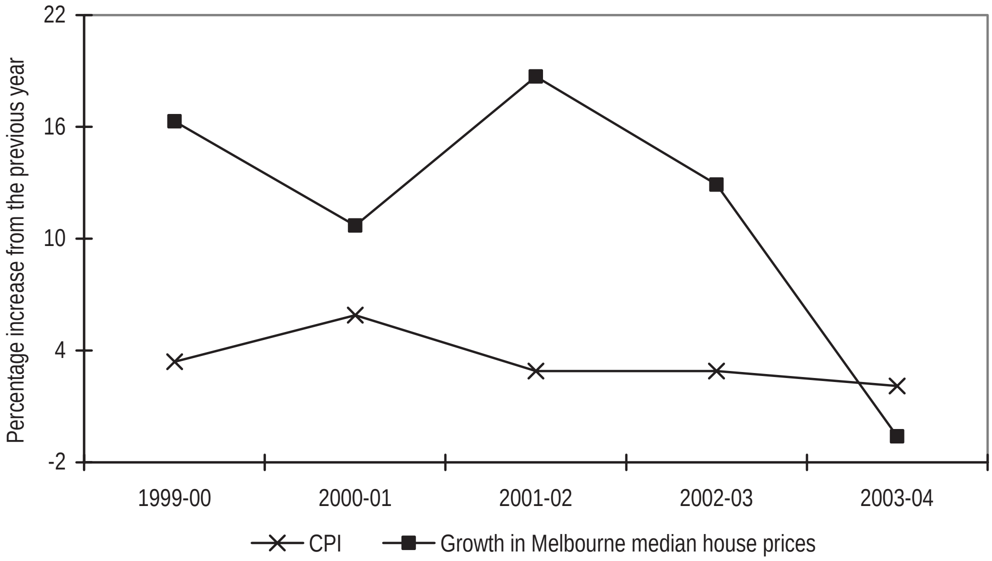
[2] This development is discussed in the Expenditure trends chapter.

In recent years, increases in house prices have substantially exceeded consumer price index (CPI) increases. Figure 5D shows the substantial gap between increases in the CPI, and increases in median house prices, for the period 1999-2000 to 2002-03. However, that trend reversed in 2003-04. As the majority of the government's long-term contracts and industrial agreements are linked to CPI movements, the state has benefited from its revenue growing at a faster rate than its expenditure.

FIGURE 5D: AVERAGE RESIDENTIAL METROPOLITAN DWELLING PRICES COMPARED WITH CPI INDEX PRICES



Sources: For 1999-2000 to 2003-04, Melbourne median house prices are sourced from data supplied by the Real Estate Institute of Victoria Ltd. Movements in the CPI index relevant to Melbourne are sourced from the Australian Bureau of Statistics. CPI index movement for 2000-01 included the impact of the GST, estimated at 3 per cent.

The lack of comprehensive and timely data makes it increasingly difficult to forecast conveyancing taxes. The level of property sales and purchases is influenced (among other things) by interest rates, investor activity, confidence levels and the level of economic growth. Several organisations, including the Reserve Bank of Australia, have recently expressed concern about the lack of up-to-date property market data, particularly data about the Victorian market. The reserve bank has stated that "Victoria is the most extreme case in this regard, where the average period between contract and settlement is around 90 days (although the gap for some transactions may be much longer), and lodgement of information can take place up to 28 days after settlement"[3].

[3] Reserve Bank of Australia, *Measuring Housing Prices*, July 2004.

Conveyancing revenue is a volatile source of revenue given the ups and downs of the housing market. The state is forecasting a decrease in conveyancing taxation revenue from 2004-05, largely because of a predicted lower number of property sales.

Other financial and capital transactions

In 2003-04, the state raised $232.6 million in stamp duty on mortgages, compared with $211.6 million in 2002-03. This tax was abolished on 1 July 2004 under revised Commonwealth-state tax arrangements. However, the state expects to collect about $54 million in stamp duty on mortgages in 2004-05, because of time lags in collecting the duty. Under the same arrangements, bank debit taxes (which raised $255.9 million in 2003-04, compared with $246.4 million in 2002-03) will also be abolished at the end of 2004-05. The Commonwealth has replaced this taxation with revenue collected through the GST.

Gambling fees and taxes

In 2003-04, the state raised $1 324 million in gambling revenue, compared with $1 326 million in 2003-04. Gambling revenue consists of fees and taxes levied on electronic gaming machines (EGMs), private lotteries, casino operations and racing. These fees and taxes were 13 per cent of the state's total revenue.

Figure 5E shows that Australian gaming tax revenue increased in 2002-03. Victoria was the exception to the Australian trend. A reason provided was the impact of banning of smoking in gaming venues[4]. EGM revenue has been most affected by this ban, falling for the first time in 2002-03 by 8.5 per cent and remaining static in 2003-04.

In the 2004-05 budget papers, the state government forecast that gaming revenue would gradually return to normal historical patterns and follow the Australian trend. In October 2004, the government announced that from July 2007, it would abolish dedicated smoking rooms in gaming venues. The financial impact of this ban on the State's gaming taxation revenue in future years is uncertain but it is likely to lead to some levelling off of the current forecast growth pattern.

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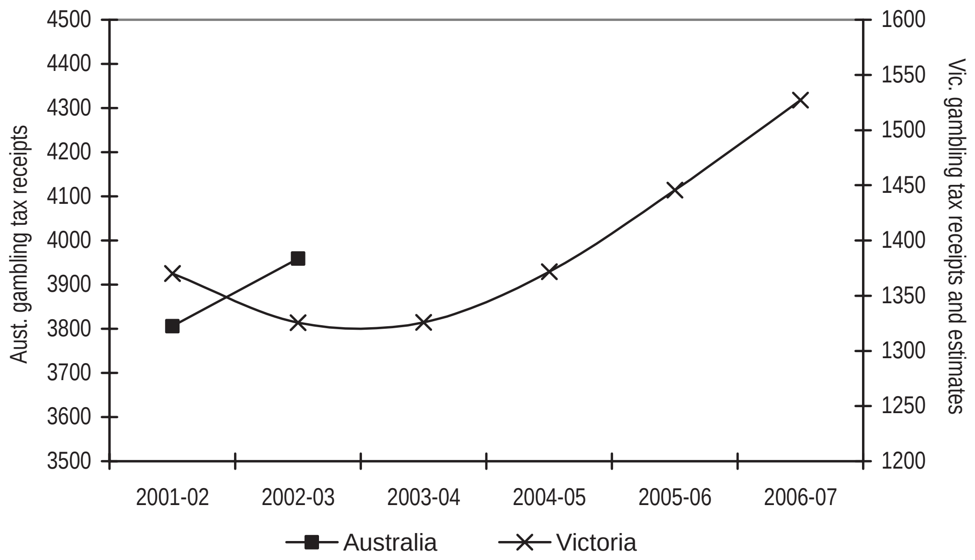
[4] From September 2002, smoking has been prohibited in gaming venues and the Crown Casino, except in declared smoking areas.

FIGURE 5E: TAXATION REVENUE FROM GAMBLING, VICTORIA AND AUSTRALIA ($M)



Revenue category	Actual			Forecast		
	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07
Casino	100	99	99	117	130	148
EGM and Keno	905	828	826	980	1 068	1 177
Other	365	399	401	275	248	203
Total Victorian Gaming Taxes	1 370	1 326	1 326	1 372	1 446	1 528

Sources: For 1999-00 to 2003-04, Victorian gambling tax revenue is sourced from the Annual Financial Reports. For 2004-05 to 2006-07, Victorian gambling forecasts are sourced from the budget papers. Australian gambling revenue is sourced from *2004 Australian Gambling Statistics*, Tasmanian Gaming Commission. Australia gambling revenue data is not available for 2003-04.

5.1.3 Sale of goods and services

State revenues	2003-04	2002-03	Movement
Sale of goods and services ($million)	7 698	7 822	(124)

In 2003-04, sale of goods and services was $124 million less than the prior year. This was mainly due to:

- decreased gas sales following the transfer of GASCOR from government control to private sector gas retailers in September 2002 ($511 million)
- one-off transactions in 2002-03, including a payment to the state by the developer of the Spencer Street Station ($66 million)
- increased WorkCover Authority premium revenue, mainly due to increases in average weekly earnings ($229 million)

- increased Transport Accident Commission premium revenue, largely due to increased motor vehicle sales ($55 million)
- ticket sales revenue, following the reversion of V/Line passenger services back to government hands ($33 million)
- miscellaneous increases mainly in the health and education sectors ($136 million).

Jurisdictional tax differences make certain states more or less attractive to businesses prepared to relocate (or to new businesses choosing a location) to take advantage of these differences. The agreement by state and territory governments to abolish business stamp duties following the introduction of revised Commonwealth-state taxation arrangements has reduced the governments options to increase or vary state taxes. As a result, the state has sought to diversify and supplement its own source revenue. In the last 2 years, revenue from the sale of goods and services (excluding gas sales, country train passenger revenue and one-off transactions) has increased by 5.6 per cent.

5.1.4 Investment revenue

State revenues	2003-04	2002-03	Movement
Investment revenue ($million)	2 531	1 101	1 430

In 2003-04, revenue received from investments was $1 430 million higher than that received in the prior year. The increase was due mainly to stronger local and international equity markets.

As explained in the asset trends section of this report, an agency's investment performance is influenced largely by its investment strategy: equity, cash and bond markets do not rise and fall together but react differently to economic events. Figure 5F compares the 3-year investment performance of the 5 key investing agencies and the State Superannuation Fund. Overall, a significant turnaround has been experienced in investment returns, consistent with that experienced by the Australian investment market generally.

FIGURE 5F: KEY AGENCIES' INVESTMENT PERFORMANCE (%) (a)

Agency	Investment return			3-year average return
	2003-04	2002-03	2001-02	
Department of Treasury and Finance (d)	3.58	8.70	5.95	6.08
Treasury Corporation of Victoria (b)(d)	5.09	5.25	5.15	5.16
Transport Accident Commission	13.29	3.83	(2.87)	4.54
Victorian Managed Insurance Authority	13.20	(0.17)	(4.68)	2.51
Victorian WorkCover Authority	14.51	(0.96)	(3.81)	2.94
State Superannuation Fund (c)	16.19	0.59	(4.80)	3.62
Combined average return	10.97	2.87	(0.84)	4.14

(a) Investment returns before fees.

(b) Excludes loans to participating authorities because these are eliminated upon consolidation of the Annual Financial Reports.

(c) The investment returns of public sector superannuation funds are not included in the state's Annual Financial Report because they are not assets of the state. However, returns do affect the state's unfunded superannuation liabilities and are, therefore, included in the analysis.

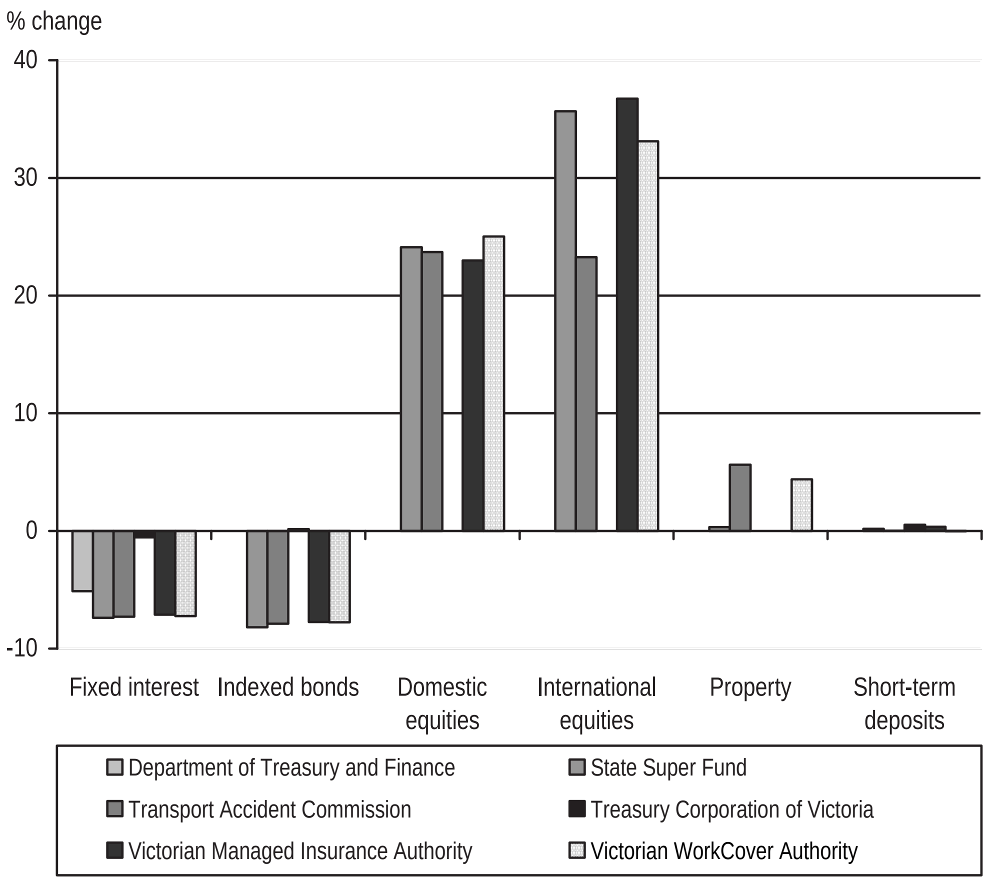
(d) The entities do not invest in equity instruments due to the nature of their financing and investment requirements.

Source: Investment reports of each agency based on market values.

Figure 5G shows the movements in investment returns between 2002-03 and 2003-04 of each investment category for the agencies with significant financial asset holdings.

