VICTORIA

Auditor General
Victoria

Auditor-General's Report on the Finances of the State of Victoria, 2004-05

November 2005

Ordered to be printed

VICTORIAN GOVERNMENT
PRINTER
November 2005

PP No. 176, Session 2003-05

ISBN 1 921060 18 2

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

Dear Presiding Officers

Under the provisions of section 16AB of the *Audit Act 1994*, I transmit the *Auditor-General's Report on the Finances of the State of Victoria, 2004-05.*

Yours faithfully

JW CAMERON
Auditor-General

16 November 2005

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 2005.

A substantial operating surplus was generated for the year - $3 962 million for the State of Victoria and $2 144 million for the general government sector (budget sector).

While I issued a clear audit opinion on the *2004-05 Annual Financial Report*, I included an emphasis of matter paragraph in the audit report because, in my view, there is a material inconsistency between the commentaries and explanations contained within the Annual Financial Report (highlights section and chapters 1 to 3) and the audited financial statements.

The commentaries and explanations contained within the 2004-05 Annual Financial Report in relation to the net result were not presented in a manner that is consistent with the reporting framework adopted in the audited financial report. References to "A-IFRS net result from transactions", "net result from other economic flows" and the associated tables on financial performance, though prepared from data compiled from existing accounting standards, were presented in a format that the government has signalled it intends to adopt in the future. These results were not reflected in the audited financial report and, accordingly, have not been subject to audit.

The State's significant operating surplus has benefited from the continued strong performance of the economy and domestic equity markets. These factors have resulted in increased revenues from Commonwealth grants and investment returns. In addition, superannuation costs have remained relatively low due to the impact of high investment returns on the State's unfunded superannuation liabilities.

While the government needs to continue to monitor factors impacting on its revenue base and rate of expenditure growth, the financial position of the State remains strong.

1.1 Summary of major findings

1.1.1 Opinion on the government's Annual Financial Report

- While I issued a clear audit opinion on the *2004-05 Annual Financial Report*, I included the following emphasis of matter paragraph in the audit report:

  > "Without qualification to the audit opinion expressed above, attention is drawn to the following matter. The *2004-05 Annual Financial Report* has been prepared under existing generally accepted accounting principles. However, the commentary and explanations included in pages 1 to 58 of the *2004-05 Annual Financial Report* in relation to the net result are not presented in a manner that is consistent with the reporting framework adopted in the financial report. The "A-IFRS net result from transactions", "net result from other economic flows" and the associated tables on financial performance are based on data prepared according to existing accounting standards presented in a format that the government intends to adopt in the future. These results are not reflected in the financial report and therefore have not been subject to audit."

1.1.2 Operating results and financial position

- The state had an operating surplus of $3 962 million in 2004-05, $196 million more than in 2003-04. This was as a result of a $1 500 million increase in revenues, partly offset by a $1 304 million increase in expenditures.
- Revenue growth has been significantly influenced by the performance of the state and Australian economy, and investment markets. Expenditure growth has been significantly influenced by wage growth, and the impact of improved investment returns has reduced superannuation expenses.
- Since 1999-2000, while the CPI has increased by 14 per cent, state revenue has grown by 34 per cent and state spending by 25 per cent.
- The financial position of Victoria continues to be sound. At 30 June 2005, the state had net assets of $74 561 million, an increase of $13 616 million for the financial year.

1.1.3 The state's financial condition

- Continued strong performance from the economy and domestic equity markets has helped maintain the government's overall strong financial position.

1.1.4 Revenue trends

- State revenue totalled $36 774 million in 2004-05, an increase of $1 500 million from the previous year.
- The state received $13 417 million in grants from the Commonwealth Government, an increase of $796 million.
- In recent years, the Commonwealth Government has imposed a number of new funding conditions on specific purpose grants, particularly, relating to industrial relations. These include the national code of practice for the construction industry and, more recently, offering employment under Australian workplace agreements and performance-based pay.
- These new funding requirements will require careful ongoing management to ensure that the State meets the increased requirements attached to these grants, and continues to access the full amount available under specific purpose grants from the Commonwealth Government.
- The projected reduction in land tax revenue arising from the budget initiatives will be partially offset by the introduction of a new congestion levy to be collected from owners of long stay car parks in the central business district of Melbourne. The levy is estimated to generate around $139 million between 2005-06 and 2008-09.
- The State's strong investment returns continued during the year with revenue from this source totalling $2 912 million.
- Government business enterprises paid dividends into the Consolidated Fund within the Public Account totalling $501 million, an increase of $194 million compared with the previous year.
- As part of the *Our Water Our Future* initiative an environmental charge was levied on agencies in the water sector resulting in $44.6 million being paid into the Consolidated Fund within the Public Account.
- Revenue from fines totalled $337 million in 2004-05, an increase of $22 million (or 7 per cent) compared with the previous year. The majority of the increase related to the automatic indexation of fines in accordance with the forecast movements in the consumer price index and the gradual re-introduction of previously withdrawn fixed traffic cameras.

1.1.5 Expenditure trends

- State expenditure totalled $32 812 million, a $1 304 million increase on the previous year.
- Employee benefits increased by $842 million (7.9 per cent) due to the ongoing impact of enterprise bargaining agreements and budget initiatives.
- The Government and the Police Association of Victoria agreed to exercise an option in the existing enterprise bargaining agreement. The exercise of this option bypassed the requirement to comply with the government's wages policy for all new enterprise bargaining agreements. As a result, police officers will receive increases of more than 4 per cent per year for a 2 year period.
- The financial impact of the EastLink project on the state's finances in 2004-05 was an overall net cost of $282.4 million.
- The government announced extra funding for security for the Commonwealth Games as part of the 2005-06 budget cycle. As security risks are considered to be outside the state government's control, the government has removed an amount equivalent to the funding to be provided for security from the amount it agreed to contribute to the games (government's contribution cap). As a result, we would expect that the whole-of-games' budget will also be adjusted downwards by the amount previously allocated towards security.

1.1.6 Asset trends

- The State's asset base increased by $13 507 million on 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.
- Project delays were experienced in a number of the State's major capital works projects resulting in outlays being well below budget.
- Based on the June 2005 project report for the Spencer Street Station redevelopment, the completion of the main interchange facility has been delayed by 307 days compared with that agreed in the 2003 settlement deed. It is now expected that the main interchange facility will be operational by 28 February 2006. At June 2005, a total of $54.1 million in claims for compensation had been lodged in relation to the project.
- In June 2005, the government and Transurban entered into an arrangement to upgrade the interchange of the Tullamarine and Calder Freeways. The government will fund the upgrade by redeeming concession notes to the value of the cost of works to be undertaken. Over the next 2 financial years, it will redeem concession notes to the value of $153.7 million in net present value terms.

- At 30 June 2005, total uncollected fines totalled $613.4 million, an increase of $59.1 million on the previous year. Fines outstanding for a period greater than 12 months totalled $466 million.

1.1.7 Liabilities, commitments and contingencies trends

- The state's liabilities decreased by $109 million on the previous year.
- Several successive years of budget surpluses have enabled the government to maintain borrowings at current levels and refinance debt as it matures. The government has also been helped by low interest rates over a number of years which have kept interest costs relatively low.
- At 30 June 2005, the state's unfunded superannuation liability totalled $10 540 million, some $1 220 million less than 12 months previously. This was mainly due to improved yields from investments and a $708 million additional payment made by the state to reduce the unfunded superannuation liability.
- The state's unfunded superannuation liability is heavily influenced by the investment yields generated by the superannuation funds. The State Superannuation Fund actuary had forecast a 7.5 per cent investment return for 2004-05. The actual return achieved was 16.12 per cent (after fees). This had a positive impact on the level of unfunded superannuation liabilities.
- During 2004-05, the state's outstanding insurance claims liability increased by $916 million (7.3 per cent). The liability increased mainly as a result of claims incurred during the year by the state's insurance bodies, and a reduction in the discount rate applied in the assessment of the liability.
- Commitments increased by $607 million mainly as a result of new contractual arrangements entered into during the year.
- As the majority of risks associated with the Royal Women's Hospital and the Emergency Alerting System projects have been retained by the state, the assets and liabilities associated with these projects will be ultimately reported in the state's statement of financial position.
- Under the Royal Melbourne Showgrounds redevelopment arrangements, despite the state contributing around 87.5 per cent of the total contribution to the arrangement up to 30 June 2005, both the government and the Royal Agricultural Society of Victoria will have an equal share holding in the project company. As the state has contributed more to the joint venture than its equity holding, the difference of around $66 million will be written-off as an expense by the state.

2. Opinion on the 2004-05 Annual Financial Report of the State

2.1 Audit opinion on the 2004-05 Annual Financial Report of the state

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 2004-05*[1] consolidates the financial reports of 321 agencies in 3 sectors, being:

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

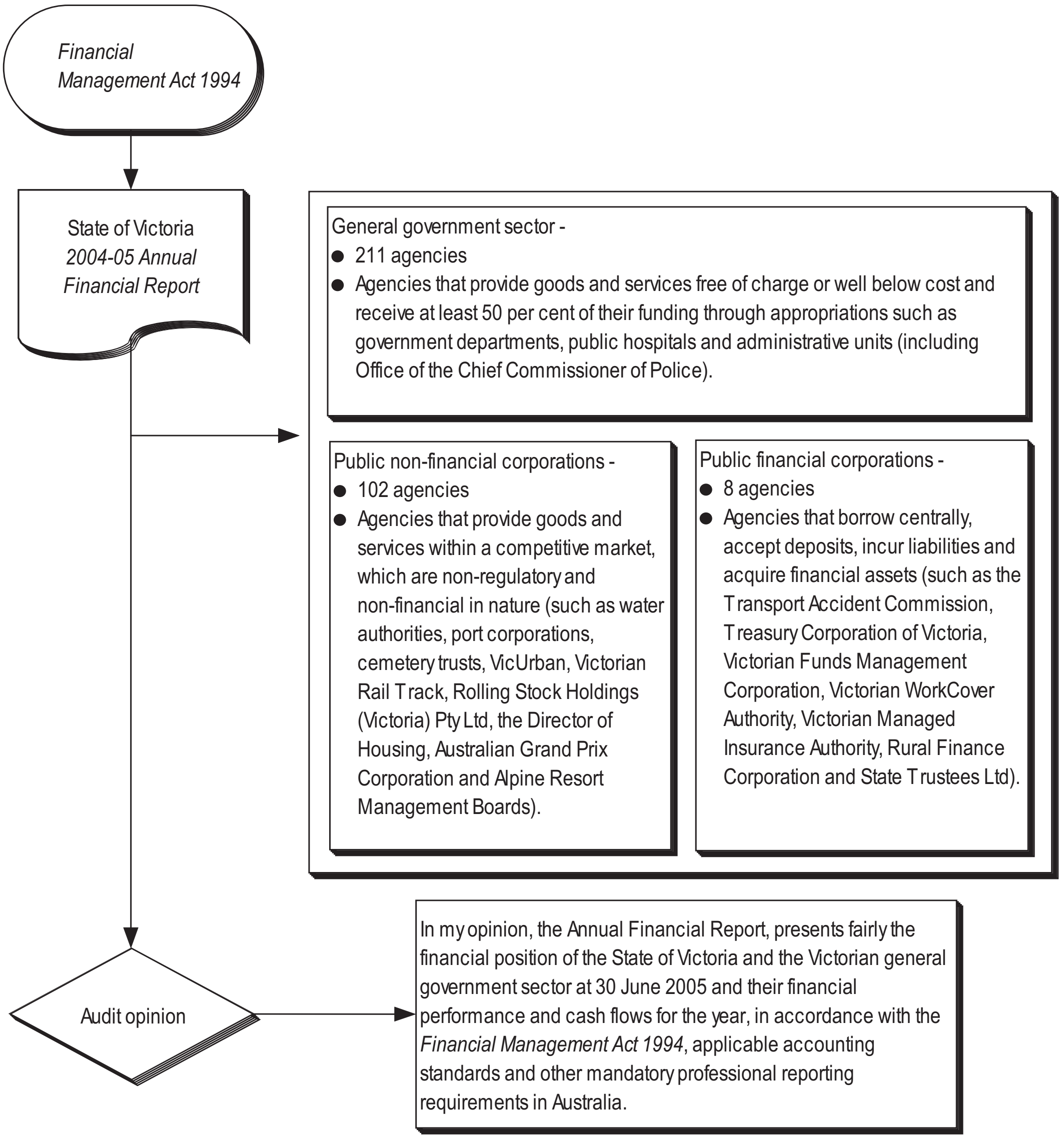
The Annual Financial Report sets out the 2004-05 consolidated operating result (essentially, revenue less expenditure), and financial position (assets less liabilities) for Victoria, and the general government sector. The Annual Financial Report also provides the financial results for the Public Account (comprising the Consolidated Fund and the Trust Fund).

Figure 2A provides further details about which agencies were included in the *2004-05 Annual Financial Report*.

---

[1] Throughout this report we refer to this document as the, *2004-05 Annual Financial Report*.

FIGURE 2A: AGENCIES COVERED BY 2004-05 ANNUAL FINANCIAL REPORT



Source: Victorian Auditor-General's Office.

We issued a clear audit opinion on the *2004-05 Annual Financial Report* on 30 September 2005. The scope of the opinion is detailed on page 60 of the *2004-05 Annual Financial Report*.

This report complements the *2004-05 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 better understand the state's finances and the role of significant transactions in shaping the state's financial position and performance in 2004-05 and into the future.

2.2 Emphasis of matter for Annual Financial Report

While I issued a clear audit opinion on the *2004-05 Annual Financial Report*, I included an emphasis of matter paragraph in the audit report because, in my view, there is a material inconsistency between the commentaries and explanations contained within the Annual Financial Report (highlights section and chapters 1 to 3) and the audited financial statements.

For the 30 June 2005 reporting period, entities are required to prepare their accounts in accordance with existing Australian generally accepted accounting principles (GAAP). Early adoption of Australian equivalents to International Financial Reporting Standards (A-IFRS) is not permitted. Accordingly, the 2004-05 Annual Financial Report was prepared in accordance with existing Australian GAAP.

However, the commentaries and explanations contained within the 2004-05 Annual Financial Report in relation to the net result were not presented in a manner that is consistent with the reporting framework adopted in the audited financial report. References to “A-IFRS net result from transactions”, “net result from other economic flows” and the associated tables on financial performance, though prepared from data compiled from existing accounting standards, were presented in a format that the government intends to adopt in the future. These results were not reflected in the audited financial report and, accordingly, have not been subject to audit.