International equities have had the biggest turnaround, with a net change of about 35 per cent. Returns from Australian fixed interest and indexed bonds fell resulting from existing instruments generating lower returns than the newer instruments due to a climate of rising interest rates. This had a significant impact on the Department of Treasury and Finance's investment return, which only has Australian fixed interest investments. The impact of this on the Treasury Corporation of Victoria was minimal, largely due to the nature of their portfolio and the use of derivative financial instruments. Returns from listed property trusts were strong, benefiting agencies weighted toward these trusts (such as the Transport Accident Commission and the Victorian WorkCover Authority). The State Superannuation Fund had a greater weighting toward unlisted property trusts which also performed strongly, but not as strongly as listed property trusts.

FIGURE 5G: MOVEMENTS IN INVESTMENT RETURNS BY EACH INVESTMENT CATEGORY BETWEEN 2002-03 AND 2003-04 (PER CENT)



Note: Investment returns are before fees. Figure 5G discloses the change in investment returns between the 2 years – as an example international equities for the Transport Accident Commission generated a negative return of 3.43 per cent in 2002-03 compared with a positive return of 19.87 per cent in 2003-04, a change of 23.3 per cent.

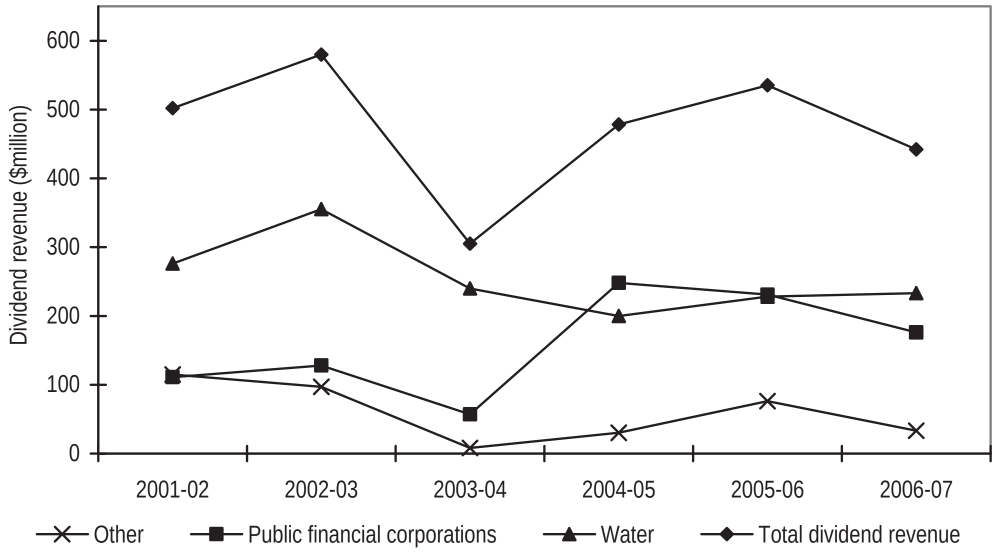
Source: Agencies' investment reports.

Dividend revenue from government business enterprises

Government business enterprises (GBEs) pay the state government dividends. Depending on the industry sector, dividends are in most cases either 50 per cent of net profits after tax, or 65 per cent of pretax profits. These percentages can be varied to take account of the GBE's liquidity and forecast cash requirements, the views of their board and the budgetary requirements of the General Government sector.

Figure 5H shows that in 2003-04, the General Government sector received $306 million in dividend revenue from the GBEs, compared with $581 million in 2002-03.

FIGURE 5H: DIVIDEND REVENUE



Source: 2001-02 to 2003-04 data is sourced from Annual Financial Reports. 2004-05 to 2006-07 data is sourced from the state budget papers. Forecasts do not take into account the impact of the implementation of International Financial Reporting Standards on forecast dividend revenue.

The $275 million decrease in 2003-04 was mainly due to:

- the completion in 2002-03 of a series of special dividend payments by the Transport Accident Commission (TAC) to fund the Accident Blackspot Program ($110 million)
- water agencies not being required to pay additional dividends, as they had in 2002-03 ($100 million)
- the transfer of GASCOR from government control to the private sector in September 2002 ($58 million).

In 2004-05, dividend revenue is forecast to increase by about $173 million, largely due to dividend payments by public financial corporations (in particular the TAC) which will be partly offset by reduced dividends from water agencies. The forecast dividend payment by the TAC (of about $236 million) will be its first dividend payment since 2000-01 (other than the series of special payments to fund the Accident Blackspot Program). It has not made a dividend payment since then because its profitability and cash holdings have been below targets.

5.1.5 Fair value of assets received free of charge or for nominal consideration

State revenues	2003-04	2002-03	Movement
Fair value of assets received free of charge or for nominal consideration ($million)	610	200	410

In 2003-04, the fair value of assets received free of charge or for nominal consideration was $410 million higher than that received in the prior year. The increase was mainly due to:

- the reversion of rolling stock from the National Express Group franchisees to the state for nominal consideration (gain of $257 million)[5, 6]
- rolling stock acquired from Connex being significantly below fair value (gain of $110 million)[5, 6]

5.1.6 Fines and regulatory fees

State revenues	2003-04	2002-03	Movement
Fines and regulatory fees ($million)	513	571	(58)

In 2003-04, revenue from fines and regulatory fees was $58 million less than that received in the prior year. This was mainly due to a decrease in fines revenue brought about by problems with red light and speed cameras.

Fines revenue

In 2003-04, the state received $315 million in fines revenue, compared with $376 million in 2002-03. The $61 million decrease in 2003-04 was mainly from fewer traffic camera fines due to:

- the withdrawal of infringement notices issued from December 2002 to November 2003 on the Western Ring Road, and suspension of speed camera operations from November 2003 on the Western Ring Road, CityLink and Monash Freeway due to camera faults and testing
- delays in introducing red light cameras, and speed cameras, on the Geelong Road, West Gate Freeway and Hume Highway. The delays were mainly due to extra testing of existing speed camera systems after the discovery of faulty cameras, and other contractual issues

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[5] The Expenditure trends chapter includes details about this transaction.

[6] The difference between the consideration paid and the fair value of these assets is brought to account as a gain and, therefore, recognised as revenue by the state.

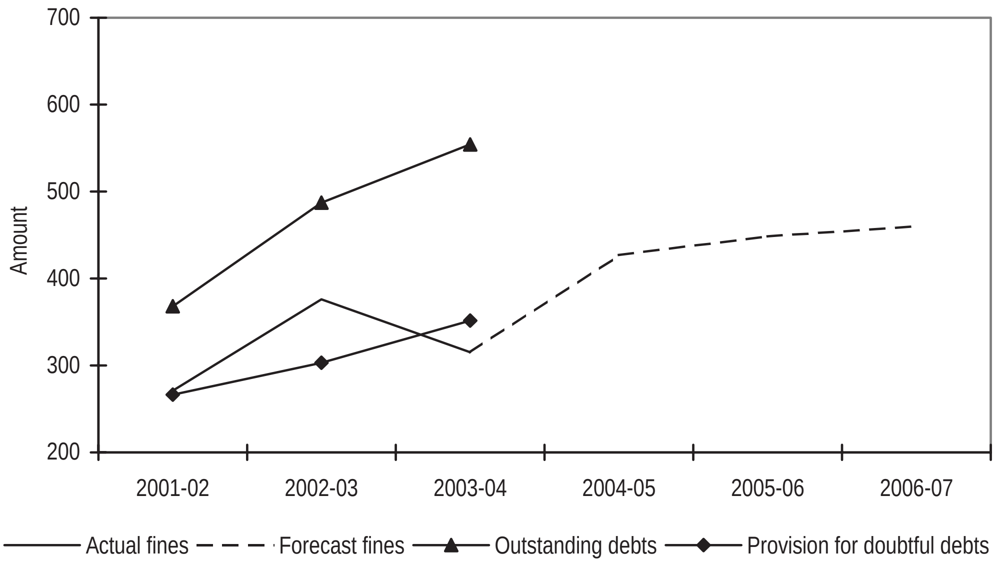
- an improvement in driver behaviour apparently due to the success of red light and speed cameras, and the practice of warning drivers about the presence of traffic cameras.

As a result, the fines revenue forecast was revised downward in the 2003-04 budget update and the 2004-05 budget cycle, by about $190 million in 2003-04, $90 million in 2004-05 and $70 million thereafter.

Traffic camera warning sign.

Figure 5I shows that despite the decrease in 2003-04, fine revenue is expected to resume its upward trend from 2004-05. The majority of fixed speed cameras are expected to be operational by the end of 2005-06.

FIGURE 5I: FINES REVENUE, FINES RECEIVABLE AND PROVISION FOR DOUBTFUL DEBTS ($M) (a)



(a) Excludes regulatory fees.

Source: 2001-02 to 2003-04 actual data is sourced from data provided by agencies which comprise the figure included in the Annual Financial Reports. 2004-05 and forward years data is sourced from budget papers.

Faulty traffic cameras

In 2003-04, the Traffic Camera Office collected $239 million in fines. This was 78 per cent of all fine revenue.

Under a contract with VicRoads, Poltech International was responsible for installing and maintaining traffic cameras on the Western Ring Road. Following some unusually high speed readings and camera downtime, the Traffic Camera Office reviewed the operation of cameras on the Western Ring Road, Monash Freeway and in the CityLink tunnels.

Following the review, in May 2004, the government announced that it would reimburse and compensate motorists who had received an infringement notice as a result of being detected for speeding by faulty speed cameras on the Western Ring Road between December 2002 to November 2003. The cameras in the CityLink tunnels and on the Monash Freeway were assessed as working satisfactorily.

An estimated 87 150 drivers were affected. At September 2004, applications totalling 80 060 had been received requesting a refund, or the withdrawal of an infringement notice and reversal of demerit points.

The Department of Justice (the department) also announced that drivers who had lost their licence could apply for an ex-gratia payment from the government for additional travel expenditure incurred while their licence was suspended. At the time of preparing this report, the department had received 1 030 applications and was in the process of assessing them. The department estimates that the cost of fine reimbursements and ex-gratia payments will be about $19.7 million.

The government also decided not to issue infringement notices against drivers detected speeding on the Western Ring Road, CityLink and Monash Freeway while cameras were being tested (from November 2003 to May 2004). This related to 42 850 speeding incidents. Cameras on the CityLink and Monash Freeway are expected to again be operational in November 2004.

Poltech International was placed in voluntary administration in November 2003. The government has funded the costs of testing the cameras and fixing the associated problems, and the ex-gratia payments. The Department of Justice is currently replacing or repairing the faulty cameras on the Western Ring Road. This is expected to be completed by late 2005.

Following the review, the government set up a new unit to oversee traffic camera operations. The unit is responsible for overhauling and upgrading cameras and strengthening the speed verification process. This will include testing and maintenance for fixed digital speed cameras.

The activities of this new unit will be crucial to restoring public confidence in traffic cameras and, therefore, in the government's road safety strategy.

Uncollected fines

Figure 5J shows that more traffic camera fines are cleared within 12 months of being issued (89 per cent) than other types of fines. Court orders and warrants have the lowest clearance rates within 12 months (32 per cent and 34 per cent, respectively).

At 30 June 2004, the state's uncollected fines were $554 million, compared with $487 million 12 months earlier. The provision for doubtful debts also increased, by $49 million to $351 million. Figure 5K shows the number of debtors by the age of the outstanding debts.

FIGURE 5J: FINE CLEARANCE RATES WITHIN 12 MONTHS OF ISSUE (%)

Type of fines	Clearance rate (a)
Traffic fines	89
On-the-spot fines (b)	79
Court orders (c)	32
Warrants (d)	34

FIGURE 5K: TOTAL OUTSTANDING DEBTS BY AGE, AT 30 JUNE 2004 ($'000)

Time debts are outstanding	Total outstanding debt	(%)
Up to 1 year	141 260	25
1 to 2 years	127 340	23
Greater than 2 years	285 773	52
Total	554 373	100
Provision for doubtful debts	351 500	63

(a) Clearance includes cash collections as well as non-cash forms of closure.

(b) On-the-spot fines are issued by Victoria Police and other agencies.

(c) Court orders relate to unpaid local government infringement notices lodged with the PERIN Court. This is a Magistrates Court function responsible for the enforcement of all government and non-government penalty infringement notices that are registered with the court.

(d) Warrants relate to court imposed fines.

Source: Department of Justice.

Due to the low clearance rates for court orders and warrants (32 per cent and 34 per cent, respectively) and the fact that 75 per cent of the outstanding debt balance represents fines outstanding in excess of 12 months, the government needs to investigate ways to improve the collectability of fines.

6. Expenditure trends

6.1 Expenditure trends

State operating result ($million)	2003-04	2002-03	Movement
Revenues	35 274	32 016	3 258
Expenses	31 508	31 962	(454)
Operating result	3 766	54	3 712

In 2003-04, state expenditure totalled $31 508 million. Figure 6A shows the major variations in expenditure from 2002-03.

FIGURE 6A: STATE EXPENDITURE MOVEMENTS ($M)

Expenditure item	2003-04	2002-03	Movement
Employee benefits	10 621	10 122	499
Supplies and services	12 812	13 116	(304)
Superannuation	364	2 677	(2 313)
Other expenses	1 559	264	1 295
Depreciation & Amortisation	1 764	1 620	144
Borrowing costs	939	939	-
Grants and transfer payments	3 449	3 224	225
Total	31 508	31 962	(454)

Source: 2003-04 Annual Financial Report.

6.1.1 Employee benefits

State revenues	2003-04	2002-03	Movement
Employee benefits ($million)	10 621	10 122	499

Employee benefits expenditure increased by $499 million compared with the prior period primarily due to:

- policy decisions and enterprise bargaining agreements in 2002-03 ($326 million)
- enterprise bargaining agreements made in the latter part of 2003-04 ($128 million).

The public sector work force is the largest public service input and cost driver. Therefore, one of the most important financial risks confronting the state is the government's ability to manage wage settlements within budgetary constraints.

Enterprise bargaining agreements

In November 2003, we reported[1] that a number of key enterprise bargaining agreements were due to expire in 2003-04. The government responded to the budgetary risk that this presented by developing a revised wages policy. The main aspects of this policy were to:

- maintain real wages by providing funding for an increase equal to the budget CPI forecast of 2.25 per cent
- fund up to a further 0.75 per cent increase for identifiable service delivery improvements that are sufficient to justify funding
- potentially allow additional pay increases that are funded from productivity improvements and offset by cost savings.

Figure 6B outlines key enterprise bargaining agreements settled in 2003-04. It also shows initiatives in the 2004-05 Budget that will affect expenditure on employee entitlements in future years. Figure 6D outlines the impact of individual agreements and budget initiatives over the period 2002-03 to 2005-06.

[1] Victorian Auditor-General's Office 2003, *Report of the Auditor-General on the Finances of the State of Victoria*, Government Printer, Melbourne.

FIGURE 6B: KEY INDUSTRIAL SETTLEMENT OUTCOMES AND 2004-05 BUDGET INITIATIVES

Government schools teachers

Industrial settlement outcomes:

The 39 000 government school teachers and principals received a general increase of 3 per cent a year effective from April 2004. This comprised a 2.25 per cent increase for inflation, and a 0.75 per cent increase for service delivery improvements.

Further costs will be incurred following the implementation of a new career structure which is to be implemented over the life of the agreement. The agreement incorporates a new career structure creating additional incremental progressions that expand the salary band widths of existing classifications. Advancements under the new structure will be based on an annual review process, rather than promotion. The extension of the incremental scales provides for additional salary increases during the life of the agreement. Other changes include the eligibility for pro rata long service leave commencing after 7 years rather than the previous 10 years. The 3 per cent wage increase due in the final year of the agreement (2006) was brought forward by 2 months.

Other outcomes of the agreement include cash out options for long service leave, and a planning guide for average class sizes of 26 in primary schools and 25 in secondary schools.

Budget initiatives:

$62 million over 4 years for 250 additional teachers as part of a new resource allocation model for government schools.

TAFE teachers

Industrial settlement outcomes:

The 5 440 TAFE teachers received a 3 per cent a year increase, consisting of 2.25 per cent general increase and 0.75 per cent for service delivery improvements effective from September 2003.

Additional costs will be incurred mainly due to a 4 per cent increase for teachers at the top incremental and senior education levels over the life of the agreement.

Budget initiatives:

$90 million over 4 years towards vocational and training programs of which $85.4 million has been allocated to employee entitlements expenditure in the budget papers.

General, psychiatric and other nurses

Industrial settlement outcomes:

Approximately 26 920 equivalent full-time nurses received a general increase of 3 per cent a year, consisting of 2.25 per cent general increase and 0.75 per cent for service delivery improvements effective from April 2004.

Additional cost will be incurred due to new incremental grades and reclassifications.

Budget initiatives:

900 extra nurses and health staff at a cost of $56 million a year from 2004-05.

Victorian Government and Community and Public Sector Union employees

Industrial settlement outcomes:

Around 27 000 employees received a 3 per cent increase in each of the financial years, commencing from March 2004, and 1.5 per cent for 2007-08. Each of the 3 per cent increases is made up of a general increase of 2.25 per cent and a further 0.75 per cent for service delivery improvements.

The additional cost will be incurred following the change in the eligibility for long service leave commencing after 7 years, down from 10 years previously.

Budget initiatives:

No significant budget initiatives impacting on staff numbers or employee entitlement expenditure.

Figure 6B shows that all the enterprise bargaining agreements provided for a 0.75 per cent increase in wages for service delivery improvements. These improvements included:

- new technologies to improve the efficiency of service delivery
- efficiencies from improvements in the design and implementation of programs
- increases in output performance that was yet to be agreed at the time the enterprise bargaining agreement was signed.

These service delivery improvements were identified by the agencies party to the agreements, however, they were not all costed to justify payment of the 0.75 per cent increase.

The government's wages policy also allowed for additional increases above 3 per cent if the cost was fully met by productivity improvements and that the government was satisfied that the productivity improvements were real and sustainable.

Figure 6C analyses the costs of the enterprise bargaining agreements above the 3 per cent benchmark, and shows the funding source. The total cost of the agreements above the 3 per cent benchmark is $420 million over the 4 years of the agreements.

FIGURE 6C: FUNDING OF WAGE COSTS ABOVE THE 3 PER CENT BENCHMARK ($M)[2]

Funding source	2003-04	2004-05	2005-06	2006-07	Total
Funded from the contingency sum not allocated to departments					
CPSU	20.0	10.0	10.0	10.0	50.0
TAFE teachers	1.9	2.0	2.0	2.1	8.0
School teacher (a)	26.6	28.9	60.0	88.2	203.7
Nurses and other health sector staff	9.7	13.5	17.0	18.8	59.0
Subtotal	58.2	54.4	89.0	119.1	320.7
Funding available from productivity savings					
TAFE teachers (b)	-	8.9	13.6	13.6	36.1
Nurses and other health sector staff	4.1	18.2	19.8	21.5	63.6
Subtotal	4.1	27.1	33.4	35.1	99.7
Total	62.3	81.5	122.4	154.2	420.4

(a) Excludes additional employer superannuation contributions resulting from the changes to government school teacher superannuation arrangements in the revised and new scheme which provides for superannuation contributions to be paid pre-tax (estimated by the Department of Treasury and Finance at between $3 million to $5 million a year).

(b) A portion of the cost of the TAFE teacher enterprise bargaining agreement is to be funded from attrition rate savings. Attrition savings represents forecast savings derived from the retirement of existing teachers at relatively higher classification levels, replaced by new teachers at lower classification levels. The Department of Education and Training was not able to provide details of attrition rate savings as these are to be managed by individual TAFE institutes.

Source: Department of Treasury and Finance, Department of Education and Training, and the Department of Human Services.

The $320.7 million additional funding over 4 years will be sourced from existing general government sector budget expenditure contingencies. At the date of preparation of this report, the Department of Treasury and Finance had not identified in all cases, the productivity improvements that the respective agencies expect to deliver for this funding as required by the government's wages policy.

The funding to be provided by the respective departments of $99.7 million over 4 years will mainly be sourced from funding available following the abolition of the productivity dividend under the revised departmental funding model, and from cost reductions and productivity improvements. Although general as well as specific productivity improvements have been identified, they have not all been costed.

[2] Figure 6C also includes the additional funding required for long service leave, and the additional impact on long service leave due to changes in the pro rata entitlement for government school teachers and eligible members of the Victorian Government and Community and Public Sector Union.

To calculate the funds required to pay for these wage increases, all agencies used their salary costs in the period before the new agreement, assuming a static work force before adding the impact of the across-the-board wage increase and other changes (including reclassifications and changes to salary increments).

However, in addition to the above, the education sector used another work force model to cost the impact of the agreement. This model included workforce projections over the period of the agreement, taking into account factors such as attrition. Attrition-related savings represent forecast savings derived from the retirement of existing teachers at relatively higher classification levels, replaced by new teachers at lower classification levels.

The government needs to carefully monitor productivity improvements and attrition related savings to ensure that additional funding does not have to be provided in the future to finance these elements of the enterprise bargaining agreements. Further, all agencies need to adopt a uniform wage cost model, to ensure a consistent approach across the public sector.

The 2004-05 Budget allocated $90 million over 4 years to vocational and training programs to increase the student contract rates and deliver more innovative training programs - targeting young people, mature age students and people with disabilities, and to continue the development of specialist centres. Of this, $85.4 million was allocated in the budget papers to wages, though the funding is provided to TAFE institutes who will use the funds to cover the costs relevant to the above programs.

The Department of Education and Training needs to ensure that TAFE institutes achieve the productivity improvements and savings that they identified to fund the additional salary increases of $36.1 million as outlined in Figure 6C, and that the additional 2004-05 budget funding for vocational and training programs are not utilised for that purpose.

Department of Education and Training restructure

In 2003-04, the Department of Education and Training was restructured. Of 1 625 head office and regional staff, 196 accepted voluntary departure packages. Another 10 accepted targeted departure packages. Staff numbers were further reduced by staff departures and redeployment.

The total cost of the departure packages was $8.5 million. The department has estimated that ongoing, full-year savings will be $19.2 million on the basis that head office and regional staff numbers remain static. The department will need to carefully monitor its use of non-permanent staff, to ensure that savings are ongoing. The department is currently addressing its surplus head office accommodation as a result of the impact of the downsizing.

Impact of industrial agreements and budget initiatives

Figure 6D shows the estimated net additional costs of major public sector industrial agreements and associated budget initiatives. In 2003-04, these costs were estimated at $1 927 million, compared with $1 482 million in 2002-03. This was an increase of $445 million for the year.

As previous enterprise bargaining agreements expired throughout 2003-04, the costs of the new agreements were only partially felt during this year. These costs were estimated to be $128 million in 2003-04, and are expected to increase by another $334 million in 2004-05, when the new agreements will be in effect for the whole year.

FIGURE 6D: ESTIMATED COSTS OF MAJOR PUBLIC SECTOR INDUSTRIAL AGREEMENTS AND BUDGET INITIATIVES ($'000) (a)

Salaries and on-costs	2002-03	2003-04	2004-05	2005-06
Agreements cost				
Impact of major prior year agreements (b) (c) (f)	1 224 073	1 429 555	1 533 751	1 602 419
Impact of major agreements entered in 2003-04 -				
Public service agreement	-	34 900	92 200	145 100
Health services sector (b)	-	33 200	167 900	254 400
Education sector – government schools (g)	-	48 900	171 700	296 100
Education sector – TAFE	-	10 800	30 693	46 700
Total estimated cost of major agreements	1 224 073	1 557 355	1 996 244	2 344 719
Less redirection of existing funding towards agreements and savings resulting from redundancies and attrition rates -				
Redirection requirements for prior year agreements (c)	72 610	74 700	72 700	72 700
Savings for redundancies – DET	-	9 600	19 200	19 200
Savings from attrition rates – TAFE (d)	-	-	-	n.a.
Total redirection of existing funding, redundancy and attrition rate savings	72 610	84 300	91 900	91 900
Total net cost to the state of new agreements, excluding impact of policy decisions (e)	1 151 463	1 473 055	1 904 344	2 252 819
Major policy decisions – additional permanent staff -				
Prior year decisions (c)	330 180	453 800	490 170	521 310
Major new funding decisions arising from 2004-05 Budget initiatives -				
DE&T - Additional 250 school teachers	-	-	7 500	16 900
DE&T - Additional funding TAFE employee entitlements cost	-	-	9 490	18 983
DHS - Additional 900 nurses/health staff	-	-	56 000	56 000
Total estimated cost of new budget initiatives	-	-	72 990	91 883
Total estimated cost of policy decisions	330 180	453 800	563 160	613 193
Total net cost Including additional staff (e)	1 481 643	1 926 855	2 467 504	2 866 012
Net Increase on prior year		445 212	540 649	398 508

(a) Data sourced from estimates provided by Department of Treasury and Finance, Department of Human Services, Department of Education and Training, Department of Justice and Victoria Police. Data covers new major agreements entered into from 2000-01 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 our *Reports on the Finances of the State of Victoria* for 2001-02 and 2002-03 for further details.

(d) A portion of the costs of the TAFE teacher enterprise bargaining agreement to be funded from attrition rate savings. The Department of Education and Training is unable to cost these savings as these are to be managed by individual TAFE institutes.

(e) The total cost does not include the consequential impact on superannuation liabilities.

(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 additional employer superannuation contributions required resulting from the changes to government school teachers superannuation arrangements, estimated at between $3 million to 5 million a year.

Source: Victorian Auditor-General's Office.

6.1.2 Supplies and services

State revenues	2003-04	2002-03	Movement
Supplies and services ($million)	12 812	13 116	(304)

Supplies and services expenditure decreased by $304 million compared with the prior period due to:

- decreased gas sector expenditure after GASCOR was transferred from government control to the private sector in September 2002 ($541 million)
- decreased claims against, and actuarial revisions by, Victorian WorkCover Authority ($428 million)
- a one-off prior period transaction relating to the wind-down of the privately operated LaTrobe Hospital ($61 million).

These decreases were offset by increased expenditure on:

- public transport franchise arrangements ($413 million)
- an ex-gratia payment relating to the sale of Loy Yang A ($49 million)
- other miscellaneous factors ($264 million).

Passenger rail franchising

Public passenger rail transport is vital to the state's economic growth by linking people to services, employment and a wide range of activities and events. The provision of such services represents a major financial commitment by the government. My previous reports have commented on the initial implementation of passenger rail franchising, subsequent developments and the impact on the state's finances.