I consider that the “A-IFRS net result from transactions” could confuse the reader and conflict with the net result presented under the existing GAAP framework. The former reflects one element of the government’s financial performance while the latter reflects the comprehensive result of the activities of the government. Under GAAP, the determination of the “net profit or loss/result” must include all revenues, expenses and valuation adjustments, unless there are standards that specify the contrary. In addition, the reference to A-IFRS in the commentaries and explanations contained within the Annual Financial Report could potentially mislead users to believe that financial measures referred to are prepared on an A-IFRS basis.

Accordingly, I include the following emphasis of matter paragraph in the audit report on the *2004-05 Annual Financial Report*:

Emphasis of matter - Comparability of commentary and financial report

Without qualification to the audit opinion expressed above, attention is drawn to the following matter. The *2004-05 Annual Financial Report* has been prepared under existing generally accepted accounting principles. However, the commentary and explanations included in pages 1 to 58 of the *2004-05 Annual Financial Report* in relation to the net result are not presented in a manner that is consistent with the reporting framework adopted in the financial report. The "A-IFRS net result from transactions", "net result from other economic flows" and the associated tables on financial performance are based on data prepared according to existing accounting standards presented in a format that the government intends to adopt in the future. These results are not reflected in the financial report and therefore have not been subject to audit.

RESPONSE provided by Treasurer

In the 2005-06 Budget Papers the government adopted a new budget financial target or "bottom line" - the net result from transactions. The Auditor-General reviewed this presentation format in the 2005-06 Budget documents. This key fiscal aggregate is based on an operating result which distinguishes transactions arising from policy decisions of government from valuation gains and adjustments based largely on movements in financial markets. Transactions are defined according to the Government Finance Statistics Framework, and in addition to being an appropriate measure of government financial accountability, provide a first step in the harmonisation of GFS and GAAP, foreshadowed by the release by the Australian Accounting Standards Board (AASB) of ED 142 - Financial Reporting of General Government Sectors by Government.

***RESPONSE provided by Treasurer** - continued*

The analysis of the GGS and whole of State outcome using the Government's new target measure in the 2004-05 Annual Financial Report for the State of Victoria is appropriate, particularly given that the government has already adopted the measure. The presentation into transactions and other economic flows has clear advantages in providing additional and complementary analysis to the financial statements included in the audited section of the report. Although presented in the format to be used under A-IFRS, the analysis clearly states that income and expenses have not been remeasured on an A-IFRS basis.

2.3 Australian equivalents to International Financial Reporting Standards (A-IFRS)

New Australian accounting standards are to be implemented for all reporting entities for reporting periods beginning on or after 1 January 2005 to harmonise the Australian reporting framework with international financial reporting standards. These new standards are referred to as Australian equivalents to International Financial Reporting Standards, or A-IFRS.

Most public sector agencies would have included disclosures in their notes to the financial statements for 2004-05 of any known or reliably estimable information about the impacts on the financial report had it been prepared using A-IFRS. While the impact of the new accounting standards varied depending on individual agencies' business and scope of financial operations, the major changes for the public sector relate to:

- valuation and impairment of non-current assets
- accounting for financial instruments
- valuation of insurance liabilities, unfunded superannuation and other employee benefit liabilities
- accounting for foreign exchange movements.

The application date for agencies with 31 December balance dates (mainly educational bodies such as universities and TAFE institutes) is for their 2005 financial statements. Public sector agencies with 30 June balance dates will be required to fully apply A-IFRS for the first time in their financial statements for 2005-06.

There are still some significant challenges that remain, particularly for agencies with substantial financial instruments and insurance products, given that the new accounting standards dealing with these issues are not required to be retrospectively implemented for reporting periods prior to 1 January 2005. However, these agencies are well advanced in planning and implementing the requirements of these specific standards.

One of the key matters for the government will be to decide how to incorporate the financial statements of for-profit entities into the whole-of-government financial report, which will be prepared on a not-for-profit basis, as there are different accounting and reporting requirements applicable to for-profit and not-for-profit entities. We believe this matter requires urgent resolution not only within the Victorian whole-of-government context, but by the Australian Accounting Standards Board (AASB) so that a consistent treatment is adopted by all government reporting entities.

We will continue to work closely with the Department of Treasury and Finance and public sector agencies in implementing and monitoring the impact of adopting Australian equivalents to International Financial Reporting Standards.

2.4 Harmonisation of GAAP and GFS financial reporting frameworks

The harmonisation of the Generally Accepted Accounting Principles (GAAP) and the Government Finance Statistics (GFS) framework continues to be a high priority for the Australian public sector as the financial statements of all Australian jurisdictions are currently based on a mix of the 2 frameworks[2].

Under GAAP, transactions are reported from an accounting viewpoint, whereas under GFS, transactions are reported from an economic impact perspective. Accordingly, reports based on the different frameworks can give quite different operating results and perspectives of the financial position of a government. The main objectives of the harmonisation of the GAAP and GFS reporting frameworks are to enhance comparability between jurisdictions and to reduce the confusion that results with the publication of 2 sets of financial statements. The GAAP-based financial statements are subject to audit, whereas the GFS statements are not.

---

[2] The Victorian Government uses GAAP to prepare accrual-based, whole-of-government, general purpose financial statements, and uses GFS to prepare statements for the Uniform Presentation Framework.

To this end, the AASB issued an exposure draft in July 2005, ED 142 *Financial Reporting of General Government Sectors by Governments,* for public comment which presents proposals for reporting for the general government sector (GGS) of a government and the presentation of financial statements based on a converged GAAP/GFS framework. Comments on this exposure draft will provide the basis for the AASB's future deliberations on the remainder of the harmonisation project.

While supporting any move to see better reporting of the budget (general government) sector, we do have concerns about a number of proposals in the exposure draft.

These concerns centre around:

- The proposal to treat the GGS as a separate reporting entity with its results being reported separately from the whole-of-government results. There is a need to preserve the integrity of the whole-of-government financial statements and any heightened focus on the GGS should not be at the expense of whole-of-government reporting.

  At present, accounting standards require reporting entities to report all of the interests of a reporting entity on a consolidated basis so as to show the aggregate financial picture in comprehensive form. It is the consolidated financial statements that are audited and presented to parliament each year. The proposals to permit partial consolidations for the GGS and for the GGS to be treated as a separate reporting entity will create a risk of presenting incomplete information to users for the purpose of making and evaluating decisions about the allocation of scarce resources.

  This risk will be increased if the GGS results are reported separately from the whole-of-government results. Such a risk has been recognised by the International Public Sector Accounting Standards Board in a recently released exposure draft of a standard on *Disclosure of Financial Information about the General Government Sector,* in which there is a specific requirement that the GGS should not be placed in a position of greater prominence than the financial statements for a government as a whole.
- The risk that the resultant "converged" document leads to confusion over the financial outcome/results of a government. While acknowledging the complexities of governments' wide range of activities and the need to find the best way to present the financial picture in a clear and unambiguous manner, the convergence model proposed will introduce a greater range of "results", which has the potential to create many "bottom lines" and may confuse users in understanding the financial affairs of the government.

The AASB is also proposing to withdraw 3 public sector-specific standards, being AAS 31 *Financial Reporting by Governments*, AAS 29 *Financial Reporting by Government Departments* and AAS 27 *Financial Reporting by Local Governments*. This may have implications for the public sector as there are particular financial reporting issues faced by not-for-profit public sector agencies, which are not specifically addressed by the current suite of Australian equivalents to International Financial Reporting Standards. The AASB is currently considering a number of proposals to address these issues.

We will continue to closely monitor the developments in accounting standard setting to ensure that the improvements made to financial reporting in the Australian public sector over the past 6 to 8 years are enhanced rather than put at risk.

RESPONSE provided by Treasurer

In April 2000, the Government introduced a new budgeting and reporting framework, consistent with principles of sound financial management, through the Financial Management (Financial Responsibility) Act 2000. This Act provides for full, accurate and timely disclosure of financial information relating to the Government's activities, by mandating reporting of the whole of State and the General Government Sector (GGS). The whole of government mid-year and annual financial reports will continue to be an important part of the government's financial disclosure commitments.

The move by the AASB, in releasing ED 142 to treat the GGS as a separate reporting entity is seen in a positive light by governments in Australia, as enhancing the reporting of the annual budget outcome. The new GGS reporting requirements will better complement the existing whole-of-Government and departmental reporting requirements. Rather than creating a risk of presenting incomplete information the proposal contained in ED 142 will expand the information available to users, by incorporating important elements into the accounting presentation which are currently only included in the GFS version of the financial statements.

Governments in Australia, through the Heads of Treasuries, are working with the AASB to address any shortcomings in the current exposure draft in pursuit of the Financial Reporting Council's objectives of a single set of Government reports which are auditable and comparable between jurisdictions and with the budget statements. A reporting standard for general government reporting by governments will supplement and enhance existing whole-of-Government financial statements. Jurisdictions will continue to report at both General Government and whole of State levels.

2.5 Preparation of the 2004-05 Annual Financial Report

To prepare the *2004-05 Annual Financial Report*, the Department of Treasury and Finance (DTF) electronically collated financial and non-financial data from 321 public sector agencies. These agencies were required to send data from their annual financial report to DTF using the budget management system (BMS), an internet-based data exchange facility, within specified time frames.

The timely completion of the Annual Financial Report, therefore, depends on all agencies completing their financial reports within the required time. When preparing the *2004-05 Annual Financial Report*, DTF placed particular focus on 48 “material entities” (the largest agencies), which account for around 95 per cent of the state’s transactions and balances.

DTF’s processes to consolidate agency information and prepare the *2004-05 Annual Financial Report* were satisfactory.

However, we found that there was some potential to improve the ability of the BMS system to process necessary adjustments on a timely basis. Initial delays were also experienced by DTF due to a significant number of material entities that had not finalised their 2004-05 financial reports within agreed timelines. This affected the timeliness and accuracy of the information the material entities provided to DTF and, consequently, the timely completion of the *2004-05 Annual Financial Report.*

Delays in material entities preparing their financial reports and finalising the information they sent to DTF were mainly due to:
- delays incurred by a number of material public hospitals
- certain asset valuations not finalised in a timely manner
- delays in finalisation of A-IFRS disclosures
- 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 the reporting processes more efficient and timely.

2.5.1 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. The Annual Financial Report's credibility is enhanced because it is prepared applying the full range of Australian Accounting Standards. Despite the existing high standard, there are still opportunities to improve the quality of the Annual Financial Report.

Insurance claims expense

Insurance claims 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.

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.

"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 Royal Women's Hospital development). 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.

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.

Provision movements

Employee benefits provisions and insurance claims provisions are disclosed in notes 26 and 28, respectively, of the Annual Financial Report. These provisions form a major component of state liabilities, however, their movements are not disclosed in the Annual Financial Report. Current and future Australian Accounting Standards require movements (arising from payments, additional provisions recognised and changes in discount rates) to be disclosed within the notes to the financial report.

We will continue to work closely with the Department of Treasury and Finance to improve the quality of the Annual Financial Report disclosures.

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 321 agencies, but does not include local government agencies, denominational hospitals or universities.

Figure 3A shows the State of Victoria's 2004-05 operating result, as disclosed in the *2004-05 Annual Financial Report*.

FIGURE 3A: STATE OF VICTORIA'S OPERATING RESULT 2004-05 ($M)

Item	2003-04	2004-05	Movement
Revenues	35 274	36 774	1 500
Expenses	31 508	32 812	1 304
Operating surplus for the year	3 766	3 962	196

Source: 2004-05 Annual Financial Report.

The state had an operating surplus of $3 962 million in 2004-05, $196 million more than in 2003-04. This was as a result of a $1 500 million increase in revenues, partly offset by a $1 304 million increase in expenditures.

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
2003-04 revenue			**35 274**
Revenue movements -			
Taxation	Additional payroll tax	328	
	Increased motor vehicles taxes	101	
	Additional land tax revenue	98	
	Increased gambling taxes	45	
	Increased insurance levies revenue	43	
	Decreased conveyancing duty revenue	(108)	
	Abolition of stamp duty on mortgages	(219)	
	Other net movements	31	319
Investment income	Mainly related to improvements in the equity markets		381
Fines and fees	Additional traffic camera infringement notices	22	
	Other net movements	18	40
Commonwealth grants	Increase in GST general purpose grants	371	
	Increase in national competition policy payments	23	
	Increase in specific purpose grants to non-government schools	152	
	Increase in specific purpose grants for health care	97	
	Increase in other specific purpose grants	153	796
Sales of goods and services	Revised pricing structure for VenCorp market participants	107	
	New pricing structure for water authorities	100	
	Other net movements	(3)	204
Loss on disposal of physical assets	Net movements		10
Fair value of assets received free of charge	One-off prior year gain resulting from rolling stock reassumed by the state for nominal consideration following franchise restructure	(367)	
	Other net movements	(56)	(423)
Other revenue	Revaluation gain on CityLink concession notes	96	
	Revenue received from EastLink consortium	36	
	Other net movements	41	173
Total revenue change			**1 500**
2004-05 revenue			**36 774**

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

Item	Major factors contributing to the movement		Total
2003-04 expenditure			**31 508**
Expenditure movements -			
Employee benefits	Increase mainly due to the additional cost of major public sector industrial settlements and higher staffing levels		842
Superannuation	Increase mainly due to higher employer contributions partially offset by the impact of increased gains on superannuation investments.		281
Supplies and services	Write-off of state land and infrastructure for the Eastlink project	318	
	One-off prior period transaction - ex-gratia payment to Loy Yang A	(49)	
	One-off prior period transaction - assumption of public transport franchise operators employee entitlements	(148)	
	Increase in accident claim payments by the Transport Accident Commission	230	
	Royal Melbourne Showgrounds net contribution	66	
	Increase in electricity network payments by VenCorp	84	
	Other net movements across agencies relating to supplies and services expenses	547	1 048
Grants and transfer payments	Increase in grants to non-government schools	172	
	Increase in first home buyers grants	227	
	Other net movements	16	415
Depreciation and amortisation	Increase due to impact of asset acquisitions and asset revaluations		145
Borrowing costs	Net movements		73
Other expenses	One-off prior year transaction for the write-off of the smelter reduction levy receivable	(1 140)	
	Write-down in the value of native forests to be made available for commercial timber harvesting	54	
	Increase in the provision for doubtful debts for fines	51	
	Revaluation gain on SECV onerous contract provisions	(187)	
	Other net movements	(278)	(1 500)
Total expenditure change			**1 304**
2004-05 expenditure			**32 812**
Difference between revenue and expenditure changes			**196**
Operating surplus			**3 962**

Source: Victorian Auditor-General's Office.

The major sources of the state’s revenue and expenditure and the contribution of each of the key sources to the increased operating surplus are shown in Figures 3C and 3D.