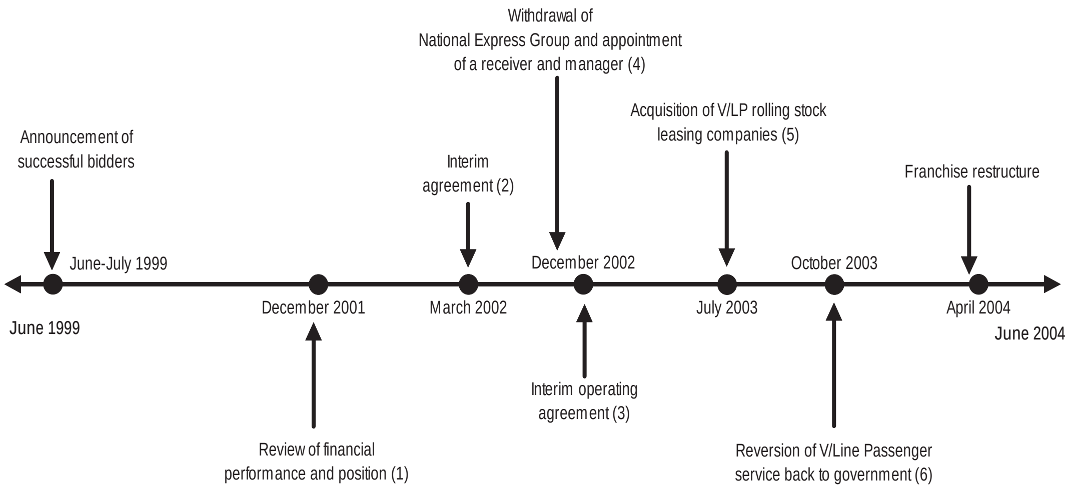
In 1999, the previous government awarded 5 separate passenger rail (tram and railway) franchises to private sector companies, for periods of up to 15 years. The state retained ownership of the rail infrastructure (except for rolling stock) while transferring responsibility and associated commercial risks for the day-to-day management of the rail system to the franchisees. The aims of the franchise arrangement were to improve service quality, significantly increase patronage, minimise long-term costs to the taxpayer, transfer risks to the private sector and maintain high safety standards.

The franchisees were to receive a fixed annual subsidy from the state, as well as receive fare revenue. It was expected that the subsidy would decrease over time, as the financial viability of the franchisees' business improved. Annual payments to the franchisees were expected to reduce from $390 million in the first full year of operation to $9 million by 2015.

In the first 2 years of operations, the franchisees did not meet the passenger growth and cost reduction targets, jeopardising their financial viability. Consequently, the state entered into 2 interim agreements to resolve contractual disputes and ensure the short-term viability of the businesses, and to restructure the industry. However, in December 2002, one of the franchisees (National Express Group) withdrew from the franchise arrangement (before the restructure).

Figure 6E shows the main events since 1999.

FIGURE 6E: PASSENGER RAIL FRANCHISING HISTORY



(1) The Director of Public Transport commissioned a review of financial performance and position of all franchisees, which identified a number of significant viability issues.

(2) Interim agreement settled a number of outstanding disputes between the parties.

(3) Interim operating agreement entered into with Yarra Trams and Connex Trains provided funding to ensure short-term viability and facilitate the restructure of the franchise arrangements, including contract termination provisions.

(4) National Express Group operated M>Train, M>Tram and V/Line Passenger Service franchises.

(5) Acquisition of National Express Group – V/Line Passenger Service rolling stock leasing companies by the state.

(6) V/Line Passenger Service operations reverts back to the government to facilitate a number of large-scale regional infrastructure works projects.

Source: Victorian Auditor-General's Office.

In December 2002, the government entered into interim operating agreements with Connex[3] and Yarra Trams[4]. This (as well as the withdrawal of National Express Group) enabled the government to retender the franchises and terminate all existing contracts once it had done so. The interim agreement provided for the state to reimburse Connex and Yarra Trams in the event the state took control of specified franchisee assets.

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[3] Connex Melbourne Pty Ltd, trading as Connex Trains.

[4] Metro Link Victoria Pty Ltd, trading as Yarra Trams.

On the assumption of the specified assets, the state agreed to pay Connex and Yarra Trams $120 million in early termination payments for capital investments they had made during their franchise terms. Connex's termination payment also included the cost of terminating its old rolling stock lease. Connex was the only franchisee that entered into a sale and lease-back arrangement for the old rolling stock it initially received from the state.

After retendering of the franchises (which involved contract changes and revised financial bids), the government awarded Connex the metropolitan train franchise and Yarra Trams the metropolitan tram franchise in April 2004. Both were to start operating under new agreements in April 2004. Connex and Yarra Trams provided performance bonds to the value of $65 million and $35 million respectively.

The main contracts under the new arrangements are the franchise agreement, infrastructure lease and new rolling stock agreements. Contracts allocate risk and specify the service quality required and funding mechanisms, among other things. They move away from transferring significant commercial risk to the franchisees, which was the intention of the 1999 agreements. Under the new arrangements, the state has assumed:

- ownership of the majority of existing rolling stock
- responsibility for franchisees' accrued employee entitlements
- responsibility to pay insurance premiums
- responsibility to pay fixed percentages of revenue shortfalls (actual revenue compared with forecast) to the franchisees below certain threshold levels.

Return of existing rolling stock

As part of the 1999 franchise arrangements, the state transferred existing rolling stock valued at $663 million to the franchisees for a nominal amount. This transaction was factored into the operating subsidy sought by the franchisees from the government.

Following the new contracts entered into in April 2004, all the existing rolling stock used by the National Express Group reverted back to the state for nominal consideration. The state also acquired some of the existing rolling stock used by Connex for $79 million as part of the restructure of the franchise arrangements. The balance of the existing rolling stock remaining with Connex and Yarra Trams will gradually be replaced with new rolling stock. The existing rolling stock that reverted back to the state was revalued at 30 June 2004 to $450 million.

Assumption of franchisee employee entitlements

The previous agreement required the franchisee to pay to the Director of Public Transport or a successor operator the accrued employee entitlements at the end of the franchise term. The new contracts do not include this obligation. This, in effect, means that the state will have to take on the accrued employee entitlements at the end of the franchise term. The state also assumed $148 million of the employee entitlements liability that was accrued up to the commencement of the new franchise period.

Insurance arrangements

The state is required to arrange insurance for property damage, including rolling stock, and public liability on behalf of the franchisees over the franchise period. The contract allows for the premiums for these insurances to be paid by the state, with franchisees liable for specified amounts in the event of an accident.

Forecast revenue shortfalls

The franchisees' revenue forecasts are based on assumptions about future events and circumstances that may or may not come to pass. In the new contracts, the state in relation to the train and tram franchises agreed to meet 50 per cent and 75 per cent, respectively, of the short falls in revenue below certain threshold levels.

Additional subsidy required

As a result of the new contracts, the state will spend an extra $265 million a year above what was spent in 2003-04 in franchisee subsidies and to operate V/Line Passenger Service. This will increase the total annual operating subsidy to around $654 million from 2004-05 which will total over $4 200 million for the life of the franchise agreements which expire in 2008-09 (not including options to extend agreements) and up to 2008 for V/Line Passenger Service[5].

New rolling stock – financial reporting disclosure

At the time of agreeing the initial franchising contracts, the government set a target of 70 per cent of the fair market value of the rolling stock to be covered by the present value of discounted lease payments to ensure that a transfer of risk had occurred. This is consistent with the spirit of accounting concepts, which require that any value beyond 90 per cent is deemed to leave the residual value risk in the hands of the lessor (government) rather than the lessee.

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[5] V/Line Passenger Service is expected to be franchised from 2008.

New rolling stock unit at modernised city location tram stop.

These arrangements were originally accounted for as operating leases. However, our June 2000 *Report on Ministerial Portfolios* recommended that the government complete further work to support the appropriateness of the underlying assumptions and, accordingly, the accounting treatment.

In accordance with professional accounting requirements, the new rolling stock arrangements were re-assessed in 2004 to determine the financial reporting impact of the recent changes to the franchise arrangements, as well as reviewing the assumptions supporting the Department of Infrastructure's initial accounting treatment.

Figure 6F shows the rolling stock payments made by the state as a percentage of the rolling stock fair value.

FIGURE 6F: NEW ROLLING STOCK PAYMENTS AS A PERCENTAGE OF THE ROLLING STOCK FAIR VALUE

Franchise (a)	2004(b)(c)	2000(d)
Bayside Trains (now Connex Trains)	101.6	80.0
Hillside Trains (now Connex Trains) (e)	82.7 – 87.7	71.0
Swanston Trams (now Yarra Trams)	99.7	80.0
Yarra Trams	104.3	92.0

(a) Excludes V/Line Passenger Service, given that the state has acquired the interest in the special purpose financing vehicle used to acquire the rolling stock.

(b) Does not include termination payments upon expiry of the lease term.

(c) Calculation by the Victorian Auditor-General's Office.

(d) Calculation based on information provided by the Department of Infrastructure in April 2000.

(e) Differential margin of 5 per cent as no details are available on a timing of a related payment.

Source: Victorian Auditor-General's Office.

According to information obtained from the final lease contract documents and associated agreements, the present value of discounted lease payments made by the state are over the 90 per cent threshold for 3 of the 4 leases. Further, the government has, in the lease contracts, effectively guaranteed to pay the capital cost over the lease period. This means that, in essence, the lease arrangement represents the acquisition of an asset by the state via a finance lease.

The impact of this from a financial reporting perspective, is that the new rolling stock leases have been reclassified from an "off balance sheet" transaction to a finance lease in the Statement of Financial Position for 3 of the 4 lease arrangements. Accordingly, an asset and liability of around $453 million respectively has been recognised as at 30 June 2004, reflecting the new rolling stock currently in service. By the end of 2005-06, when all the rolling stock is in service, this is expected to increase to around $608 million (excluding the Hillside lease).

The disclosure of the Hillside lease arrangement will need to be reconsidered when the International Financial Reporting Standards come into effect on 1 January 2005. The International Financial Reporting Standards retain the qualitative indicative tests that currently apply in determining the nature of the lease arrangement. However, the quantitative indicator of 90 per cent of the fair value of the asset is omitted.

Receivership of National Express Group franchises

After the government awarded contracts to the new franchises in April 2004, the franchise arrangements with the National Express Group (administered by the appointed receiver and manager) were terminated. M>Tram operations were transferred to Yarra Trams and M>Train to Connex. V/Line Passenger Service reverted back to government operation in October 2003, with excess assets over liabilities of $10 million. The shortfall between revenue and expenditure for the franchisees in receivership for the 2003-04 year were estimated to be $212 million. These costs were assumed by the state, in addition to the receiver and manager fees of $5 million.

2003-04 financial impact

Figure 6G shows the financial impact in 2003-04 of the new franchising arrangements and of the continued support of the franchisees in receivership. The impact on the statement of operating performance was a net cost of $46 million made up of additional franchisee costs of $413 million, offset by a gain of $367 million as a result of receiving existing rolling stock for nominal consideration. The net impact on the Statement of Financial Position was a $336 million gain.

FIGURE 6G: 2003-04 IMPACT OF THE RAIL FRANCHISE ARRANGEMENTS ON THE STATEMENT OF FINANCIAL PERFORMANCE AND POSITION

Statement of financial performance	$million	Statement of financial position	$million
Revenue		Assets	
Existing rolling stock and parts returned to the state free of charge and revalued (a)	257	Existing rolling stock and parts received free of charge and revalued (a)	257
Existing rolling stock acquired from Connex Trains and revalued.	110	Existing rolling stock purchased from Connex Trains for $79 million and revalued.	189
		Assets purchased from Connex and Yarra.	28
		V/Line Passenger Service assets (b)	61
		Recognition of a finance lease asset (c)	453
Expenditure		Liabilities	
Additional funding provided to meet shortfalls in revenue of the franchisee businesses in receivership (including $20 million paid under the deed of company arrangement)	(212)	Recognition of a finance lease liability (c)	(453)
Additional funding provided to Connex and Yarra Trams under the December interim operating agreement (July 2003-April 2004)	(36)	Assumption of employee entitlements	(148)
		V/Line Passenger Service liabilities (b)	(51)
Receiver and manager fees	(5)		
Restructure taskforce fees	(21)		
Assumption of employee entitlements from franchisees	(148)		
Principal component of the new rolling stock subsidy payment re-classified from expenditure to repayment of a liability	9		
Net impact	(46)	Net impact	336

(a) Former National Express Group old rolling stock including M>Train and M>Tram.

(b) Asset and liability values when assumed by the state in October 2003.

(c) Present value of finance lease obligations recognised for Bayside Trains (now Connex), Swanston Trams (now Yarra Trams) and Yarra Trams.

As indicated previously, the state will spend an extra $265 million a year above that spent in 2003-04 in franchisee subsidies and to operate the V/Line Passenger Service.

The difficulties associated with the franchise arrangements over the last few years have resulted in substantial additional costs to the state and the assumption of further risks associated with the franchise operations. In going forward, the new franchise arrangements will need to be carefully managed to minimise any further additional costs to the state.

Loy Yang A – associated transactions

Loy Yang A is Victoria's largest power station, accounting for 24 per cent of Victoria's electricity generation capacity. Loy Yang A sells its electricity on the national electricity market.

Loy Yang A was sold to a consortium of investors in May 1997. In April 2004, as a result of financial difficulties, the consortium sold Loy Yang A to a new consortium comprising AGL Electricity, Tokyo Electric Power Company and institutional investors.

The State Commissioner of Taxation had assessed the stamp duty payable by the new consortium as $84.8 million (based on the sale price of $3 500 million). Of this, $40 million was paid on settlement in April 2004, with the balance to be paid over a 4 and half-year period. Interest, in line with the market rate, is payable on the outstanding amount.

To facilitate the sale, the state government and the new consortium agreed that the net inflow to the state on the transaction would not exceed $40 million. To meet this requirement, the state decided to pay some of the contractual obligations of the old consortium, on behalf of the new consortium as an offset to the stamp duty and interest payable.

In 1991, the State Electricity Commission of Victoria (SECV) entered into a Pulverised Dried Brown Coal Agreement with other parties. This agreement required the SECV to take (or pay a set amount for) the pulverised dried brown coal output of a newly constructed plant from 1993 to 2011. The plant was built to supply pulverised dried brown coal to Loy Yang B and have enough capacity to supply other customers (including Loy Yang A) with an alternative to briquettes.

In 1997, the sale price to the consortium which bought Loy Yang A was reduced by an amount equivalent to the remaining obligations under the agreement, that were estimated at $109 million. In other words, the state paid the consortium to assume the full contractual obligations.

The Department of Treasury and Finance advised us that if Loy Yang A had not been sold to the new consortium, the old consortium risked going into receivership. The department was of the view that this would have exposed the state (through the SECV) to the remaining contractual obligations of the Pulverised Dried Brown Coal Agreement. The government, therefore, agreed to pay $48.8 million to the new consortium over a 5-year period, starting in 2003-04. **The payments to be made from 2004-05 onwards are the same as the stamp duty instalment payments to be made by the new consortium to the state (including the interest)**.

The ex-gratia payable of $48.8 million has been recognised as part of supplies and services expenditure and the $84.8 million as part of stamp duty revenue in the government's Annual Financial Report. In addition, the associated receivable and payable has been recognised.

Melbourne 2006 Commonwealth Games

As evidenced by the Sydney and Athens Olympic Games, hosting a major international sporting event can be a substantial financial and logistical commitment over several years. So it is with the Melbourne 2006 Commonwealth Games.

Budget

In 2002-03, the whole-of-games budget was increased to $1 142 million, as part of the state budget process. This included the cost of related capital works. The state's contribution to the cost of hosting the games, excluding the cost of capital works, is estimated at $474 million. This estimate is based on revenue and expenditure assumptions, including the estimated contribution to be made by the Commonwealth Government towards the games and the level of security to be provided.

In May 2004, the Commonwealth Government announced that it will provide $272.5 million toward the games. Of this, $102.9 million will be through a direct grant to the state government, of which $40 million was provided to the state on 29 June 2004 for specific games' programs, the majority of which is to be managed by the Melbourne 2006 Commonwealth Games Corporation. The balance will be in non-cash contributions. The $40 million was on-passed to the Melbourne 2006 Commonwealth Games Corporation (an agency outside the general government sector) on 30 June 2004 in advance of need.

A large portion of the non-cash contribution ($84.8 million) is for security services to be delivered by Commonwealth agencies as part of their national security responsibilities. The state has also made an allowance for security in the revised whole-of-games budget.

The volatile nature of security threats means that the assumptions behind the security component of the whole-of-games budget can change quickly, and dramatically increase the resources required. Should threats escalate, the budget may need to be increased.

Sponsorship revenue is a significant portion of whole-of-games revenue. The ability to attract sponsorship dollars is influenced by a number of factors, including other international events competing for sponsorship dollars, and the domestic and international economic climate leading up to the games. Three sponsorship agreements were made in 2003-04, but the company engaged to procure sponsorships was below target at 30 June 2004. Despite this, the government is confident that sponsorship targets will be achieved.

Games village

The host city contract for the games requires the provision of suitable accommodation for the anticipated 6 000 athletes and officials.

The government's winning submission for hosting the games nominated the 20-hectare former Royal Park Psychiatric Hospital site at Parkville as a potential site for the games village. In March 2002, the government confirmed this site as its preferred site. However, the tender process to select a developer for the games village was also to determine if there were other development options at suitable locations within 5 kilometres of the central business district. These tenders were to meet all government requirements, including no additional cost compared with the Parkville development proposals that were to be received.

In addition to the proximity requirement, other requirements of the tender included completion milestones, a component of the development to be designated for social housing, and design and operation of the proposed facilities during and after the games.

Following a tender selection and evaluation process, Village Park Consortium (consisting of Australand Holdings Limited and Citta Property Group) was selected as the preferred tenderer in October 2002. The site selected was at Parkville. A heads of agreement was entered into in November 2002 and the final contract executed in December 2003.

We intend to undertake a separate review of this project which will also include a review of the tender process.

The contract specifies what must be completed before the games, and what can be completed after the games. The contract's major works are the construction of private and public residential dwellings, an aged care facility and environmental improvements. Figure 6H outlines the key risks and obligations of the parties relating to the major works for the state and the developer components.

FIGURE 6H: DEVELOPMENT OF COMMONWEALTH GAMES VILLAGE - MAIN RISKS AND OBLIGATIONS OF THE STATE AND DEVELOPER

Major works	Developer's key risks and obligations	State's key risks and obligations
Private residential dwellings (homes, townhouses and apartments)	Design and construction risks (including cost variations, insurance and construction delays). Developer-initiated changes. Retrofit costs after the games. Risk (and benefits) associated with sale demand, including sales price and turnover (sales to be completed by December 2011, with provision for time extensions). Provide the dwellings to the government over the games period. If the developer does not meet key construction milestones, the state can step in and claim rectification costs, including access to bank guarantees.	All relevant planning approvals (a). Contribute cash of around $52 million and land to the developer. Contribute around $6.8 million for further specified modifications (if required). Receive a share of sales to recoup land costs and a contribution from the developer (estimated at $62 million). Changes in state law and policy that increase costs. Changes to the approved design requested by the state that increase the developer's costs. Variances in projected games village population. Retain land title until full payment is received for the land.
Social housing (1 and 2 bedroom apartments and 4 bedroom townhouses) remaining in state ownership	Design and construction risks (including cost variation, insurance and construction delays).	All relevant planning approvals (a). Contribute $35.1 million to the developer to construct the dwellings on crown land. Changes in state law and policy that increase costs. Changes to the approved design requested by the state that increase the developer's costs.
Aged care facility (up to 100 beds)	Design and construction risks (including cost variation, insurance and construction delays). Risk (and benefits) associated with sale demand, including sales price and turnover.	All relevant planning approvals (a). Contribute land. Changes in state law and policy that increase costs. Changes to the approved design requested by the state that increase the developer's costs.
Environmental	n.a.	All relevant planning approvals (a). Costs greater than the state contribution of $15.6 million for environmental works.

(a) Under the *Commonwealth Games Arrangements Act 2001*, the Minister for Commonwealth Games is responsible for issuing planning approvals for the development of the games village.

Source: Victorian Auditor-General's Office.

Financial reporting implications

The contribution of cash of around $52 million and land valued at $11.7 million to the developer is in return for the use of the development (comprising permanent and temporary accommodation) as an athletes village for the 3-month games period, and for a proportion of proceeds from subsequent property sales (estimated at $62 million). The portion of the contribution to the developer that relates, "in substance", to the lease of the athletes village will be deferred and recognised as an expense at the time of the games (valued at $3.4 million). The balance of the contribution to the developer will also be deferred and recognised progressively as an expense at the same time revenue from the sale of each property is recognised.

The government will fund the public housing construction, which will be retained in state ownership, estimated at $35 million. Further, the government will fund $15.6 million in environmental works.

6.1.3 Superannuation

State revenues	2003-04	2002-03	Movement
Superannuation ($million)	364	2 677	(2 313)

Part 8 of this report (Liabilities, Commitments and Contingencies) has more information about unfunded superannuation liability movements which contributed to the $2 313 million reduction in superannuation expenditure.

6.1.4 Other expenses

State revenues	2003-04	2002-03	Movement
Other expenses ($million)	1 559	264	1 295

The $1 295 million increase in other expenses compared with the prior period was mainly due to writing-off the $1 140 million receivable as a result of the abolishment of the smelter reduction levy which was used to assist in funding the flexible electricity tariff arrangements.

The Liabilities, Commitments and Contingencies trends part of this report has more information about changes to the flexible electricity tariff arrangements.

RESPONSE provided by Minister for Finance and Treasurer

Enterprise Bargaining Agreements

From 2002-03 to 2003-04 growth in employee benefits expenditure has slowed, despite significant negotiations being concluded in 2003-04.

The transitional wages funding policy, which refined previous wages policies, applied during 2003-04. This policy required departments to identify service delivery improvements to justify funding of up to 0.75 per cent. The outcome of these departmental negotiations was determined by Government. Each bid for improved service delivery funding was assessed in terms of price or value for money for the improved service delivery offered based on the following information: costing where appropriate, measures of performance, outcome reporting requirements and extent of impact.

7. Asset trends

7.1 Asset trends

State's financial position ($million)	2004	2003	Movement
Assets	109 114	102 218	6 896
Liabilities	48 169	49 361	(1 192)
Net assets	60 945	52 857	8 088

State assets totalled $109 114 million at 30 June 2004. Figure 7A shows the major variations in assets from 30 June 2003.

FIGURE 7A: STATE ASSET MOVEMENTS ($M)

Asset Item	2004	2003	Movement
Other financial assets (investments)	22 101	20 098	2 003
Physical assets	79 476	72 748	6 728
Receivables	4 353	6 361	(2 008)
Cash	2 377	2 319	58
Prepayments	158	134	24
Inventories	649	558	91
Total	109 114	102 218	6 896

Source: 2003-04 Annual Financial Report.

7.1.1 Investments

State assets	2004	2003	Movement
Other financial assets ($million)	22 101	20 098	2 003

At 30 June 2004, the state's investment portfolio (excluding cash) was $2 003 million higher than that in the prior year. This was mainly due to improved domestic and international equity markets.

The portfolio consists of domestic and international equities, fixed interest securities, bonds, property and term deposits. Five agencies account for 97 per cent of the state's total investments. Public sector superannuation funds are not recorded in the *2003-04 Annual Financial Report* because they are not assets of the state, however, movements in the valuation of their investment portfolio directly impacts on the state's reported liability. Overall, 2 main investment strategies are used by these agencies and superannuation funds:

- a long-term funding strategy, the aim of which is long-term capital growth: agencies that adopt this strategy aim to hold their investments for longer periods and accept the risk that returns will fluctuate, but over the long-term the returns will meet their requirements
- a short-term funding strategy, the aim of which is capital preservation: agencies that adopt this strategy are investing for shorter terms and do not want the level of short-term risk that applies to some asset classes, such as equities.

The state's portfolio is managed according to the requirements of (and within the limits imposed by) legislation and government policy. Through these mechanisms, the portfolio is managed within acceptable levels of risk.

Risk is also managed by investing in diverse asset classes using different fund managers, and by using derivative financial instruments which hedge the state's exposures or take positions in markets.

The Treasury Corporation of Victoria, the Transport Accident Commission, the Victorian WorkCover Authority and the Victorian Managed Insurance Authority use derivative instruments in varying degrees to hedge against foreign currency exposures.

Each agency chooses its investment strategies and portfolio asset mix to meet its short and long-term operational requirements. Figure 7B shows the investment portfolio of each agency.

FIGURE 7B: INVESTMENTS HELD BY MAJOR STATE AGENCIES ($M) (a)

Agency and objective in holding financial assets	Total 30 June 2003	Total 30 June 2004	Domestic equities	International equities	Australian and international fixed interest	Indexed bonds	Property	Short-term deposits
Department of Treasury and Finance: mainly to manage cash surpluses	2 650	382	-	-	382	-	-	-
Transport Accident Commission: to fund insurance liabilities	5 499	6 353	1 602	1 771	2 011	286	592	91
Treasury Corporation of Victoria: to retire debt, manage liabilities and programs, and to invest deposits lodged by public sector agencies (b)	5 784	7 427	-	-	2 459	543	-	4 425
Victorian Managed Insurance Authority: to fund insurance liabilities	415	455	119	146	132	49	-	9
Victorian WorkCover Authority: to fund insurance liabilities (c)	5 344	6 799	2 213	1 927	1 395	614	630	20
Total	19 692	21 416	3 934	3 844	6 379	1 492	1 222	4 545
State Super Fund: to fund superannuation entitlements (d)	7 222	8 686	2 983	2 257	1 794	370	733	550
Overall fund allocation 2004 (%)	n.a.	100	23	20	27	6	7	17
Overall fund allocation 2003 (%)	n.a.	100	19	14	48	7	4	8

(a) All investments are shown at their market values and sourced from the financial investment reports of the agencies.

(b) Includes $278 million of Treasurer's Guaranteed Investments, including investments in the Melbourne Cricket Club ($186 million).

(c) The June 2003 figure for Victorian WorkCover Authority is after deducting the provision associated with the cost of investment disposal, whereas the June 2004 figures are prior to the deduction of this provision.

(d) Public sector superannuation funds are not recorded in the *2003-04 Annual Financial Report* because they are not an asset of the state. However, movements in the valuation of their investment portfolio directly impact on the state's reported liability for unfunded superannuation obligations.

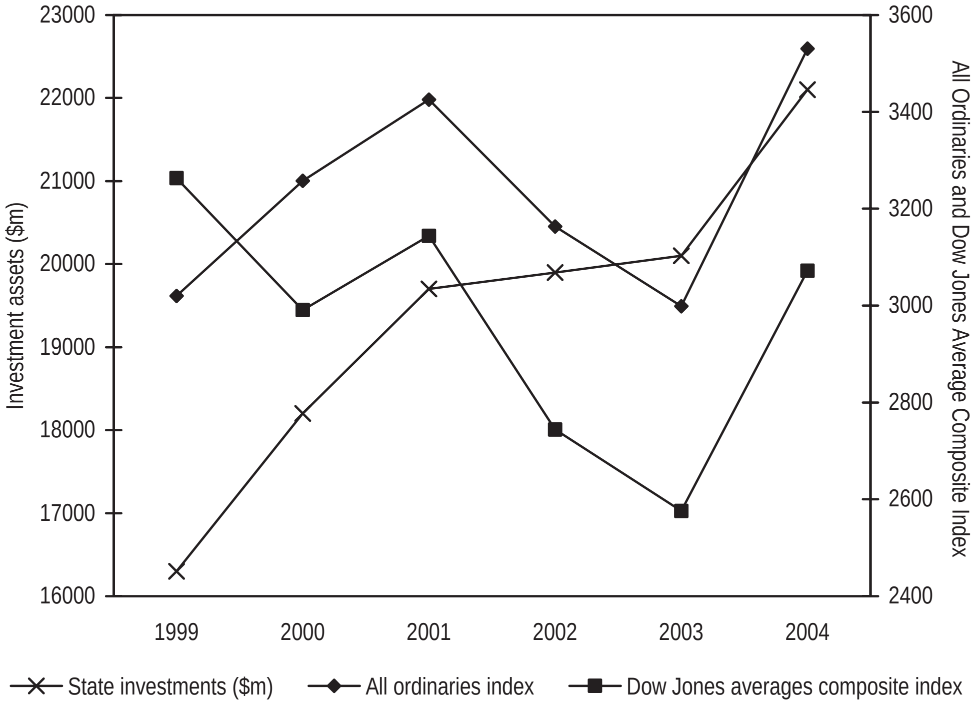
Source: Victorian Auditor-General's Office.