FIGURE 3C: MAJOR REVENUE ITEMS AND MOVEMENTS BETWEEN YEARS ($M)

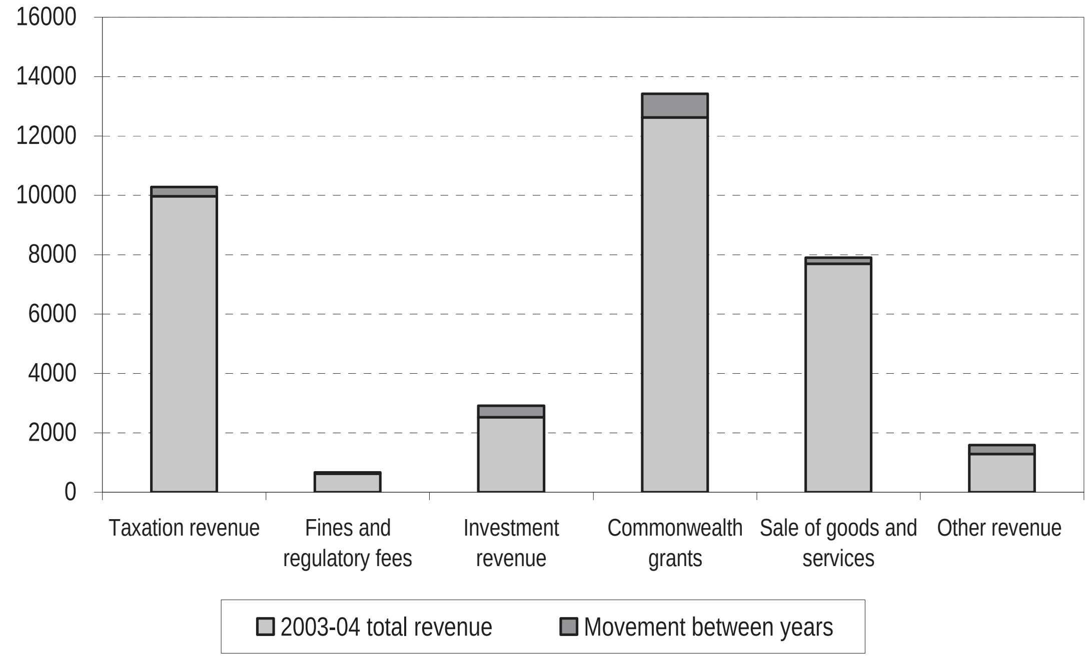
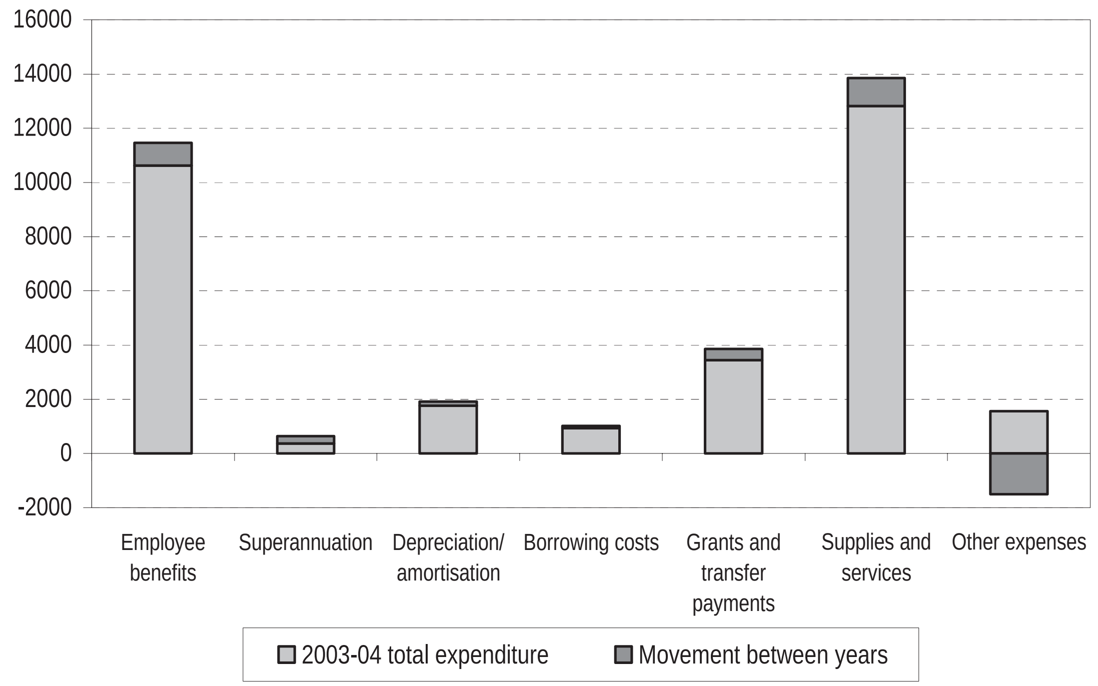


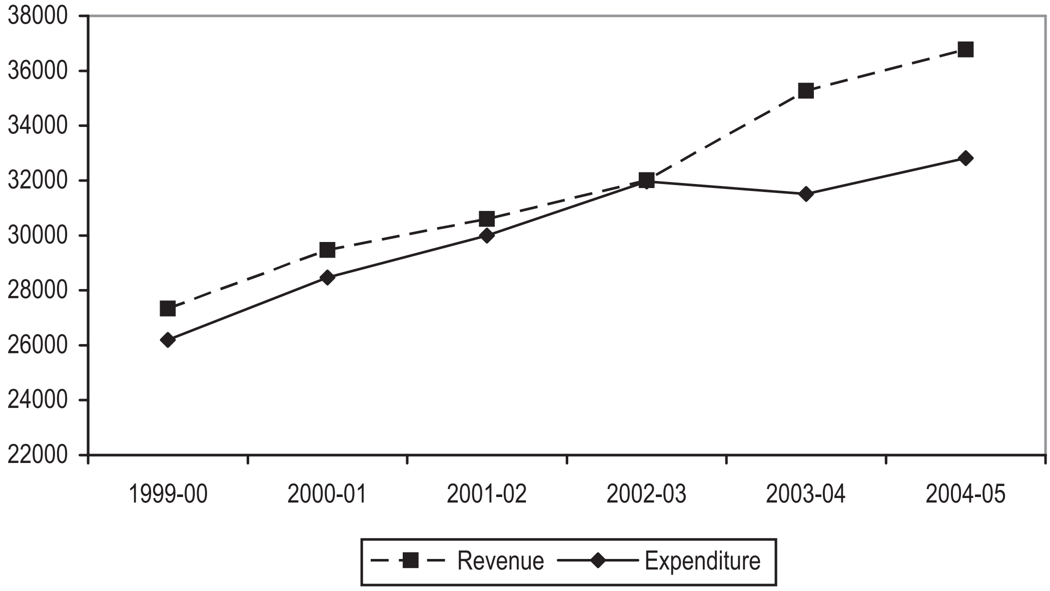
FIGURE 3D: MAJOR EXPENDITURE ITEMS AND MOVEMENTS BETWEEN YEARS ($M)



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 3E shows that since 1999-2000, revenue has grown on average by a rate of 6.1 per cent per annum and expenditure has increased on average by a rate of 4.7 per cent per annum.**

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



Source: Victorian Auditor-General's Office.

Revenue growth has been significantly influenced by the performance of the state and Australian economy, and domestic and international equity markets. Expenditure growth has been significantly influenced by wage growth, and over the past 2 financial years the impact of the performance of equity markets has reduced superannuation expenses.

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 3F and 3G compare the growth in total state revenues and expenditures to CPI.

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

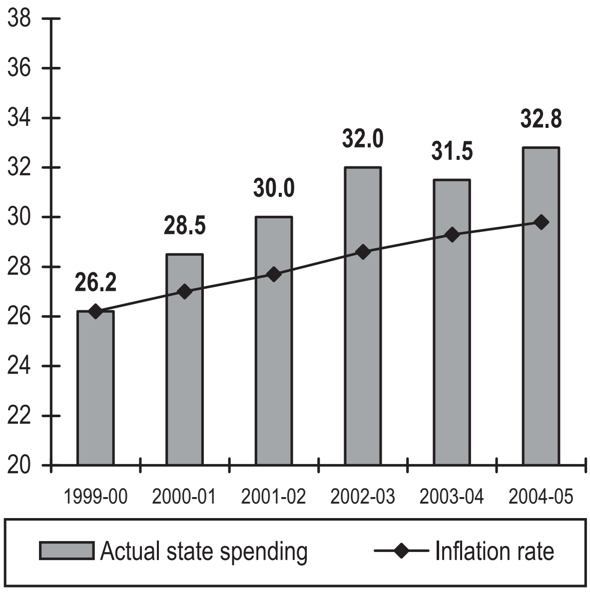
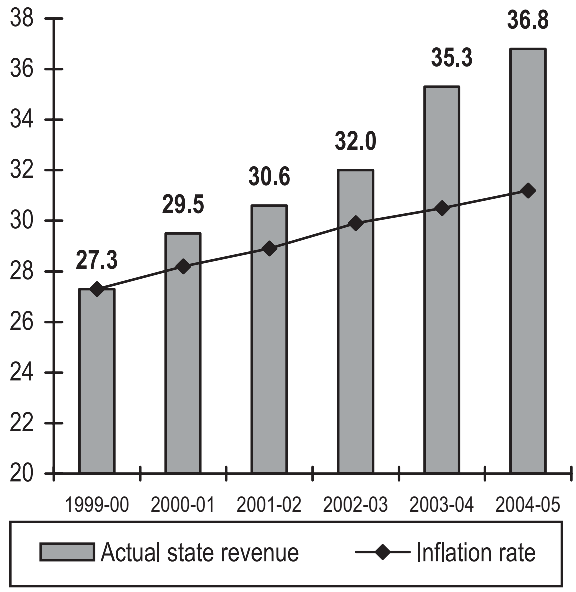


FIGURE 3G: ACTUAL STATE REVENUE COMPARED WITH INFLATION RATE ($B)



Source: Actual state revenue and expenditure obtained from the *2004-05 Annual Financial Report*. Consumer price index sourced from the ABS. Base year of 1999-2000 used to arrive at inflation-linked revenue and expenditure growth.

Since 1999-2000, while the CPI has increased by 14 per cent, state revenue has grown by 34 per cent and state spending by 25 per cent.

3.1.2 Financial position

The Statement of Financial Position contains information about the value and composition of the state's assets and liabilities, at 30 June 2005. Figure 3H shows the state's financial position as disclosed in the *2004-05 Annual Financial Report*.

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

Item	2004	2005	Movement
Assets	109 114	**122 621**	13 507
Liabilities	48 169	**48 060**	(109)
Net assets	60 945	**74 561**	**13 616**

Source: Annual Financial Report, 2004-05.

The financial position of Victoria continues to be sound. At 30 June 2005, the state had net assets of $74 561 million, an increase of $13 616 million for the financial year.

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

FIGURE 3I: FINANCIAL POSITION ANALYSIS ($M)

Item	Major contributing factors for the movement		Total
2003-04 assets			109 114
Asset movements -			
Cash	Net movements		(378)
Physical assets	Revaluations	9 542	
	Increase in leased assets	104	
	Other asset additions	3 699	
	Depreciation/amortisation in the year	(1 909)	
	Other net movements	(143)	11 293
Receivables	Increase in fine debtors	59	
	Increase in value of CityLink concession notes	140	
	Increase in tax receivables	63	
	Decrease in the value of derivative receivables	(716)	
	Other net movements	239	(215)
Other financial assets	Increase due to improved performance of investment markets and additional investments made		2 819
Inventories	Net movements		1
Prepayments	Net movements		(13)
Total changes to assets			13 507
2004-05 assets			122 621
2003-04 liabilities			48 169
Liabilities movements -			
Superannuation	Decrease mainly due to the impact of strong performance of superannuation fund investments		(1 220)
Interest-bearing liabilities	Increase in finance lease liabilities	104	
	Higher third party deposits	466	
	Other net movements including debt repayments	(269)	301
Payables	Decrease in the value of derivative payables	(713)	
	Contribution payable for Royal Melbourne Showgrounds redevelopment	87	
	Other net movements	336	(290)
Other provisions	Increase in WorkCover claims	405	
	Increase in Transport Accident claims	414	
	Other net movements	(78)	741
Employee benefits	Increase mainly due to the impact of wage growth on entitlements for long service leave		249
Other liabilities	Revenue received in advance for 2006 Commonwealth Games	53	
	Net movements	57	110
Total changes to liabilities			(109)
2004-05 liabilities			48 060
Differences between asset and liability changes			13 616
Net assets			74 561

Source: Victorian Auditor-General's Office.

3.2 General government sector operating result and financial position

The general government sector includes all government departments, offices and other bodies engaged in providing services free of charge or at prices significantly below their cost of production. The general government sector is not a separate entity, but represents a sector within the State of Victoria reporting entity. The primary function of entities within the general government sector is to provide public services (outputs) which are mainly non-market in nature, for the collective consumption of the community, and involve the transfer or redistribution of income and are financed mainly through taxes and other compulsory levies.

3.2.1 Operating result

Figure 3J shows the general government sector's 2004-05 operating result, as disclosed in the *2004-05 Annual Financial Report*.

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

Item	2003-04 Actual	2004-05 Estimate	2004-05 Actual
Revenues	28 344	28 985	**29 904**
Expenses	27 354	28 440	**27 760**
Operating surplus for the year	**990**	**545**	**2 144**

Source: Annual Financial Report, 2004-05.

The general government sector had an operating surplus in 2004-05 of $2 144 million, some $1 154 million more than in 2003-04 and $1 599 million above that originally estimated in the *2004-05 Budget Papers*. This result was well above the government's short-term financial target of $100 million.

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

- Commonwealth grants revenue ($382 million)
- Investment revenue ($137 million)
- Sales of goods and services ($151 million)
- Other revenue ($194 million).

The main expenditure movements from that forecast were increases in:

- Employee benefits ($266 million)
- Supplies and services ($149 million)
- Other expenses ($141 million).

These increases were offset by decreased superannuation expenses for the year compared with that forecast ($1 209 million). While the government budgeted for superannuation expenses of $1 789 million, actual expenses were $580 million.

3.2.2 Financial position

Figure 3K shows the general government sector's financial position in summary form at 30 June 2005.

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

Item	2003-04 Actual	2004-05 Estimate	2004-05 Actual
Assets	51 083	52 761	**60 623**
Liabilities	24 804	26 719	**23 774**
Net assets	**26 279**	**26 042**	**36 849**

Source: 2004-05 Annual Financial Report.

At 30 June, the general government sector had net assets of $36 849 million. In 2004-05, the sector's net assets increased by $10 807 million compared with that initially forecast in the Budget Papers. This was mainly due to higher than expected physical asset balances ($7 413 million) – mainly due to asset revaluations; increased cash balances ($730 million); and lower than anticipated unfunded superannuation liabilities ($2 384 million) – mainly due to the impact of higher than expected superannuation investments yields; and lower interest-bearing liabilities ($919 million) – due to additional debt repayments.