The movements in the classes of investment holdings during the year is a result of improvements in equity markets, and the impact of decisions about the placement and funding requirements throughout the year. Overall, investments have been shifted from Australian fixed interest and short-term deposits to equities, reflecting the improvements in the equity markets and the change in strategy to suit conditions. The Department of Treasury and Finance redistributed around $1 200 million of its fixed interest investment to a short-term deposit facility managed by the Treasury Corporation of Victoria. In June 2004, it also provided $800 million to the Treasury Corporation of Victoria, of which $630 million was used to retire debt[1].

[1] Part 8 of this report (Liabilities, Commitments and Contingencies) has more information about this matter.

Figure 7C shows that despite a significant downturn in the value of equities from July 2001 to June 2003, the value of the state's total financial assets over the past 5 years has continued to increase. This is largely due to strong cash surpluses over successive years and the government's policy of maintaining net debt levels, thereby building up its financial asset holdings. This upward trend continued in 2003-04, helped significantly by stronger equity markets.

FIGURE 7C: MOVEMENTS IN THE ALL ORDINARIES, DOW JONES AVERAGE COMPOSITE INDEX AND STATE FINANCIAL ASSET HOLDINGS



Source: All Ordinaries: Australian Stock Exchange. Dow Jones Average Composite Index: Dow Jones. Investments (excluding cash): government's Annual Financial Reports.

7.1.2 Physical assets

State assets	2004	2003	Movement
Physical assets ($million)	79 476	72 748	6 728

At 30 June 2004, the state's physical asset portfolio was $6 728 million higher than the previous year. Figure 7D shows the major variations for the year.

FIGURE 7D: STATE PHYSICAL ASSET MOVEMENTS, 2003 TO 2004 ($M)

Opening balance	72 748
Revaluations	4 323
Disposals	(362)
Additions	4 057
Depreciation and amortisation	(1 764)
Other	474
Closing balance	79 476

Source: 2003-04 Annual Financial Report.

Major movements include:

- revaluation of public housing ($1 518 million), schools ($991 million) and public hospitals ($238 million)
- rolling stock acquired for nominal consideration, or acquired below fair value ($450 million)
- acquisition of new public housing ($307 million), education assets ($222 million) and road infrastructure ($325 million)
- recognition of new rolling stock acquired under finance lease ($464 million).

Infrastructure spending

Infrastructure investment is essential for the state's economic growth and productivity, for its ability to attract and retain businesses and for Victorian's quality of life. Infrastructure includes highways, ports, wastewater treatment facilities, water supply and distribution facilities, as well as the facilities and equipment used to provide government services.

Figure 7E shows that over a 5-year period, the state continued to add to its total stock of assets. Although capital spending on public infrastructure as a portion of gross state product fell from 1999-2000 to 2001-02, it rose strongly in 2002-03 before falling slightly in 2003-04.

FIGURE 7E: NET ADDITION TO STATE'S ASSET BASE ($M)

	1999-2000	2000-01	2001-02	2002-03	2003-04
Purchase of property, plant and equipment (a)	2 418	2 399	2 499	3 274	3 413
Depreciation (a)	(1 267)	(1 316)	(1 407)	(1 515)	(1 637)
Net addition to State's asset base	1 151	1 083	1 092	1 759	1 776
Purchases as a percentage of GSP (b)	0.72	0.63	0.60	0.91	0.88

(a) Annual Financial Reports.

(b) Australian Bureau of Statistics 1999-2003, Department of Treasury and Finance estimate of Gross State Product for 2003-04.

Capital Works Program

Significant construction risks arise because of the unique nature of large infrastructure projects and their long gestation periods. Both of these factors make costs difficult to estimate accurately. Each project offers a multitude of different risks that need to be carefully managed to minimise cost overruns, completion delays and quality issues.

Based on the government's *Budget Information Paper 1, 2003-04*, there were around 1 850 capital works projects in progress, or planned to be commenced across the Victorian public sector during 2003-04, with a combined value of $9 488 million.

A summary of the major individual capital works projects with an approved total budget in excess of $20 million and actual capital outlays in 2003-04 of at least $10 million at variance from those forecast for the year, is outlined in Figure 7F. Figure 7F shows that for 2003-04, overall capital outlays were $146.6 million less than forecast, essentially due to project delays.

FIGURE 7F: MAJOR 2003-04 CAPITAL WORKS - BUDGET TO ACTUAL VARIANCES ($M)

Project	Original budget	Revised budget (a)	Forecast capital outlay in 2003-04	Actual capital outlay in 2003-04	Shortfall in capital expenditure
Showgrounds redevelopment	100.7	100.7	71.5	6.0	(65.5)
State Library Victoria redevelopment phase 4	91.4	91.4	41.3	14.0	(27.3)
Bushfire Recovery Strategy - Restoration	31.8	27.0	22.2	0.6	(21.6)
Melbourne Sports and Aquatic Centre redevelopment	50.0	50.0	26.9	5.7	(21.2)
Pakenham Bypass	221.2	221.2	40.0	28.9	(11.1)
Total	495.1	490.3	201.9	55.2	(146.7)

(a) Revised budget as per *Budget Information Paper 1, 2003-04.*

Source: Department of Treasury and Finance.

The reasons for the variations for each of the above projects is detailed below:

- Showgrounds redevelopment – delays in the tender process
- State Library Victoria redevelopment – construction delays in phases 1-3 of the redevelopment, in addition to delays with phase 4 attributable to industrial disputes, and health and safety concerns
- Bushfire Recovery Strategy – majority of funding for capital outlays was received from insurance proceeds, with only limited state funding required
- Melbourne Sports and Aquatic Centre – delays due to revisions in project scope
- Pakenham Bypass – environmental and planning delays.

In addition to the above projects, the state has also entered into a number of public-private sector initiatives. These are used to procure a number of projects involving construction of assets, which are needed to deliver public services. It is important that construction work is completed on time to enable the delivery of public services by the time agreed. We examined one of these major projects, namely, the Spencer Street Station redevelopment.

Spencer Street Station redevelopment

The redevelopment of the current Spencer Street Station covers an area of around 21 hectares and is the gateway to Victoria's interstate rail, coach services and metropolitan trains.

In July 2002, the redevelopment contract was awarded to Civic Nexus Pty Ltd. This consortium comprised of ABN AMRO Australia Pty Ltd as 100 per cent equity holder (the developer), Leighton Contractors Pty Ltd and a number of other sub-contractors. Upon completion, the developer is to be granted a 30-year lease to operate the facility. The Spencer Street Station Authority was created to oversee the redevelopment and subsequent operations period.

The redevelopment includes the construction of the main interchange facility and residual works including rail modifications and signal upgrades. In addition, the consortium purchased from the government a parcel of land outside the main interchange facility to be commercially developed.

Spencer Street Station redevelopment works.

Under the contract arrangements, the developer assumes the key risks including construction cost overruns, construction delays, design construction flaws and operational risks. The arrangement provides for the construction to be undertaken in a manner that will not disrupt the daily operations of the station. The developer is required to compensate the country and metropolitan train operators using the station for agreed occupation costs. In the event of unplanned occupation delays or late hand back, the developer is liable for specified liquidated damages.

Under public-private partnership arrangements, the risk of construction cost increases are generally borne by the developer. The allocation of construction risk to the developer is based on the assumption that the private party is better placed to manage these risks. The developer is, therefore, motivated to estimate the full costs of construction, including allowances for risks when pricing the contract, as it will generally not be able to recover unforeseen cost increases later by claiming them back from the state.

Status of the redevelopment

The contractual arrangements require that, if the redevelopment is delivered late, the state is able to defer payment of the core service payments until the asset is ready for use, and seek financial damages from the developer. Where construction progress milestones are not achieved, the developer could be liable for liquidated damages of $10 000 a day and if final completion does not occur by the scheduled completion date, the developer could be liable for liquidated damages of $25 000 a day until the final completion date.

In November 2003, the state entered into a settlement deed with the developer, to settle a number of specific claims lodged by the developer. Under the settlement deed, the state agreed to pay $3.05 million on completion of certain extra works, and modified or cancelled progress milestones for the main interchange facility. In addition, completion milestones for residual works were also changed. The state, in effect, had forgone potential claims for liquidated damages from the developer for not meeting milestones in return for the withdrawal of notices of dispute against it. Changes to progress milestones and final residual works milestone dates are illustrated in Figure 7G.

FIGURE 7G: SPENCER STREET STATION REDEVELOPMENT - KEY PROJECT MILESTONES (a)

Key project milestone	2002 contract date	2003 settlement deed	Project Steering Committee Reports	Total days overdue compared with 2002 contract dates (c)	Total days overdue compared with 2003 settlement deed (c)
Main facility – Final completion milestone					
Final completion of the interchange facility works	27 Apr 05	27 Apr 05	22 Dec 05	239	239
Main facility – Progress milestones					
Complete piling on platforms	27 Feb 03	Cancelled	Cancelled		-
Collins Street Concourse commissioned	10 Feb 03	13 Jan 04	4 Mar 05	753	416
Complete roof erection	20 Aug 04	Cancelled	Cancelled		-
Commence interchange facility roof erection	n.a. (b)	10 Oct 03	10 Oct 03		-
First platform upgrade completed	n.a. (b)	18 Jun 04	11 June 04		-
Bus Interchange facility completed	n.a. (b)	27 April 05	07 Sept 05	n.a. (b)	133
Residual works – Final completion milestones					
Final completion of the rail modifications	30 Sep 03	27 Jul 05	19 Dec 05	811	175
Final completion of the signalling upgrade	26 Nov 04	27 Jul 05	09 Dec 05	378	165
Final completion of the slab construction works	n.a. (b)	27 Jul 05	22 Dec 05	148	178

(a) *Source*: Original construction contract, settlement deed and Project Steering Committee Reports.
(b) n.a. – not specified in the original agreement as a progress milestone.
(c) Delays calculated on the latest estimates by the Project Steering Committee Report – August 2004.
Source: Victorian Auditor-General's Office.

The Project Steering Committee Report for August 2004 indicates a delay of around 239 days for the completion of the main interchange facility. In addition, a total of $35.7 million in additional claims for compensation have been lodged by the developer with the Authority up to 30 June 2004. The claims lodged relate to delays attributable to access issues and pre-existing contamination issues. We were advised that the government considers that these are ambit claims and they will review each claim rigorously to determine its legitimacy.

To progress the redevelopment, the state entered into access agreements with the developer in August 2004. The agreements provide the developer with partial access to the Collins Street bridge for a 12-month period and to 4 platforms for a 5-month period. Under the arrangements, the developer is liable for long-term occupation costs incurred by V/Line Passenger Corporation for forfeiting its access rights to the platforms. Since the commencement of construction, the developer has paid around $3.2 million in occupation costs up to 30 June 2004.

7.1.3 Receivables

State assets	2004	2003	Movement
Receivables ($million)	4 353	6 361	(2 008)

At 30 June 2004, the state's receivables were $2 008 million less than the prior period. The decrease for the year was due to:

- writing-off the receivable following the cessation of the smelter reduction levy ($1 140 million) which was used to assist in funding the flexible electricity tariff arrangements
- maturity of various Treasury Corporation of Victoria derivative transactions ($686 million)
- other net movements ($227 million).

The decrease was offset by the recognition of an amount owing to the state by way of stamp duty on the sale of Loy Yang A ($45 million).

Part 8 of this report (Liabilities, Commitments and Contingencies) has more information about changes to the flexible electricity tariff arrangements.

8. Liabilities, commitments and contingencies trends

8.1 Liabilities, commitments and contingencies trends

State's financial position ($million)	2004	2003	Movement
Assets	109 114	102 218	6 896
Liabilities	48 169	49 361	(1 192)
Net assets	60 945	52 857	8 088

At 30 June 2004 state liabilities totalled $48 169 million. Figure 8A shows the major variations in liabilities from 30 June 2003.

FIGURE 8A: STATE LIABILITY MOVEMENTS, AT 30 JUNE ($M)

Liability item	2004	2003	Movement
Interest-bearing liabilities	14 226	13 891	335
Unfunded superannuation	11 760	13 489	(1 729)
Outstanding insurance claims	12 473	11 946	527
Payables	3 652	4 291	(639)
Employee benefits	3 184	2 976	208
Other liabilities	2 874	2 768	106
Total	48 169	49 361	(1 192)

Source: 2003-04 Annual Financial Report.

8.1.1 Interest-bearing liabilities

State liabilities	2004	2003	Movement
Interest-bearing liabilities ($million)	14 226	13 891	335

At 30 June 2004, the state's interest-bearing liabilities increased by $335 million. The increase was due to:

- the recognition of new rail rolling stock as a finance lease ($453 million)
- new borrowings ($882 million).

This increase was offset by:

- lower third-party government-related deposits ($370 million)
- a one-off repayment of debt ($630 million).

The government borrows to repay maturing debt and to fund capital works. It borrows from the investment community (through bond issues, promissory notes and other instruments) and by entering into finance leases[1].

Domestic and foreign borrowings

The main component of the state's interest-bearing liabilities are domestic and foreign borrowings. At 30 June 2004, the state's domestic and foreign borrowings totalled $13 535 million.

Borrowings are accumulated debt built up by the government over a number of years. The state's borrowings are on terms ranging up to 26 years. About 90 per cent of borrowings are based on fixed interest rates, and 88 per cent was raised in Australia. In 2004-05, debt with a face value of about $3 139 million[2] is due to be repaid.

Budget surpluses over a number of years have enabled the state to increase its financial assets, which has reduced its need to increase its borrowings. Accordingly, the state's borrowings have been stable in recent years[3], reflecting the government's preference of maintaining borrowings at current levels and re-financing debt as it matures.

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[1] A finance lease is a lease under which the state has the majority of the risks and benefits incidental to ownership of the asset. Essentially, it is the purchase of an asset over a period of time.

[2] This amount excludes short-term deposits lodged with the state.

[3] Excluding deposits held by the Treasury Corporation of Victoria, mainly on behalf of superannuation funds.

In 2003-04, the state borrowed term debt to replace matured borrowings and to provide funds to manage its liquidity resulting in new borrowings of $882 million. In late June 2004, the government retired debt of $630 million. In July 2004, it repaid a further $170 million of debt.

Deposits held by the Treasury Corporation of Victoria on behalf of the State Superannuation Fund reduced by $370 million during 2003-04. As the assets of the State Superannuation Fund are not part of the state, these transactions reduced interest-bearing liabilities.

The state's credit rating reflects the credit rating agency's opinion about the state's capacity to pay its financial obligations when they fall due. Credit ratings affect the interest rate payable on new borrowings. Currently, the state's credit rating is at the highest possible level: AAA long-term rating.

Finance lease obligations

At 30 June 2004, the state's finance lease obligations were $691 million, compared with $305 million a year earlier. This was mainly due to new rail rolling stock currently in service being recognised for the first time as a finance lease[4], increasing liabilities by $453 million.

Finance lease obligations will increase significantly over the next 2 years as more new rolling stock is delivered. As well, several public-private partnership projects that have been funded through finance leases are scheduled for completion. They include the Spencer Street Station redevelopment, Casey Community Hospital, correctional facilities and the Metropolitan Mobile Radio Project. Completion of these projects will substantially increase the level of finance lease liabilities, and the level of gross debt[5].

In 2003-04, the state wound-down its current motor vehicle leasing arrangements. This offset the increase in the finance lease liability by about $50 million.

In 1997, the government established a lease facility with the Commonwealth Bank of Australia (CBA) to finance its vehicle fleet. The agreement required the state to fund any shortfall between the value of vehicles sold at the end of the lease term and the previously agreed residual value of the motor vehicles. It is to do this by paying increased rentals on new leases. At 30 June 2004, the Department of Treasury and Finance estimated the total remaining shortfall to be $48.4 million.

The CBA has sought to increase interest rates on all new vehicle leases acquired as well as maintaining the presently agreed low residual values for an extended period of time to ensure the shortfall is repaid.

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[4] Part 6 of this report (Expenditure trends) has more information about this matter.

[5] The Commitments section of this part of the report has more information about the new public-private initiatives entered into during the year.

Following a cost-benefit analysis, the government decided in October 2003 to replace the CBA facility with a new facility that it would manage. Existing CBA leases would continue until the end of their terms. The government expects all leases to end by 2007.

Vicfleet (a division of the Department of Treasury and Finance) will manage the new motor vehicle acquisition arrangements. The government has established a $230 million draw-down facility to finance the new arrangement with the Treasury Corporation of Victoria. At 30 June 2004, Vicfleet had acquired vehicles to the value of $41 million for government agencies.

This new arrangement will gradually offset the (reducing) CBA finance lease liability with an increase in interest-bearing liabilities.

8.1.2 Unfunded superannuation

State liabilities	2004	2003	Movement
Unfunded superannuation liabilities ($million)	11 760	13 489	(1 729)

At 30 June 2004, the state's unfunded superannuation liability decreased by $1 730 million due to:

- additional superannuation payments by the government to the superannuation fund ($1 006 million)
- improvement in investment returns (particularly on domestic and international equities) ($1 025 million)
- changes in actuarial assumptions ($345 million)
- offset by growth in superannuation benefits ($826 million).

The state government has an obligation to ensure that funds are available to pay superannuation benefits to public servants as they become eligible to receive them. Before 1994, this obligation was met from the Consolidated Fund. From November 1995, each agency began paying employer contributions for the accruing superannuation costs for those employees that belonged to the defined benefit schemes.

In the mid-1990s, the government began to invest these accumulating contributions (along with further large contributions it made) in income earning assets in superannuation funds to meet future superannuation obligations. Nevertheless, there is still a shortfall between the funds available to pay benefits, and the value of benefits that have accrued to date. This shortfall is called the unfunded superannuation liability.

The State Superannuation Fund has about 96 per cent of the total unfunded superannuation liability. The remainder is for the Emergency Services Superannuation Scheme, the Health Superannuation Fund, the Constitutionally Protected Schemes and the Local Authorities Superannuation Fund.

Government policy is for the unfunded superannuation liability to stabilise in real terms by 30 June 2007 and to disappear by 2035. This 30-year time frame gives the government flexibility to weather the ups and downs of financial markets and the economy.

Impact of changes to actuarial assumptions

Superannuation fund actuaries periodically determine the value of the liabilities and assess the adequacy of the assets held to meet these liabilities. To do this, they make assumptions about long-term economic and demographic matters such as rates of return on investments, salaries, inflation and mortality. They undertake annual valuations and full investigations every 3 years to take account of changes in actuarial assumptions that affect the value of future superannuation liabilities.

A 3-year actuarial review of the State Superannuation Fund was conducted in December 2003, for the year ending 30 June 2003. Changes to various assumptions arising from that review resulted in a net reduction in the unfunded liability of $345 million.

Impact of investment returns

Up until the early 1990s, a large proportion of the state’s employees were in defined benefit superannuation schemes. Under these schemes, the state promised to provide a defined benefit to the employees. This was either a lump sum or a pension based on the person’s final salary and years of employment.

The state then invested funds in order to meet the emerging claims on these schemes, and bore the investment risk. If investment returns were low, the state was required to contribute more (and vice versa). As the state invests more funds for these schemes, it takes on more investment risk.

Defined benefit schemes were closed to new members in 1993. Employees since then have been required to join an accumulation scheme. This is a scheme in which members bear the investment risk, and benefit from increases in the value of investments.

The State Superannuation Fund had forecast a 7.5 per cent investment return for 2003-04. The actual return achieved was 14.4 per cent, compared with 0.4 per cent in 2002-03. This had a positive impact of $728 million on the level of unfunded superannuation liabilities.

Better than expected investment returns reduced the unfunded superannuation liabilities of all Victorian public sector superannuation funds by $1 025 million in 2003-04. This was mainly due to stronger Australian and international equity markets, and the depreciation of the Australian dollar against major currencies towards the end of the financial year (which increased the value of unhedged investments).

Impact of additional payments

To achieve its long-term policy of fully funding the defined benefits schemes' liability, the government makes additional top-up payments to the schemes (as well as its ongoing employer contributions). Generally, the size of the top-up payments has depended on the state's cash flow position, and on the rate of return on investments by the funds and future superannuation liabilities.

In 2003-04, the government made top-up contributions of $1 006 million (compared with $1 605 million in 2002-03) to the State Superannuation Fund, the Emergency Services Superannuation Scheme and the Health Superannuation Fund.

8.1.3 Outstanding claims liability

State liabilities	2004	2003	Movement
Outstanding insurance claims ($million)	12 473	11 946	527

At 30 June 2004, the state's outstanding insurance claims liability increased by $527 million. This was due to:

- growth in the liability for common law claims to be paid by the Victorian WorkCover Authority ($298 million)
- the higher cost of compensation claims for major injuries against the Transport Accident Commission, due to increased health care costs ($148 million)
- miscellaneous movements ($81 million).

Figure 8B shows the outstanding claim liabilities managed by agencies.

FIGURE 8B: COMPOSITION OF OUTSTANDING CLAIMS LIABILITIES, AT 30 JUNE ($M)

Agency and nature of outstanding claims managed	Total 2004	Total 2003	Movement
Victorian WorkCover Authority – personal work-related compensation	6 842	6 544	298
Transport Accident Commission - transport accident compensation	4 826	4 678	148
Victorian Managed Insurance Authority – claims relating to participating public sector agencies insurance cover, run-off (mainly asbestos-related) insurance and medical indemnity insurance for the health sector (a)	396	525	(129)
Other agencies - mainly medical indemnity insurance claims (a)	409	199	210
Total outstanding claims liabilities	12 473	11 946	527

(a) As a result of the new arrangements between the Department of Human Services and the Victorian Managed Insurance Authority, the department assumed all the liabilities in respect of claims arising before 1 July 2003. The authority is responsible for medical indemnity claims incurred after that date.

Source: Agencies' annual financial reports.

In 2003-04, the rate of growth in outstanding claims liabilities declined. This was mainly due to:

- reduced weekly compensation benefits, due to better management of liabilities
- the effectiveness of claims management projects to control the costs for claims for medical, legal and rehabilitation expenses
- fewer motor vehicle accidents
- favourable changes in economic assumptions (such as inflation and investment returns) used to estimate future costs and revenues.

Outstanding claims liabilities cover claims reported but not paid, and claims incurred but not reported. As for unfunded superannuation liabilities, outstanding claims liabilities are measured by independent actuaries taking into account the nature of the claim and a range of economic assumptions.

The Australian Prudential Regulation Authority advocates the use of "prudential margins" if there is a significant level of uncertainty in actuarial estimates. A prudential margin (risk margin) is a requirement for the insurance agency to maintain assets in excess of reported liabilities by at least a prescribed amount. AASB 1023 advocates the use of a prudential margin and a risk-free discount rate[6] in relation to outstanding claims liabilities of insurance entities.

[6] A risk-free discount rate is the long-term Commonwealth Government bond rate.

Currently, each agency decides (after considering advice from their actuaries) whether to use a prudential margin when valuing outstanding insurance claims, and the size of the margin. The prudential margins of the Transport Accident Commission and the Victorian Managed Insurance Authority totalled $755 million at 30 June 2004. This was 14 per cent of their combined outstanding claims liabilities. The Victorian WorkCover Authority does not use a prudential margin, but relies on the central estimate determined by its actuaries and uses a risk-free discount rate.

In late 2003-04, the Commonwealth Government passed legislation that extends the Commonwealth workers compensation scheme to people who are not Commonwealth Government employees. The financial implications of these changes on the state's workers compensation scheme will need to be examined and monitored.

8.1.4 Payables

State liabilities	2004	2003	Movement
Payables ($million)	3 652	4 291	(639)

At 30 June 2004, the state's payables decreased by $639 million. This was due to:

- transactions by the Treasury Corporation of Victoria, related to the maturity of certain financial derivative instruments ($990 million)
- a reduction in payables following the transfer of GASCOR from government control to the private sector gas retailers in September 2002 ($66 million).

This decrease was offset by;

- the recognition of an ex-gratia payment related to the sale of Loy Yang A ($45 million)
- other miscellaneous increases ($372 million).

Flexible electricity tariff arrangements

Australia is one of the world's largest producers of aluminium, and aluminium smeltering is highly energy intensive. In previous years, state governments offered aluminium smelterers low electricity prices to attract new aluminium smelters.

In 1984, the state government offered a flexible electricity tariff to the Point Henry and Portland aluminium smelters. The tariff arrangements required the State Electricity Commission of Victoria (SECV) to subsidise the lower prices charged to the smelters. These subsidies were funded through the Department of Treasury and Finance. To reduce the state's exposure to electricity pool price movements, the SECV entered into a hedge arrangement. Also, from 1 July 1998, wholesale electricity market participants were obliged to pay the SECV a smelter reduction levy which the SECV used to fund future expected losses under the electricity tariff arrangements.

In 2003-04, the SECV paid out $103.7 million under the arrangements, compared with $111.7 million in 2002-03. Since assuming the funding of the liability in 1997, the SECV has paid a total of $834 million under the arrangements. This has been partially offset from smelter reduction levy receipts of $453 million, leaving a shortfall of $381 million.

The SECV's obligations and rights under the arrangements are assessed at the end of each financial year. The assessment takes into account changes in the electricity market and predicted future changes in aluminium and electricity prices, foreign exchange rates, discount rates and the consumer price index. The estimated future liabilities from the arrangements until the smelter contracts expire in July 2014 and October 2016 is estimated at $ 1 723 million in nominal terms and $1 232 million in net present value terms.

As just noted, the majority of liabilities have been funded from the smelter reduction levy. However, the legality of the smelter reduction levy was challenged in 2002-03, and the state government subsequently decided to abolish it from 30 June 2004 and wrote-off a receivable (from electricity wholesalers) amounting to $1 140 million. The Department of Treasury and Finance has assumed an amount equivalent to the SECV's exposure under the flexible electricity tariff arrangements ($1 232 million) from 30 June 2004. During the year, the state made land tax payable on transmission companies' electricity easements. The revenue from this source will minimise the impact on the general government sector's cash flows from the requirement to fund this obligation. The tax is expected to generate $114 million in 2004-05, and $80 million a year thereafter.

The assumption by the Department of Treasury and Finance, which forms part of the general government sector, of an amount equivalent to the SECV's exposure under these arrangements, increased the sector's expenses and liabilities for 2003-04 by $1 232 million.

The legal challenge to the smelter reduction levy is currently before the courts. The plaintiff is seeking reimbursement of the amounts previously paid, together with interest and costs. The legal challenge is referred to in the contingent liabilities section of the *2003-04 Annual Financial Report*.