These movements were offset by lower than anticipated investment balances ($1 046 million) - mainly due to additional debt repayments made in June and July 2004 subsequent to the tabling of the Budget Papers.

3.2.3 Government Financial Statistics reporting

The audited consolidated financial statements in Chapter 4 of the *2004-05 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. We do not audit those statements.

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

FIGURE 3L: 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	2 144
Adjustments for revenues and expenses not used in the calculation of the GFS -	
Add doubtful debts expense	35
Less gain/(loss) on revaluation of financial instruments	(208)
Add revaluations and gains on sale of physical assets	153
Less change in provision for unfunded superannuation	(1 329)
Unaudited GFS net operating balance	795

Source: Department of Treasury and Finance.

The main differences between the 2 approaches are:

- 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.
- GFS does not recognise gains or losses on securities marked to market, or on revaluations or write-downs of non-financial assets.
- GFS does not recognise allowances for doubtful debts and certain amortisation expenses.

The difference between the audited GAAP operating result for the general government sector and the unaudited GFS net operating balance in 2004-05 is $1 349 million.

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.

Consolidated Fund

The Consolidated Fund is the government's main operating account, into which all Crown 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 3M shows the Consolidated Fund's cash flows for the year (before borrowing transactions).

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

Item	2003-04	2004-05	Movement
Receipts -			
Operating activities	24 221	**25 767**	1 546
Investing and financing activities	35	**175**	140
Total receipts, excluding borrowing transactions	24 256	**25 942**	1 686
Less – Payments (operating and capital transactions) -			
Special appropriations	2 461	**2 272**	(189)
Annual appropriations	21 964	**24 111**	2 147
Total payments, excluding borrowing transactions	24 425	**26 383**	1 958
Consolidated Fund deficit for year, excluding borrowing transactions	(169)	**(441)**	(272)
Borrowing repayments	(793)	**-**	**793**
Cash deficit for the year	**(962)**	**(441)**	**521**

Source: Annual Financial Report, 2004-05.

In 2004-05, the Consolidated Fund had a cash deficit for the year of $441 million, compared with a cash deficit of $962 million in 2003-04. Consolidated Fund payments increased by $1 958 million, driven by increased program expenditure mainly in the health and education sectors. This was offset by a reduction of $298 million in top-up contributions made by the government as part of its planned reduction of unfunded superannuation liabilities and a reduction of $793 million in borrowing repayments. Consolidated Fund receipts increased by $1 686 million mainly driven by increased taxation receipts and GST grants from the Commonwealth Government.

Trust Fund

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

In 2004-05, there was a net increase of $127 million in the Trust Fund cash and investment balances. This was mainly due to a $119 million increase in the Better Roads Victoria Trust Account.

RESPONSE provided by Treasurer

The Consumer Price Index (CPI) is not a suitable benchmark for Government revenues and expenses as it does not reflect growth in the size of the economy or take account of population growth over the period. A more relevant benchmark is the growth in nominal Gross State Product (GSP) over the period. This measure picks up both activity in the State and the effects of price changes.

Nominal Gross State Product has grown by approximately 36 per cent over the period from 1999-00 to 2004-05, compared with a 34 per cent increase in the State's total revenue.

Projecting revenues forward on an assumption of CPI growth of 2.5 per cent per annum and nominal GSP growth of 5.25 per cent per annum, within 10 years State revenue would fall as a percentage of GSP from 17 per cent to 13 per cent. This would significantly constrain the Government's ability to deliver services to a community that will have increased in size and complexity.

4. The state's financial condition

4.1 Introduction

This part of the report provides an assessment of the state's fiscal health. 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 – *In other words, can the government continue to raise revenue in order to spend the way it does now*?
- ***flexibility indicators***, to examine movements in the degree to which the government can increase its financial resources to respond to rising commitments – *In other words, how much room is there in the state economy for the government to pay for additional spending by increasing either taxes or 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 – *In other words, does the government rely too much on revenue that it is unable to control from year-to-year?*

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]. The analysis facilitates the better understanding of how the government can deal with future uncertainties, particularly in areas where it is financially vulnerable; and how it can change course with reasonable flexibility to introduce new programs or reduce its dependence on volatile sources of revenue. We provide an analysis of these indicators over a 5-year period at a whole-of-government level.

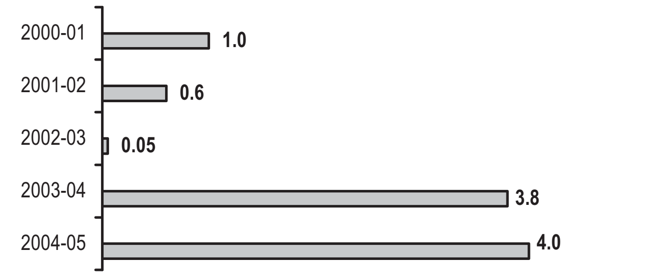
[1] All data used in the analysis is sourced from the audited Annual Financial Reports, except for Victoria's gross state product (GSP), which is sourced from the Australian Bureau of Statistics for financial years up to 2003-04. Estimates of the GSP for 2004-05 are sourced from the Victorian Department of Treasury and Finance.

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.

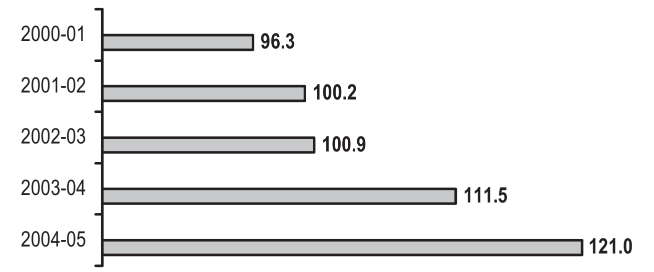
We used the following 4 indicators.

Level of operating surplus/(deficit) ($billion)



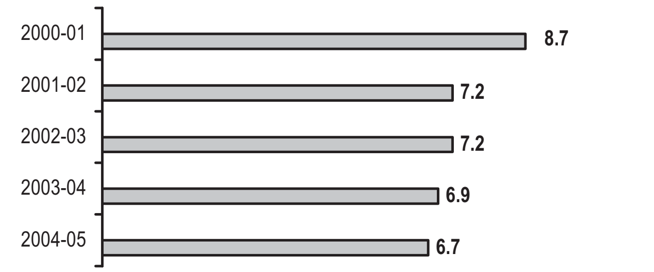
The annual operating surplus (or deficit) indicates whether the government spends more than it raises: that is, whether the government is living within its means. The continual decline in the operating surplus since 2000-01 was reversed in 2003-04 and has improved in the current financial year. The continued strength of the equity markets, as well as an increase in Commonwealth grants, has contributed to the state's performance.

Current assets to current liabilities (per cent)



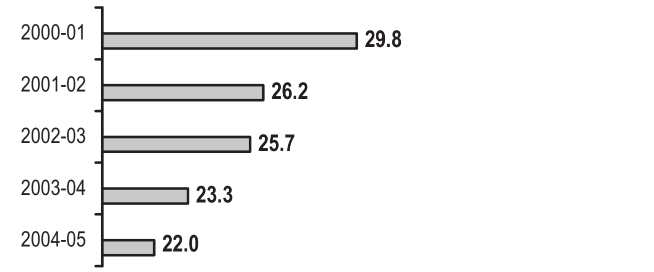
The ratio of current assets to current liabilities is generally known as the "working capital ratio". It measures the ability of the state to meet its short-term obligations. The state's continued improvement in this area was maintained in 2004-05, predominantly due to the government's maturing debt profile. A substantial amount of maturing debt was refinanced to long-term domestic borrowings.

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



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 steady decline in this ratio is more a result of Victoria's continued economic growth than a change in the government's debt profile. In 2004-05, nominal GSP continued to grow at 5.5 per cent, while interest bearing liabilities only increased by 2 per cent.

Total liabilities to Victoria's GSP (per cent)



The ratio of total liabilities to GSP measures the level of state liabilities relative to the size of the Victorian economy. The continual decline in this ratio is reflective of a strong economy and the impact of strong equity markets on unfunded superannuation liabilities.

Sustainability conclusion

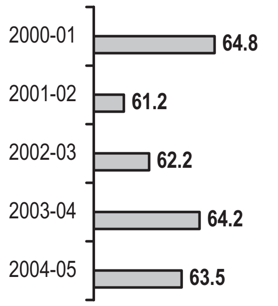
The government's improved sustainability in the last 4 years continued into 2004-05 due to a healthy state and Australian economy and improved equity markets impacting on investment revenue, superannuation expenditure and unfunded superannuation liabilities.

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.

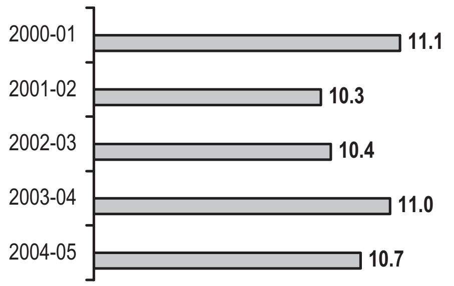
We used the following 5 indicators.

Own-source revenue to total revenue (per cent)



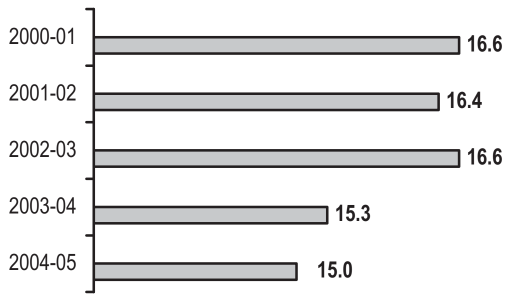
Own-source revenue is total (state) revenue, excluding grants provided to the state. The state's ability to generate its own revenue was reduced in 2000-01 due to revised Commonwealth-state taxation arrangements which required state and territories to abolish a number of taxes which were replaced by Commonwealth grants. Since 2002-03, the government reported a positive revenue trend with an improvement and growth in both the equity and property markets. Overall the state's ability to raise own-source revenue has continued to remain strong.

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



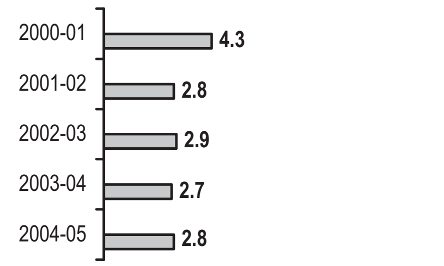
The ratio of own-source revenue to GSP is a measure of the economy's capacity to withstand increased state taxes and charges. As the ratio increases, the government's flexibility decreases, due to the increasing impact of the taxes and charges on the economy. A decrease in this ratio since 2000-01 was a direct result of the impact of the changes to the Commonwealth-state taxation arrangements; however, this trend was reversed in the prior year because of growth in property-related transactions and investment revenue, and a significant one-off transaction. The last 2 years have remained stable when a significant one-off prior year transaction is taken into account.

Expenditure to Victoria's GSP (per cent)



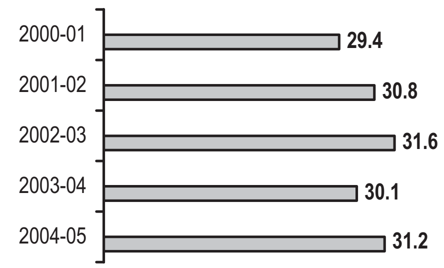
The changing ratio of expenditure to GSP shows whether government spending is becoming a bigger or smaller part of the state's economy. From 2000-01 to 2002-03, the state's expenditure grew at the same rate as the Victorian economy. This trend has been reversed in the last 2 years as a result of reduced superannuation expenses and the continued growth in the state's economy.

Borrowing costs to total revenue (per cent)



The ratio of borrowing costs to total revenue measures the proportion of revenue spent paying interest on state debt. The more the government pays in interest, the less funds it has for its programs. The government's debt profile has remained fairly stable over the last 5 years with only minor increases to its interest-bearing liabilities mainly resulting from increases in finance lease obligations. Further, a period of low interest rates has had an effect on keeping current and future interest costs relatively low.

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. Increased services in key portfolios and the impact of industrial settlements were the key drivers behind the increase in this ratio up to 2002-03. Although employee benefits paid by the government have continued to grow since that time ($842 million increase in 2004-05), these cost increases have been partially offset by an increase in total revenue over the last 2 years.

Flexibility conclusion

Overall, the government's financial flexibility has remained stable over the last 2 years off the back of a strong economy.

4.1.3 Vulnerability

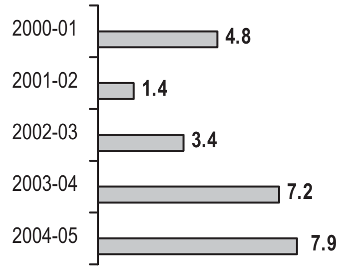
We use financial vulnerability indicators to assess the degree to which the government is dependent on (and therefore vulnerable to) domestic and international sources of funding outside its control.

We used the following 4 indicators.

Commonwealth revenue to total revenue (per cent)

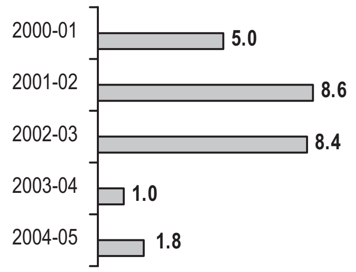
The ratio of Commonwealth revenue to total revenue indicates the dependence of the government on Commonwealth funding. This ratio increased in 2001-02 because of the revised Commonwealth-state taxation arrangements. The trend was reversed over the next 2 years with the improvement of equity markets and strong growth in property-related transactions. The current year has seen a reversal of this trend with an increased portion of revenue funded by Commonwealth grants. This was mainly due to the continued strength of the Australian economy.

Investment revenue to total revenue (per cent)



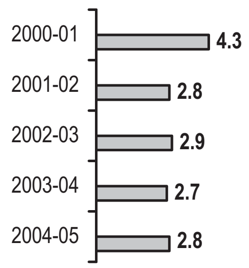
The ratio of investment revenue to total revenue indicates the extent to which the state relies on investment income (which is largely influenced by external conditions). Since 2001-02, there has been a steady increase in the amount of revenue generated through investments. The positive returns experienced are a direct result of the strong performance of domestic equity markets and indexed bonds, partially offset by the growth in the total revenue base.

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 decline in superannuation expenditure in the prior year has been sustained because of the impact of a continued strong equity market which, in turn, has led to a further decline in the net liabilities of superannuation funds.

Borrowing costs to total revenue (per cent)



The ratio of borrowing costs to total revenue measures the proportion of revenue spent paying interest on state debt. The more the government pays in interest, the less funds it has for its programs. The government's debt profile has remained fairly stable over the last 5 years with only minor increases to its interest-bearing liabilities, mainly resulting from increased finance lease obligations. Further, low interest rates have had a favourable effect on keeping current and future interest costs relatively low.

Vulnerability conclusion

Continued strong performance from the economy and domestic equity markets has helped maintain the government's overall strong financial position. The significant movements in Commonwealth grants, investment revenues and superannuation costs highlight the state's vulnerability to a number of external factors outside its control.

The last 2 financial years have been the strongest 2 consecutive financial years for the Australian share market since the build-up to the 1987 stock market crash. The Victorian economy has grown for 13 consecutive years and the Australian economy has grown for 14 consecutive years.

Commonwealth grants are subject to different variables outside the state's influence such as federal fiscal policies, and the performance of other state economies. Further, the Commonwealth Government is placing an increasing number of funding requirements on specific purpose grants, which have impacted on the timing of the receipt of these grants and imposed conditions which will require ongoing careful management.

While the state's financial position is strong, any downturn in the economy or investment markets beyond what is currently anticipated remains a budgetary risk for the government.

4.1.4 Overall conclusion on financial condition

Since 1999-2000, revenue has grown on average by a rate of 6.1 per cent per annum and expenditure has increased on average by a rate of 4.7 per cent per annum. The growth in revenue in the previous 12 months was marginally higher than the growth in expenditure.

State revenue is closely tied to the performance of the Victorian and Australian economy and investment markets (in particular equity markets). The increased revenues from these sources (e.g. Commonwealth grants and investment returns) and their impact on superannuation costs has improved the state's sustainability.

The government will need to continue to monitor factors impacting on its revenue base and carefully manage the rate of expenditure and commitment growth.

5. Revenue trends

5.1 Revenue trends

State's operating result	2003-04	2004-05	Movement
	($m)	($m)	($m)
Revenues	35 274	36 774	1 500
Expenses	31 508	32 812	1 304
Operating result	3 766	3 962	196

In 2004-05, state revenue totalled $36 774 million. Figure 5A shows the major variations in revenue from 2003-04.

FIGURE 5A: STATE REVENUE MOVEMENTS ($M)

Revenue item	2003-04	2004-05	Movement
	($m)	($m)	($m)
Grants	12 621	13 417	796
Taxation	9 963	10 282	319
Sale of goods and services	7 698	7 902	204
Investment revenue	2 531	2 912	381
Fair value of assets received free of charge or for nominal consideration	610	187	(423)
Fines and regulatory fees	625	665	40
Gain (loss) on disposal of physical assets	(45)	(35)	10
Other revenue	1 271	1 444	173
Total	35 274	36 774	1 500

Source: 2004-05 Annual Financial Report.

5.1.1 Grants

State revenues	2003-04	2004-05	Movement	Movement
	($m)	($m)	($m)	(%)
Grants	12 621	13 417	796	6.3

In 2004-05, the state received $13 417 million in grants from the Commonwealth Government, an increase of $796 million on the previous year.

The Commonwealth Government provides 2 types of grants to the state:

- general purpose grants, which include the state's share of goods and services tax (GST) receipts and national competition policy payments. These are untied grants that can be used by the states for any purpose
- specific purpose payments, which are generally earmarked for specific projects and have conditions attached. This category also includes amounts received by the state for on-passing to other bodies (such as local government and non-government schools).

In 2004-05, around 56 per cent of Commonwealth Government grants were general purpose grants. The balance were specific purpose payments.

Grants – General purpose grants

Intergovernmental Agreement

The June 1999 Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations, outlines the basis by which the Commonwealth Government collects GST revenue on behalf of the states and territories.

The agreement required the states and territories to forgo financial assistance grants, to abolish a range of state taxes, and review the need to maintain a number of other taxes by 2005.

A key feature of the agreement was a guarantee that no state or territory would be financially disadvantaged by the provisions of the agreement. In line with this guarantee, the Commonwealth Government agreed to provide budget balancing assistance (BBA) payments until the end of the 2005-06 financial year to offset any shortfall between the GST payments and a guaranteed amount based on the previous funding arrangements. Since 2003-04, the GST payments to Victoria have exceeded the guaranteed amount.

Early in 2005, as part of its discussions with the Commonwealth Government regarding the review of the remaining taxes raised by the state, the Victorian Government abolished the rental business duty (which raises around $65 million a year) from January 2007.

Figure 5B shows the taxes that were required to be abolished or reviewed under the agreement, and the current status of those taxes. All the taxes listed for abolition or review under the Intergovernmental Agreement have been or are earmarked to cease, with the exception of the stamp duty on non-residential property (real property) which raised around $514 million in revenue in 2004-05.

At the date of preparation of this report, the Commonwealth Government was considering the state's offer regarding the taxes listed for review in 2005.

FIGURE 5B: STATUS OF APPLICABLE STATE TAXES TO BE ABOLISHED/REVIEWED UNDER THE TERMS OF THE INTERGOVERNMENTAL AGREEMENT

Tax	Date to be abolished/reviewed	Date abolished by the state
Financial institutions duty	1 July 2001	1 July 2001
Stamp duty on quoted marketable securities	1 July 2001	1 July 2001
Stamp duty on unquoted marketable securities	To be reviewed by 2005	1 July 2002
Stamp duty on non-residential property (real property)	To be reviewed by 2005	Retained
Bank debits tax	1 July 2005	1 July 2005
Stamp duty on other business transactions -		
Leases	To be reviewed by 2005	26 April 2001
Bonds	" "	1 July 2001
Mortgages	" "	1 July 2004
Debentures	" "	1 July 2004
Other loan securities	" "	1 July 2004
Rental arrangements	" "	1 January 2007

Note: Does not include other taxes that were required to be abolished/reviewed that were not levied in Victoria or that were previously abolished before the Intergovernmental Agreement was signed. Prior to July 2001, duties on mortgage, debentures, bonds and other loan securities were payable on both real and non-real property. From July 2001 to June 2004, these duties were payable only on real property.

Source: Victorian Department of Treasury and Finance.

Goods and services tax (GST) revenue

In 2004-05, the state received $7 534 million from the Commonwealth Government in general purpose grants. This was an increase of $394.2 million from the previous year ($371 million GST general purpose grants and $23.2 million national competition policy payments), and continued the strong growth trend in GST revenue in recent years.

Under the terms of the intergovernmental agreement, the Commonwealth Grants Commission recommends per capita "relativities" for each state and territory, which the Commonwealth Government uses to apportion GST revenue. These relativities take into account differences in each jurisdiction's expenditure needs, and its capacity to raise other revenue.

In its *Report on state revenue sharing relativities - 2005 update*, the commission recommended an increase in Victoria's relativity. This recommendation was accepted in March 2005 and the state will receive an estimated additional $106 million in 2005-06.

National competition policy payments

In line with national competition policy agreements between the Commonwealth, and state and territory governments that were signed in 1995, related payments commenced in 1997. Under these agreements, Victoria is required to review legislation that restricts competition, ensure competitive neutrality in the operations of government businesses and comply with national reform frameworks relating to the gas, water and road transport sectors. Payments are made if the National Competition Council assesses that the state has complied with the requirements of the agreement. Once received, payments can be used for whatever purpose is decided by the state government.

Payments made under these agreements are distributed among the states on an equal per capita basis. In 2004-05, Victoria received $202 million, and expects to receive $197 million in 2005-06 which is the last year that national competition policy payments will be made.

The Commonwealth Government is expected to complete a review of the national competition policy by the end of 2005.

Grants - Specific purpose payments

The Commonwealth Government makes specific purpose payments for both recurrent and capital expenditure purposes. It uses various approaches to calculate and award payments, including using its discretion, with reference to past payments, and according to various formulas. In 2004-05, Victoria received an increase of $402 million in specific purpose payments. This mainly related to grants provided to non-government schools and for health care purposes. New specific purpose grants entered into related to a number of areas, including the National Water Initiative, and School and Vocational Education and Training funding.

National Water Initiative

The National Water Initiative is a strategy driven by the Commonwealth Government to improve water management across the country. The state agreed to be involved in this initiative in June 2004. Key elements of the initiative include:

- various strategies to return to the controlling agencies over-allocated surface and groundwater entitlements
- perpetual access entitlements to a share of water resources available for use
- the requirement that governments compensate entitlement holders for any changes in their entitlement that result from changes in government policy
- a robust and transparent regulatory water accounting framework that protects the integrity of entitlements
- measures to emphasise the need for urban users to use water efficiently (by promoting water reuse and recycling, more efficient technologies and a review of the effectiveness of pricing).

In September 2004, the Commonwealth Government committed $2 billion over 5 years to the Australian Water Fund. The fund will help finance projects that are consistent with the initiative's objectives.

The *2005-06 Budget Papers* did not include any revenue from the fund, as the Commonwealth Government's conditions of funding were uncertain at the time the Budget Papers were prepared. Subsequently, in June 2005, the Commonwealth Government committed $167 million from the fund to assist in financing the Wimmera-Mallee Pipeline Project. This project, which is estimated to cost $501 million, involves replacing open channels with the construction of over 8 000 kilometres of networked pipeline. The state has agreed to match the Commonwealth Government contribution.

School funding

Every 4 years, the Commonwealth Parliament passes legislation to fund government and non-government schools. As part of this process, a new bilateral funding agreement was negotiated with the state. The funding agreement is subject to enabling regulations and administrative guidelines, and came into operation on 1 January 2005.

Of the total $31.31 billion package to be spent over 4 years, about 28 per cent will go to Victoria commencing in the 2005 school year. Of this amount, around 72 per cent will be allocated to non-government schools. The Commonwealth Government provides 3 categories of grants including recurrent grants which assist in the general running costs of schools, capital grants to fund infrastructure works, and targeted programs including improving the teaching of disadvantaged students and students in rural locations.

Figure 5C illustrates the funding received and to be received by the state government for government schools.

FIGURE 5C: COMMONWEALTH FUNDING FOR STATE GOVERNMENT SCHOOLS ($M)

Funding	2004-05	2005-06	2006-07	2007-08	2008-09
Recurrent	388.701	417.901	448.704	481.378	515.418
Targeted programs	87.362	92.051	97.005	102.235	107.759
Capital	59.829	60.350	61.799	63.282	64.801
Total	**535.892**	**570.302**	**607.508**	**646.895**	**687.978**

Note: The Average Government School Recurrent Cost index is based on expected annual movements. The estimates do no include allowance for new capital funding announced in the 2005-06 Commonwealth Budget under the *Investing in our schools* program. Forward year projections are estimates.

Source: Source data supplied by the Department of Education and Training.

The increase in funding over the term of the new agreement essentially reflects increases in enrolments and indexation of payments (AGSRC index)[1].

Figure 5D illustrates the funding received and to be received by the state government for on-passing to non-government schools. The increase in funding over the term reflects changes to the basis of providing recurrent funding, and strong growth in expected student enrolments (compared with government schools).

---

[1] Indexation of government schools is based on the Average Government School Recurrent Cost (AGSRC) index. The index aims to measure increases in state and territory expenditure on government schools and thus the recurrent cost of providing education in these schools.

FIGURE 5D: FEDERAL FUNDING FOR STATE NON-GOVERNMENT SCHOOLS ($M)

Funding	2004-05	2005-06	2006-07	2007-08	2008-09
Recurrent	1 269.876	1 343.587	1 440.997	1 545.469	1 657.516
Targeted programs	64.333	64.682	68.305	72.130	76.169
Capital	29.128	29.862	30.579	31.313	32.064
Total	**1 363.337**	**1 438.131**	**1 539.881**	**1 648.912**	**1 765.749**

Note: The Average Government School Recurrent Cost index is based on expected annual movements. The estimates do not include allowance for new capital funding announced in the 2005-06 Commonwealth Budget under the *Investing in our schools* program. Forward year projections are estimates.

Source: Source data supplied by the Department of Education and Training.

All non-government schools will now be covered by the Socio Economic Status (SES) model[2], which was introduced in 2001 and phased in over 4 years. At the time of its introduction, the Commonwealth Government made a commitment that schools would not be financially disadvantaged by the SES system. Under the new funding agreement, Catholic schools which previously had separate general recurrent funding arrangements will be covered under the SES system. The new agreement maintains a funding guarantee to keep funding at 2004 levels and adjusted in line with movements in the government schools AGSRC index.

The enabling legislation for the new 4-year agreement imposed new requirements including requirements for greater national consistency, better reporting to parents and transparency of school performance. It also gave school principals greater autonomy, emphasised safety and physical activity, and makes "core values" a key part of schooling. Some of these additional conditions flow from decisions and processes agreed to by the Ministerial Council on Education, Employment, Training and Youth Affairs in April 2004. The Commonwealth minister can also include further conditions at their discretion.

Further to the legislative requirements, the state government must also meet requirements in the associated regulations and guidelines. These require the state to:

- increase government school funding at least in line with the rate of inflation
- use a transparent, nationally consistent formula for indexing funding to government schools
- adhere to the National Code of Practice for the construction industry in relation to funding provided for capital purposes.

---

[2] The Socio Economic Status model aims to measure the socioeconomic background of parents who send their children to non-government schools. The score achieved forms the basis of schools funding.

The Commonwealth Government will also provide an additional $1 billion of capital funding (above the $31.31 billion in the agreement) over the 4-year period of the agreement - $700 million for government schools, and $300 million for non-government schools. Unlike the longstanding practice for school funding, the Commonwealth Government will bypass state and territory governments' education authorities and will make and administer grants directly with schools. Grants of up to $150 000 per government school will be available to improve school infrastructure.

Vocational education and training

The Australian National Training Agreement was due to expire in December 2003. However, as we reported last year[3], due to a breakdown of negotiations between the states and territories and the Commonwealth Government, the agreement was extended for another year.

In October 2004, the Commonwealth Government announced the abolition of the Australian National Training Authority from June 2005, with the responsibility for administering the agreement being assumed by the Commonwealth Department of Education, Science and Training. Recent Commonwealth Government announcements indicate that it is favouring funding its own programs rather than increasing state and territory grants. These programs include funding for its New Apprenticeship Program, the establishment of 24 Australian technical colleges at the secondary level and the creation of an Institute for Trades Skills Excellence.

In September 2005, the Victorian Government accepted the Commonwealth Government's revised agreement which covers the period July 2005 to December 2008. The new package offers $4.92 billion to all states and territories of which the state government is expected to receive $1 180 million for the period 2005 to 2008, including $136.5 million funding for the period 1 January 2005 to 30 June 2005. Figure 5E shows the actual and projected funding to be received from the Commonwealth Government for vocational education and training.