8.1.5 Commitments

State commitments	2004	2003	Movement
Commitments ($million)	15 906	15 416	490

At 30 June 2004, the state's commitments for public-private partnership arrangements, outsourced services and capital works commitments increased by $490 million. The increase was mainly due to:

- 3 new public-private sector partnerships ($1 087 million)
- outsourcing arrangements in the water sector recognised for the first time ($195 million)
- outsourcing arrangements in the health sector ($156 million)
- the state's contribution to Snowy Hydro Limited to restore river flow levels to the Snowy River and the Murray River ($135 million)
- road safety infrastructure program ($130 million)
- capital works construction contracts ($118 million).

This increase was offset by reclassification of the new rail rolling stock obligations from commitments to finance leases and revised franchise terms ($1 354 million).

Public-private sector arrangements

The number of, and investment in, public–private partnership arrangements has grown steadily in recent years. They are now a major form of government procurement. In a typical partnership, a public sector agency pays a private enterprise to design, construct and manage, over a long period, a major public asset. The agency makes regular payments to the enterprise over the life of the contract subject to an abatement regime. When the contract expires, another contract may be made, the asset may revert to state ownership, the asset may be retained by the service provider or the asset may be decommissioned.

Although contracts often transfer key commercial risks (such as construction, revenue and maintenance risks) to the private enterprise, the ultimate responsibility for service delivery cannot be transferred. If the private enterprise fails to deliver the project, the state is ultimately responsible for ensuring the continued delivery of the required public service.

At 30 June 2004, 23 public-private arrangements were in place to provide prisons, hospitals, road infrastructure, water treatment facilities and other projects. Arrangements included franchises, "design, construct, maintain and finance" agreements, "build own and operate" agreements and "build own operate and transfer" agreements.

Correctional facilities

As part of a major redevelopment of the correctional system, a prison infrastructure program was begun in 2000-01. The program involved building new prisons, decommissioning older prisons and upgrading existing prisons to improve their capacity and safety.

In December 2003, as part of this program, the state entered into a 25-year agreement with Victorian Correctional Infrastructure Partnership to design, construct, finance and maintain a 600-bed remand centre at Ravenhall and a 300-bed medium security correctional programs centre at Lara. The state, through Corrections Victoria (a unit within the Department of Justice), will operate the facilities. This followed an 18-month tender process in which the financial component of the proposal compared favourably with the public sector comparator. The comparator is used to estimate the cost of a project had it been undertaken by the state on comparable terms and conditions as specified in the project proposal (adjusting for risks and assessment of lifecycle costs).

After the tender process was completed, the appointed probity auditor concluded that there were no material departures from the government's purchasing policy. We concur with this observation.

The planned completion date for the correctional programs centre is June 2005, and October 2005 for the remand centre. On completion of the program, Corrections Victoria estimates that the state will directly manage 68 per cent of the prisoner population, including those within these 2 new prisons. The remaining 32 per cent of the prisoner population are accommodated in 2 existing privately operated prisons. Privately constructed and maintained prisons will accommodate around 53 per cent of the prisoner population.

Proposed remand centre at Ravenhall.
(Photo courtesy of the Department of Justice.)

Figure 8C shows the rights and obligations of the parties to the arrangement.

FIGURE 8C: RIGHTS AND OBLIGATIONS OF THE VICTORIAN CORRECTIONAL INFRASTRUCTURE PARTNERSHIP AND THE STATE

Type of risk	Victorian Correctional Infrastructure Partnership	The state
Design and construction risk	Assumes the design, construction and finance risks (including cost overruns, construction delays and design or construction flaws). Meets the costs of any proposed modification not requested by the state before final completion. Liable for damages, if construction is not completed by the required date.	Determines the key features of the facility. Obtains rezoning approvals. Issues the developer a 25-year licence over the land. Meets the costs of any state-initiated design changes requested before construction is completed. On issuing the construction completion certificate, must commence facility licence.
Obsolescence, including the effect of change in technology	Ensures the facility has a design life of 50 years. Maintains the facility, plant and equipment in accordance with an asset management plan. Maintains the facility to achieve its design life of 50 years. Maintains plant and equipment to achieve operational objectives.	Bears the risk and cost of technical obsolescence of the plant and equipment at the end of the 25-year period (except for the security system which is retendered after 7 years).
Potential changes in relevant costs	Bears the risk of maintenance costs exceeding the forecast amount. Maintains all prudent insurances over the facility, and the plant and equipment. Bears the risk of loss, damage or destruction of the facility.	Makes fixed monthly payment for accommodation, maintenance and security, the major component of which is increased by 2 per cent a year and the balance adjusted for movements in relevant indices. Pays the costs of any facility modifications it requests, changes in scope of services and costs attributable to its operational acts of prevention. At its option, either responsible for uninsurable risk or requiring a force majeure termination. Meets 90 per cent of the potential costs from changes in legislation that adversely affect the construction (in limited circumstances) or operation of the facility. Shares the cost of increases in insurance premiums for industrial special risks and public liability during operation. Agrees to change the security systems (excludes prison officers) service component of the monthly payment in the event of scope changes and improvements in technology. Retenders security arrangements every 7 years. Compensates the developer for additional costs arising from damage to the facility caused by prisoners or, within secured areas, by visitors and staff. Liable for compensation claims arising from prisoner death and injury resulting from inadequate facility design features of the *Cell & fire safety guidelines.*

FIGURE 8C: RIGHTS AND OBLIGATIONS OF THE VICTORIAN CORRECTIONAL INFRASTRUCTURE PARTNERSHIP AND THE STATE - continued

Type of risk	Victorian Correctional Infrastructure Partnership	The state
Abatements for non-availability	Monthly payments are subject to an abatement scaled to increase with the severity of the failure. Monthly payment is subject to abatement up to 100 per cent of the monthly payment. Liable for $155 000 (CPI-adjusted) for each prisoner escape, where the escape was attributable to its breach of the agreement. Performance bonds provided to the state can be drawn-down.	In a default event, the facility may revert to the state. Termination payments depend on the type of termination event. If a default event occurs after construction is completed, the termination payment is based on the fair market value of the facility at the date of termination, less costs and damages payable to the state. If the default event occurs before construction is completed, the termination payment is based on total cost of construction, less costs to complete construction, and costs and damages payable to the state. At any time over the period, the state can acquire the facility for a termination payment based on all financing costs, an equity return plus associated costs.
Third party revenues	No scope for third party use of the facility.	The state restricts use of the facility.
Asset residual value	The developer has not generally accepted any residual value risk. The pricing of the licence takes into account the end residual value, to be paid by the state. To the extent that the facility does not meet the agreed condition at the end of the term, the developer is liable for any costs to make good.	Facility reverts back to the state at end of the 25-year term for an agreed residual value of $4 million for Lara and $6 million for Ravenhall, adjusted for CPI from the date of the agreement (less amounts required to reinstate the facilities to the agreed condition at the end of the term). Following the end of the term, the state assumes the risks and costs associated with the remaining economic life of the facility (estimated at 25 years) and the remaining life of the plant and equipment.
Demand risk	Nil.	The utilisation rate of the facility (beds). The state makes fixed monthly payments for the facility whether or not it is used. Additional fee to be paid to the developer where demand exceeds initial bed capacity.

Source: Victorian Auditor-General's Office.

The total payments to be made by the state over the 25-year contract term for the 2 facilities is $275 million in net present value terms (and $900 million in nominal terms). As the majority of the risks have been retained by the state, the assets and liabilities associated with this project will be reported on the state's balance sheet.

When construction is complete, the facilities will be recorded as state assets at a value of about $210 million in net present value terms. Corresponding liabilities will be recorded, representing the state's obligation to finance the capital cost of the facilities. Until the facilities are completed, the associated financial commitments will be disclosed as part of commitments in the Annual Financial Report.

Metropolitan mobile radio network

In March 2004, and following a 16-month tender and evaluation period, the state entered into a contract with Motorola Australia Pty Ltd to design, construct and operate for 7 years a metropolitan mobile radio network.

The network will replace the existing analogue network for the emergency services of greater Melbourne with a secure, digital, trunked radio network, which will be used to transmit and receive voice data. The initial participating organisations will be the Victoria Police, the Metropolitan Fire and Emergency Services Board and the Metropolitan Ambulance Service.

The network will connect 2 662 radios in vehicles, including 2 300 police cars, 165 firefighting vehicles and 197 ambulances. As well, 4 119 portable units will be provided to 3 300 police, 351 fire officers and 468 paramedics.

We intend to undertake a separate review of the tender process associated with this project.

Figure 8D shows the rights and obligations of the parties to the arrangement.

FIGURE 8D: RIGHTS AND OBLIGATIONS OF MOTOROLA AND THE STATE

Type of risk	Motorola	The state
Design and construction risk	Designs, finances, constructs and commissions the network. Obtains access, approvals and leases with private and government land owners for the erection of communication towers. Pays liquidated damages if completion milestones are not achieved on time.	Specifies the key network features. Leases land to Motorola if communication towers are to be erected on crown land. The network must be tested before it is accepted by the state.
Obsolescence, including the effect of change in technology	Owns network plant, equipment and software. Upgrades the network (when operational) to ensure that it complies with the specification requirements. Pays costs of replacing outdated network technology to comply with the specification requirements. Pays initial costs of integrating the network with other nominated state communication systems.	The specifications are based on the available technology at the time of tender. The state bears the risk of technology advancements over the term of the agreement. Any state-initiated modifications to increase the technological capabilities of the network or additional functionality will be at the expense of the state. Pays the costs of integrating any future state communication systems with the network. Bears the obsolescence risk of the network's remaining life if it exercises the option to acquire the network on termination or expiry of the agreement. Significant capital costs include the central equipment and communication towers which have a design life longer than the 7-year agreement.

FIGURE 8D: RIGHTS AND OBLIGATIONS OF MOTOROLA AND THE STATE - continued

Type of risk	Motorola	The state
Potential changes in relevant costs	Pays costs of repairs and maintenance arising from the ordinary usage of the terminals. Movements in forecast costs and revenues associated with network, including insurance and upgrades. Pays to use land or property, and pays cost of construction, for additional towers (above forecast bid) to meet the specification requirements.	Movements in the consumer price index. Pays the costs of repairing or replacing damaged terminals if damage was caused by user's negligence or omission. Shares with Motorola productivity efficiencies in managing the network's ongoing costs. The financial impact of state laws and changes in policies above a certain threshold. Pays for modifications requested by the state.
Abatement for non-availability	Monthly service payment is subject to abatement if the specified service standards are not met. The state can draw-down performance bonds.	Pays monthly fixed service payments on final acceptance of staged transitions for emergency service organisations.
Third party revenues	New customers (including private sector customers) can use the network if approved by the state. However, Motorola does not rely on third party revenue to recoup network costs.	State shares in the financial benefits of new customers using the network (offsetting monthly service payments).
Asset residual value	On expiry of the contract term or termination event, the contractor must offer to sell, assign or transfer to the state its interest in the network (facility, sites, equipment and software) to enable the state to continue using the service.	Has the option of acquiring the network. Termination value varies according to termination event, including expiry value, default, force majeure or change in government policy. Default termination events are based on agreed written-down values at the time of termination, less costs incurred to reinstate the project. Expiry value is based on agreed written-down values. At the end of the 7 years, the nominal expiry value will be $1 million. In addition, Motorola at the end of the period will novate/assign/grant the licence to the state. Licence software fees are subject to negotiation. The key network components are the central equipment and communication towers. These have a useful life of between 10 years to 20 years and are about 70 per cent of the network's capital costs (based on the public service comparator). The portable and mobile radios have a design life of 7 years and are about 30 per cent of the network's capital costs (based on the comparator). The state has the option to continue receiving services from Motorola for a further 2 years after the 7-year agreement expires. The state has the option to renew the site lease term for the communication towers beyond 7 years, where a site lease provides for such a right.
Demand risk	Risk that the network will not be designed and constructed to meet the capacity requirements in the agreement.	The state pays a fixed amount which is not based on usage. It, therefore, has the risk of network underutilisation. The state pays the cost of additional units above the number specified in the agreement.

Source: Victorian Auditor-General's Office.

The state's total payments over the 7-year period will be $119 million in net present value terms, or $187.5 million in nominal terms. The cost of the project represents the total service payment due over the 7-year service term, reflecting the capital cost of the network and the costs incurred by Motorola in the installation, maintenance and customer service support.

The issue of ownership of the asset at the end of the contract term is crucial to the issue of which party has assumed the risks. The state expects to assume ownership of the network at the end of the term (in light of the expiry value of $1 million and the remaining life of the major components). Based on this and the above analysis, the arrangement is essentially a finance lease.

Following final acceptance of the network, it will be recorded as a state asset. The assets will be valued at about $83 million in nominal terms. The present value of this asset was not available at the date of preparing this report. The state will have a corresponding liability, being its obligation to finance the network's capital cost. Until the network is completed, the financial commitments of the project will be disclosed as part of commitments in the Annual Financial Report.

8.1.6 Contingent liabilities

State contingent liabilities	2004	2003	Movement
Quantifiable contingent liabilities ($million)	1 852	1 750	102

The state government is a party to various proceedings, legal actions, and claims brought by or against it, including threatened or pending litigation. Some of these may ultimately result in settlements or decisions against the government.

At 30 June 2004, total quantifiable contingent liabilities increased by $102 million mainly due to the state's possible exposure associated with the Pulverised Dried Brown Coal Agreement[7].

Major new non-quantifiable contingent liabilities relate to the construction risks associated with the Spencer Street Station redevelopment[8].

[7] Part 6 of this report (Expenditure trends) has more information about this matter.

[8] Part 7 of this report (Asset trends) has more information about this matter.

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