---

[3] Victorian Auditor-General's Office 2004, *Report of the Auditor-General on the Finances of the State of Victoria, 2003-04*, Government Printer, Melbourne.

FIGURE 5E: FEDERAL FUNDING FOR VOCATIONAL EDUCATION AND TRAINING ($M)

Funding	2003	2004	2005	2006	2007	2008
Total funding (a)	1 113.907	1 129.418	1 148.059	1 231.017	1 269.533	1 290.737
State's share (b)	266.887	263.385	280.218	292.046	301.495	306.659

(a) Total funding for 2003-2005 obtained under the authority of the *Vocational Education and Training Funding Act 1992*. Total funding for 2006-2008 to be obtained under the authority of the *Skilling Australia's Workforce Act 2005*.

(b) State's share obtained from the Victorian Department of Education and Training.

Note: Table excludes other specific purpose grants received for vocational education and training, including *Recognising and improving the capacity of people with a disability* program.

The agreement is supported by recent Commonwealth legislation, which outlines the new funding framework and funding authority. The agreements and the enabling legislation requires a number of conditions to be met by the state and territory governments in order to receive their share of the funding. The conditions include:

- providing additional training places for traditional skills and other skills where there are shortages
- participation in joint projects with the Commonwealth Government and industry to examine skill shortages
- offering employment under Australian workplace agreements, and offering performance-based pay
- adherence to the national code of practice for the construction industry for infrastructure works funded by the Commonwealth Government
- access by other parties to the facilities of institutions that receive Commonwealth Government infrastructure funding
- development of a national fees policy and to minimise the impact of any fees changes
- prohibition on the use of Commonwealth Government funds for education or training for private recreational pursuits or hobbies, or for education and training to overseas students
- provision of reports against key performance measures.

Commonwealth Government funding conditions

In recent years, the Commonwealth Government has imposed a number of new funding conditions on specific purpose grants, particularly, relating to industrial relations. These include the national code of practice for the construction industry and, more recently, offering employment under Australian workplace agreements and performance-based pay.

In February 2005, the state government signed onto the AusLink funding agreement. This will provide Victoria with around $575 million over a 5-year period, starting from 1 July 2004. The governments agreed to apply the national code of practice to AusLink projects on a project-by-project basis. As outlined previously, in 2004-05, the state government also agreed to the National Water Initiative and signed agreements associated with schools assistance and vocational education and training. Part of the conditions of these packages were the application of the national code of practice and offering employment under Australian workplace agreements (specific to the vocational education and training package).

These new funding requirements will require careful ongoing management to ensure that the State meets the increased requirements attached to these grants, and continue to access the full amount available under specific purpose grants from the Commonwealth Government.

5.1.2 Taxation

State revenues	2003-04	2004-05	Movement	Movement
	($m)	($m)	($m)	(%)
Taxation	9 963	10 282	319	3.2

In 2004-05, the state's taxation revenue increased by $319 million. This was mainly due to a strong growth in payroll tax and land tax offset by declining revenue from conveyancing duty and the abolition of stamp duty on mortgages.

Overall stability of the state's tax base

Governments traditionally favour taxes that are relatively stable compared with Gross State Product (GSP)[4] at all stages of the economic cycle, and over time. This provides the government some certainty of being able to fund public services throughout the economic cycle, and as the state grows.

Figure 5F shows that in the 4 years to 2004-05, most state taxes increased at a faster rate than the growth in the GSP. Conveyancing duty, land tax, vehicle registration fees, vehicle stamp duty and taxes on insurance increased at a faster rate than the growth in the GSP. Only revenue from payroll tax and gambling taxes increased more slowly than the growth in the GSP. Many of the growth rates have been affected by policy changes and other factors such as the impact of the introduction of smoking bans on gambling taxes.

[4] Gross State Product (GSP) is the total value of final goods and services produced within the state over a financial year. Nominal GSP refers to the total amount of money spent on GSP, whereas real GSP adjusts this value for the effect of inflation in order to estimate the actual quantity of goods and services making up GSP.

FIGURE 5F: GROWTH IN GROSS STATE PRODUCT COMPARED WITH GROWTH IN KEY TAXES

Tax description	Percentage of total taxation revenue (a)	Nominal percentage change from prior period				
		2001-02	2002-03	2003-04	2004-05	Average
GSP		**6.3**	**5.5**	**7.4**	**5.5**	**6.2**
Stamp duty on conveyancing	24	45.7	11.8	16.1	(4.5)	**17.3**
Payroll tax	31	0.7	2.3	3.6	12.2	**4.7**
Land tax	8	(2.2)	27.2	14.7	13.9	**13.4**
Gambling	14	7.4	(3.2)	0.1	3.3	**1.9**
Vehicle registration fees	7	4.3	4.5	13.2	15.7	**9.4**
Vehicle stamp duty	6	7.2	9.3	8.2	2.2	**6.7**
Taxes on insurance	10	15.1	13.9	13.3	4.5	**11.7**

(a) Percentage of total taxation revenue based on 2004-05 year actual taxation receipts.

Source: Victoria's nominal Gross State Product (GSP) sourced from the Australian Bureau of Statistics for the financial years up to 2003-04. Estimate of the GSP for 2004-05 is sourced from the Victorian Department of Treasury and Finance.

Payroll tax

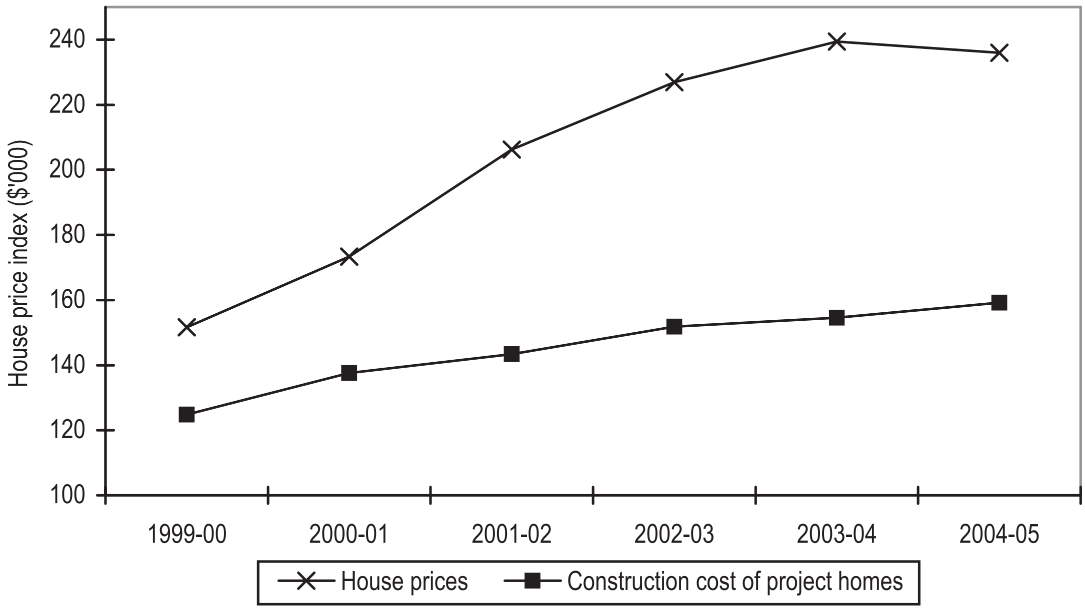
In 2004-05, payroll tax increased by 12.2 per cent. This was a result of growth in wages of around 3.9 per cent across the state, and strong labour market conditions including growth in state employment (3.3 per cent). Additional payroll tax of around $30 million was collected as a result of the full year impact of the removal of the exemption for this tax on existing apprentices and trainees wages and salaries. Further, additional payroll tax of approximately $10 million was collected as the result of employment agencies becoming directly liable for paying this tax, which came into effect for the last 6 months of the financial year[5].

Land Tax

Land tax is generally paid by those who own real property other than their own residence. In 2004-05, the state collected $808 million from land tax. This was an increase of 13.9 per cent from the previous year. The main variable determining the amount of tax collected is property values. Figure 5G shows the strong increase in resale prices for Melbourne since June 2000, and the flattening out of prices from 2003-04. The figure also shows the trend in the construction cost of project homes (excluding the value of the land). This reflects that much of the increase in established house prices up to 2003-04 has come from increases in the land value.

[5] From 1 January 2005, employment agencies are liable for payroll tax for their on-hired workers rather than the clients of the agencies.

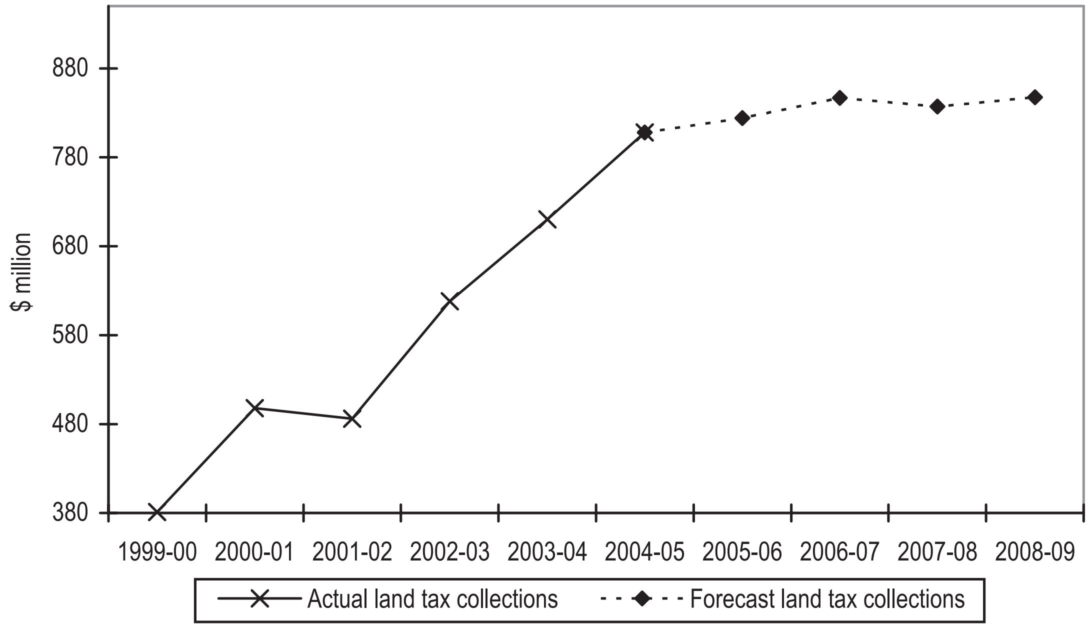
FIGURE 5G: MELBOURNE HOUSE PRICE MOVEMENTS



Sources: Australian Bureau of Statistics, *House Price Indexes: Eight Capital Cities Series*, cat. No. 6416.0, ABS, Canberra, June Quarter 2005.

Figure 5H shows that land tax collections have increased significantly, from $381 million in 1999-00 to $808 million in 2004-05. This was due mainly to substantial appreciations in underlying land valuations as determined by the Valuer-General. The majority of the increase in 2004-05 related to the introduction of land tax on transmission companies' electricity easements. Figure 5H also shows that land tax collections remained stable in 2004-05 (when taking into account the impact of the land tax on electricity transmission easements). The government projects that it will remain around the same level through to 2008-09, reflecting changes in land tax scales announced in the 2005-06 State Budget over a 5 year period. Increases in land values are forecast to slow during this period.

FIGURE 5H: LAND TAX COLLECTIONS



Note: Forward year estimates are not adjusted for inter-entity transactions.

Sources: 1999-00 to 2001-02 - the Department of Treasury and Finance. 2003-04 to 2004-05 - the government's Annual Financial Report. The forward year's estimates (2005-06 to 2008-09) obtained from the State Budget Papers.

The projected reduction in land tax revenue arising from the budget initiatives will be partially offset by the introduction of a new congestion levy to be collected from owners of long stay car parks in the central business district of Melbourne. The levy is estimated to generate around $139 million between 2005-06 and 2008-09 and will be disclosed as part of taxes from immovable property.

Stamp duty on conveyancing

Conveyancing duty is levied on property purchases and land transfer transactions . The duty is levied on a sliding scale, whereby the amount of tax paid increases with the value of the property purchased. In 2004-05, the state collected $2 337 million from conveyancing duty. This was a 4.4 per cent decrease from the previous year.

The Reserve Bank of Australia has recently developed a new index of house prices which highlights a recent slowing in the growth in house prices. As Figure 5I shows, in the 18 months prior to the 2003 December quarter, average Melbourne house prices increased by 20 per cent. In the 18 months since that date, they have remained stable.

FIGURE 5I: COMPOSITION-ADJUSTED HOUSE PRICES (PERCENTAGE CHANGE)

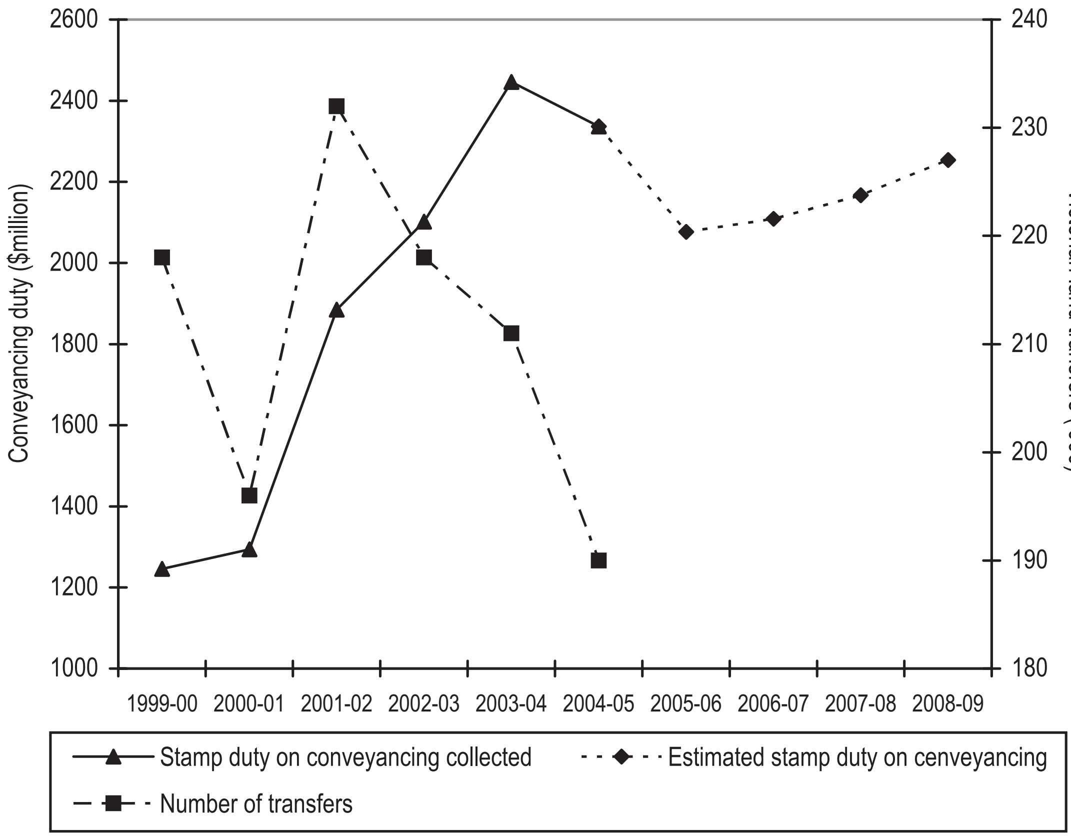
Capital city	18 months to December quarter 2003	18 months to June quarter 2005
Sydney	25	(7)
Melbourne	***20***	***0***
Brisbane	62	5
Adelaide	35	9
Perth	33	19
Canberra	41	0
Australia	***29***	***0***

Source: Reserve Bank of Australia, Statement of Monetary Policy, 8 August 2005.

With stable average house prices over the last 18 months, the primary driver of any change in the revenue from stamp duty and conveyancing is the movement in the other key variable, the volume of transactions. Figure 5J shows that the number of property transfers has fallen in the past 3 years with a 10 per cent fall in 2004-05. Despite this, as indicated previously, revenue collected decreased by 4.4 per cent. The revenue pattern is complicated by one large transaction that occurred in the 2003-04 financial year - the Loy Yang A power station was sold with stamp duty of $85 million raised in April 2004. When eliminating this one-off transaction, revenue from this source decreased by around one per cent.

Despite the stability of capital city prices, revenue from stamp duty on conveyancing decreased by a slower rate than property transfer numbers. This is attributable to the growth in property prices for higher valued properties.

FIGURE 5J: STAMP DUTY COLLECTIONS ON PROPERTY TRANSFERS



Sources: For 1999-00 to 2004-05, conveyancing tax amounts are sourced from the state's Annual Financial Reports. For 2005-06 to 2007-08, estimates are sourced from the Budget Papers. Property transfer data is sourced from the Victorian State Revenue Office.

The government anticipates that collections from stamp duty on conveyancing will continue to decrease for another 12 months before the downward trend is reversed.

The strong housing market and growth in house prices has been an overriding feature of the state's taxation collections for the last 5 years. The financial impact of a downturn in the housing market has been factored into the government's fiscal strategy.

Bank accounts debit tax

In line with the 1999 Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations, bank account debits tax was abolished from 1 July 2005. This tax raised $266 million in 2004-05, compared with $256 million in 2003-04. This loss of tax revenue has already been offset by the growth in GST-related grants from the Commonwealth Government.

Gambling fees and taxes

Gambling revenue consists of fees and taxes levied on lotteries, electronic gaming machines (EGMs), casino operations and racing. In 2004-05, the state collected $1 369 million from gambling fees and taxes. This was a 3.3 per cent increase from the previous year.

From July 2000, a levy of $333 per electronic gaming machine was applied each year to fund drug and alcohol programs. The levy was subsequently increased to $1 533 from July 2001, following a state government review of state business taxes[6]. In the 2005-06 State Budget, the government further increased the levy to $3 033 which is expected to raise an additional $45 million per year.

In 2004-05, of the total gambling fees and taxes collected, $304 million was collected from its lotteries licence ($305 million in 2003-04). Tattersalls holds the exclusive lotteries licence, which expires on 30 June 2007.

In March 2005, the government announced that it will conduct a competitive process that will result in the awarding of an exclusive, or up to 3 non-exclusive licences post-2007. The financial impact of this process will not be known until it is finalised. Accordingly, the government has not factored the impact of the awarding of new licences into the forward estimates for gaming revenue.

---

[6] The Victorian Government's *Review of State Business Taxes Report*, released in February 2001.

5.1.3 Sale of goods and services

State revenues	2003-04	2004-05	Movement	Movement
	($m)	($m)	($m)	(%)
Sale of goods and services	7 698	**7 902**	204	2.6

In 2004-05, revenue from the sale of goods and services increased by $204 million. The increase was mainly due to increased revenue collections by water authorities and VenCorp (due to a revised price structure to market participants), and the CPI indexation of fees.

The government's policy is to recover the cost of providing the goods and services sold - that is, charges are set according to user-pays principles. Charges are raised in line with movements in the CPI, or on the basis of revised costings.

From July 2004, a new price structure was introduced by water authorities as part of the government's *Our Water Our Future* initiative. The new structure comprises a 3-step block tariff, based on a user-pays system. It is estimated that an additional $100 million was collected from the new price structure in 2004-05.

In 2004-05, the water sector accounted for around 15 per cent of the total sale of goods and services revenue. This is expected to further increase in 2005-06 following a ruling in June 2005 by the Essential Services Commission (ESC) on state water prices. The ESC, which regulates prescribed essential utility services, announced increases in prices to be charged by each of the 22 water businesses, ranging from 0.5 per cent to 8.4 per cent each year (from 2005-06 to 2007-08), before adjusting for inflation.

5.1.4 Investment revenue

State revenues	2003-04	2004-05	Movement	Movement
	($m)	($m)	($m)	(%)
Investment revenue	2 531	**2 912**	381	15.0

In 2004-05, the state's investment revenue increased by $381 million. The movement is mainly due to across-the-board increases in returns within the investment portfolio, with the exception of international equities.

The state's increase in financial assets has provided it with a significant source of revenue. As outlined in Part 7 - *Asset trends* of this report, the investment performance is largely dependent on the investment strategy adopted by the particular agency to meet its objectives. Investments held by the 4 major investment agencies make up 94 per cent of the state's total investment portfolio.

The investment performance of these 4 agencies, and the State Superannuation Fund is detailed in Figure 5K. All agencies, with the exception of the Victorian Managed Insurance Authority (VMIA) improved on their 2003-04 performance. The VMIA's reduced returns were mainly due to its lower tolerance for risk than other agencies.

FIGURE 5K: KEY AGENCIES INVESTMENT PERFORMANCE (a)

Agency	Investment return 2002-03	Investment return 2003-04	Investment return 2004-05	3-year average return
Department of Treasury and Finance (b)	8.70	3.58	n.a.	4.09
Treasury Corporation of Victoria (b) (c)	5.25	5.09	5.43	5.26
Transport Accident Commission	3.83	13.02	13.93	10.26
Victorian Managed Insurance Authority	-0.45	12.94	12.48	8.32
Victorian Workcover Authority	-0.96	14.25	14.46	9.25
State Superannuation Fund (d)	0.68	16.19	16.40	11.09

(a) Investment returns at market value before fees.

(b) The Department of Treasury and Finance investments were transferred to the Treasury Corporation of Victoria in July 2004.

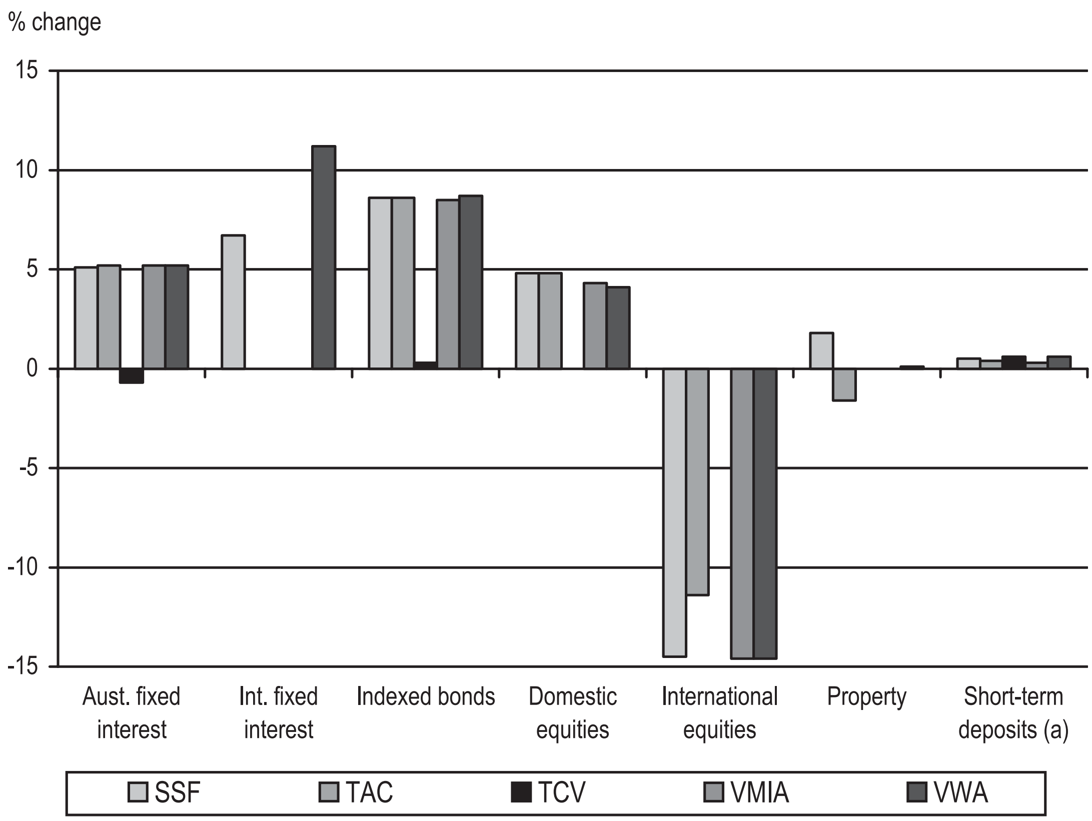
(c) Excludes loans to participating authorities as these are eliminated upon consolidation when preparing the government's Annual Financial Report.

(d) The investment returns of public sector superannuation funds are not included in the Annual Financial Report because they are not assets of the state, however, the investment returns impact on the state's unfunded superannuation liabilities and are, therefore, included as part of this analysis.

Source: Investment reports of the respective agencies, June 2005 and Treasury Corporation of Victoria Annual Report for 2004-05.

With increased investment holdings comes an increase in investment risk - that is, the chance of loss due to the uncertainty of future events. Many factors outside the control of the state government can affect the performance of investments. Figure 5L illustrates the movement in the investment returns between 2003-04 and 2004-05 for each investment category for the agencies with significant financial asset holdings.

FIGURE 5L: MOVEMENT IN INVESTMENT RETURNS BY EACH INVESTMENT CATEGORY BETWEEN 2003-04 TO 2004-05 (PER CENT)



(a) Short-term deposits include floating rate interest investments held by TCV.

Legend:
SSF – State Superannuation Fund
TAC – Transport Accident Commission
TCV – Treasury Corporation of Victoria
VMIA – Victorian Managed Insurance Agency
VWA – Victorian WorkCover Authority

Figure 5M illustrates the actual returns reported by each agency during 2004-05. This demonstrates that although some categories have experienced negative movements from the prior year they have still achieved positive returns.

FIGURE 5M: INVESTMENT RETURNS BY CATEGORY FOR 2004-05 (PER CENT)

2004-05 investment returns by category								
	Aust. fixed interest	Int. fixed interest	Indexed bonds	Domestic equities	Inter-national equities	Property	Floating rate securities	Short-term deposits
TCV	5.47	-	5.87	-	-	-	5.61	5.34
VMIA	7.97	-	11.48	26.35	6.91	-	-	5.62
TAC	7.91	-	11.57	26.98	8.47	17.67	-	5.18
VWA	7.76	12.00	11.57	26.98	4.09	16.21	-	5.44
SSF	7.82	11.77	11.42	27.33	8.26	14.48	-	5.59

Legend:
SSF – State Superannuation Fund
TAC – Transport Accident Commission
TCV – Treasury Corporation of Victoria
VMIA – Victorian Managed Insurance Agency
VWA – Victorian WorkCover Authority

Note: Investment returns are before fees.

Source: Investment reports of the respective agencies, June 2005 and Treasury Corporation of Victoria Annual Report for 2004-05.

Equities are inherently risky assets, and are subject to volatility over the short to medium term, including negative returns in some years. In 2004-05, the most significant movement in the investment portfolio has been in international equities. Despite producing positive returns for the year (ranging from 4.09 per cent to 8.47 per cent), the returns achieved were down by around 11 to 14 per cent compared with the previous year. The decreased returns compared with the previous year were due in part to the appreciation of the Australian dollar over the period which meant that currency losses impacted on the returns. The extent to which this occurred depended on the agency's hedging strategy[7].

In 2004-05, returns on domestic equities were 5 per cent above the previous year. Returns ranged from a very healthy 26.35 per cent to 27.33 per cent. Generally, the last 2 years have been the strongest consecutive financial years for the Australian share market since the build-up to the 1987 stock market crash.

[7] All of the agencies adopt various hedging strategies in order to decrease exchange rate exposure, however, none of the agencies have a 100 per cent hedging strategy.

There were across-the-board increases in returns for indexed bonds and fixed interest investments. This was mainly attributable to a decrease in bond yields in all major bond markets caused by concerns over world economic growth due to the rapid rise of oil prices in global markets. Indexed bonds and fixed interest investments benefited as their yields were locked in prior to the decline occurring. Declining bond yields have a positive effect on the value of existing indexed bond and fixed interest investments held as the yields are at a higher rate. Increases in Australian fixed interest returns were partially offset by the impact of pressures on the short-term domestic interest rate.

Dividend revenue from government business enterprises

There are around 110 government business enterprises (GBEs). They are categorised as either public non-financial corporations or public financial corporations[8].

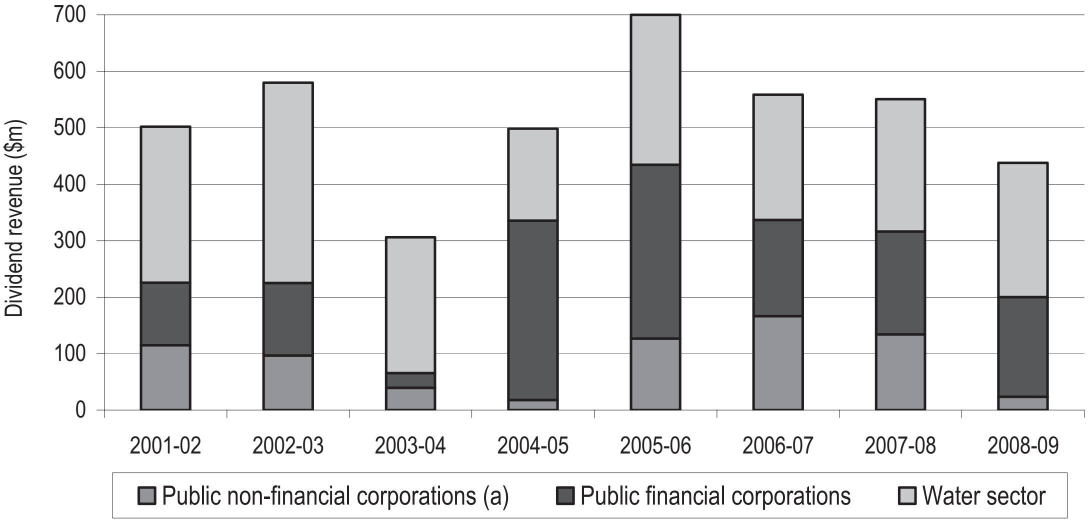
In 2004-05, GBEs generated revenues of $11 222 million and incurred expenditure of $9 111 million and, at 30 June 2005, held assets of $74 737 million and liabilities of $37 998 million. During 2004-05, GBEs paid dividends into the Consolidated Fund within the Public Account totalling $501 million, an increase of $194 million compared with the previous year.

Figure 5N shows the actual dividend revenue for the period 2001-02 to 2004-05 and forecast dividend revenue for the period 2005-06 to 2008-09.

---

[8] Public Financial Corporations and Public Non Financial Corporations are described in section 2 of this Report.

FIGURE 5N: ACTUAL AND FORECAST DIVIDEND REVENUE ($M)



(a) Excludes water sector (shown separately).

Note: Excludes public authority contributions.

Source: 2001-02 to 2004-05 - government's Annual Financial Report. 2005-06 to 2008-09 data sourced from the State Budget Papers. The impact of the Essential Services Commission decision on water prices announced in June 2005 is not included in the forward estimates of dividend revenue to be obtained from the water sector.

The increase in dividend revenue in 2004-05 was mainly due to:

- the Transport Accident Commission paying a dividend of $295 million for the first time since 2000-01, resulting from substantially improved investment returns
- a reduction in dividends from the water sector of some $78 million, mainly due to the Melbourne Water Corporation deferring the payment of an interim dividend of around $50 million.

In 2005-06, the state expects dividend income to increase by a further $199 million. This will occur due to the expected payment of a dividend by the State Electricity Commission of Victoria ($100 million), the payment of the deferred 2004-05 interim dividend by the Melbourne Water Corporation ($50 million) and a proposed payment of a special dividend from the Treasury Corporation of Victoria ($45 million).

Environmental contributions

In May 2004, the government announced its *Our Water Our Future* initiative. As part of the initiative an environmental charge was levied on agencies in the water sector. This resulted in $44.6 million being paid into the Consolidated Fund within the Public Account in 2004-05 and is expected to raise $60 million per annum thereafter. Due to its nature, it is separately disclosed and not classified as dividend revenue.

5.1.5 Resources received free of charge

State revenues	2003-04	2004-05	Movement	Movement
	($m)	($m)	($m)	(%)
Fair value of assets received free of charge or for nominal consideration	610	**187**	(423)	(69.3)

In 2004-05, the fair value of assets received free of charge or for nominal consideration decreased by $423 million compared with the previous year. The decrease was mainly due to a one-off transaction in the prior year ($367 million) related to the return of the existing rolling stock to the state from a public transport franchisee (National Express Group Australia)[9].

5.1.6 Fines and regulatory fees

State revenues	2003-04	2004-05	Movement	Movement
	($m)	($m)	($m)	(%)
Fines and regulatory fees	625	**665**	40	6.4

In 2004-05, fines and regulatory fees increased by $40 million from the prior year.

Fines

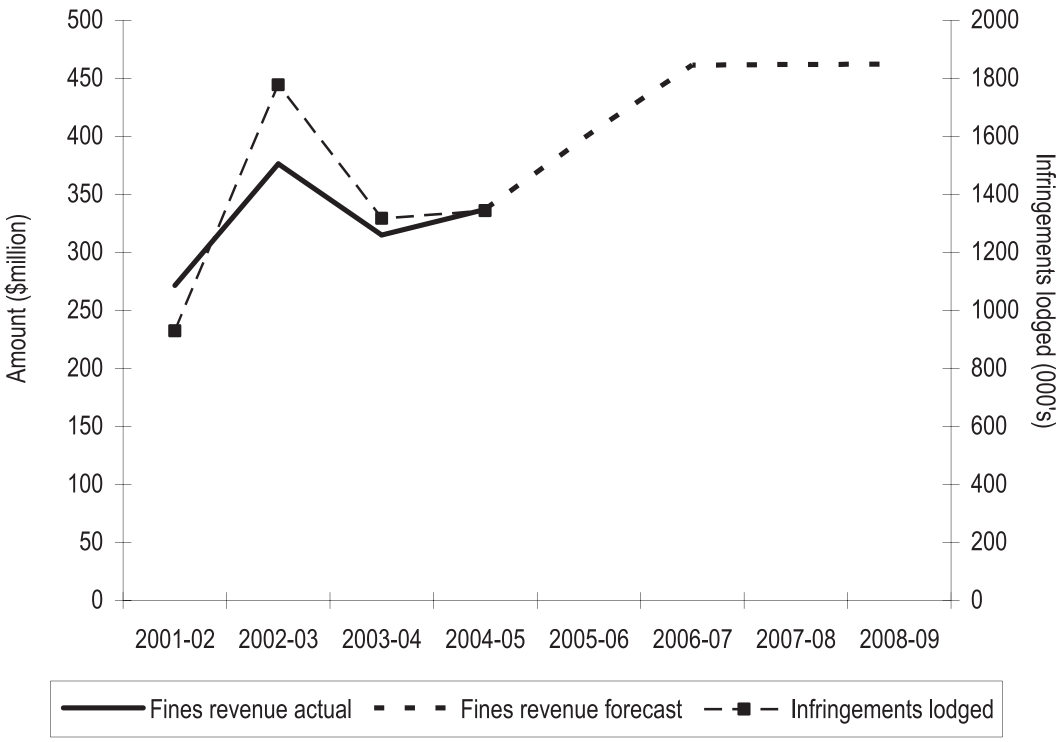
Most fine revenue comes from policing activities, including outsourced traffic camera operations. Revenue from this source totalled $337 million in 2004-05, an increase of $22 million (or 7 per cent) compared with the previous year. The majority of the increase related to the automatic indexation of fines in accordance with the forecast movements in the consumer price index (2.25 per cent) and the gradual re-introduction of previously withdrawn fixed traffic cameras.

[9] Refer to the Report of the Auditor-General on the Finances of the State of Victoria, 2003-04 for further details.

Fine revenue from fixed traffic cameras has been adversely affected by problems first identified with the Western Ring Road fixed cameras in November 2003[10]. Fixed traffic cameras were re-introduced in the last 7 months of 2004-05 on the CityLink and Monash Freeway. Traffic cameras on the Western Ring Road continue to be non-operational and are expected to be working from February 2006, after tenders to install and maintain the cameras have been let.

Figure 5O shows the impact on revenue from the gradual reintroduction of the traffic cameras. The government expected to see revenues from this source return to similar amounts and trends previously experienced in 2002-03. The forward year estimates for fines do not include the projected fine revenue that will be generated by traffic cameras to be installed on the EastLink Tollway and any changes resulting from the government's review of speed zones announced in August 2005.

FIGURE 5O: INFRINGEMENT LODGEMENTS AND FINE REVENUE



Note: Excludes regulatory fees.

Source: 2001-02 to 2004-05 actual data is sourced from data provided by agencies which comprise the figure included in the Annual Financial Reports. The 2005-06 and forward years data is sourced from the Department of Treasury and Finance.

[10] Refer to the Auditor-General's Report on the Finances of the State of Victoria, 2003-04 for further details.

The government announced in the *2005-06 Budget Papers*, that it would use the fine revenue collected from speed and red light camera operations to fund road improvements. However, this revenue source does not provide additional funding for road improvements as it replaces existing funding sources.

Commentary on outstanding fine debtors is provided in Part 7 - *Asset trends* of this report.

5.1.7 Other revenue

State revenues	2003-04	2004-05	Movement	Movement
	($m)	($m)	($m)	(%)
Other revenue	1 271	**1 444**	173	13.6

Other revenue, by its nature, consists of a range of miscellaneous revenue items, some of them one-off transactions. Significant transactions in this category in 2004-05 include revenue relating to the EastLink Project and the CityLink concession notes.

As detailed in the *Expenditure Trends* section of this Report, two transactions relating to the East Link Project impacted on state revenue. Under the arrangements associated with the project, the consortium contributed $35.6 million to the state.

Part 7 - *Asset trends* in this report also provides commentary on the gain ($96 million) arising from the revaluation of the CityLink concession notes.

6. Expenditure trends

6.1 Expenditure trends

State operating result	2003-04	2004-05	Movement
	($m)	($m)	($m)
Revenues	35 274	**36 774**	1 500
Expenses	31 508	**32 812**	1 304
Operating result	**3 766**	**3 962**	**196**

In 2004-05, state expenditure totalled $32 812 million, a $1 304 million increase on the previous year. Figure 6A shows the major variations in expenditure from 2003-04.

FIGURE 6A: STATE EXPENDITURE MOVEMENTS ($M)

Expenditure item	2003-04	2004-05	Movement
	($m)	**($m)**	($m)
Employee benefits	10 621	**11 463**	842
Supplies and services	12 812	**13 860**	1 048
Superannuation	364	**645**	281
Depreciation and amortisation	1 764	**1 909**	145
Borrowing costs	939	**1 012**	73
Grants and transfer payments	3 449	**3 864**	415
Other expenses	1 559	**59**	(1 500)
Total	**31 508**	**32 812**	**1 304**

Source: 2004-05 Annual Financial Report.

6.1.1 Employee benefits

State expenses	2003-04	2004-05	Movement	Movement
	($m)	($m)	($m)	(%)
Employee benefits	10 621	**11 463**	842	7.9

In 2004-05, the state's expenditure on employee benefits was $11 463 million, an increase of $842 million (7.9 per cent) on the previous year. This increase resulted from net additional costs of major public sector industrial agreements and budget initiatives, and the impact of salary growth on entitlements for long service leave.

Labour market

The government is a major employer in the state and has extensive service delivery functions in labour intensive sectors, including health, education and law enforcement. As such, labour is a major component of government expenditure.

The number and cost of public sector employees is influenced by various factors, including enterprise bargaining outcomes, developments in technology, demographic changes, community expectations, economic growth and government policy decisions.

Recently commissioned government reports in 2 key labour intensive sectors, namely health and education, accounting for 74 per cent of the total public sector employment costs, highlight a range of work force pressures and challenges confronting these sectors. In November 2004, the Department of Human Services[1] estimated that by 2011-12, Victoria would need for the public hospital system an additional 9 113 nurses, or 7 200 full-time equivalents (FTEs)[2]. Based on an average salary (including on-costs) of $73 800 a year, the government would need to spend an extra $531 million a year above the current cost of health sector employee entitlements to fund the additional nursing positions.

The education sector also faces labour market challenges, in particular an ageing teacher profile. The Department of Education and Training estimated that around 54 per cent of its teachers were over the age of 45 in 2004. Subject to continuing trends, a large portion of the retiring teacher population will need to be replaced in a projected climate of a tightening labour market.

---

[1] *Nurses in Victoria: A supply and demand analysis*, published by Service and Workforce Planning, Victorian Government Department of Human Services, Melbourne, Victoria, November 2004.

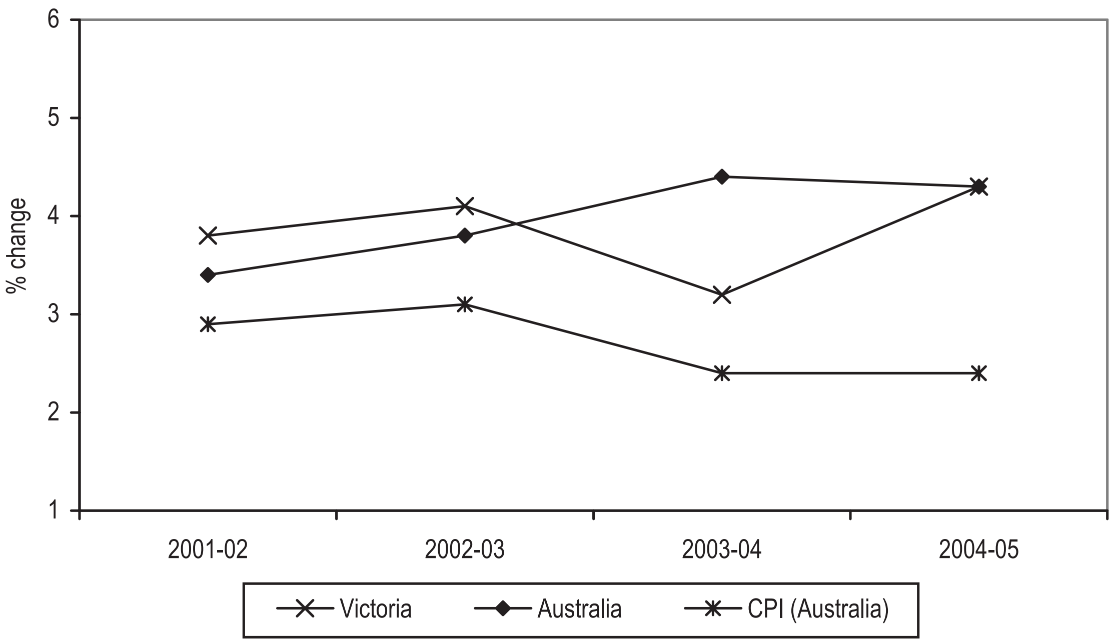
[2] Division 1 and 2 nurses, which account for around 96 per cent of the registered nurses in the state.

Labour market and demographic changes foreshadow that the next 10 years will pose a significant fiscal challenge for the state. It will need to actively manage this challenge to ensure that costs remain manageable and service levels remain acceptable to the community.

Victorian public sector wage trends

Figure 6B shows changes in recent years in the wage price index, which measure changes in wages and salary costs in the Australian labour market. In 2004-05, the wage cost for the state public sector increased by 4.3 per cent. This was on par with the Australian public sector average. However, Figure 6B shows that the increases in the public sector wage price index continue to exceed the movements in the consumer price index.

FIGURE 6B: PUBLIC SECTOR WAGE PRICE INDEX



Note: Wage cost index based on total hourly rates of pay excluding bonuses for the public sector.

Source: *Wages Cost Index* cat. No. 6345.0, Australian Bureau of Statistics, June 2005. Consumer Price Index – weighted average of 8 capital cities sourced from Australian Bureau of Statistic Consumer Price Index Publication – June 2005.

Enterprise bargaining agreements

In our *Report of the Auditor General on the Finances of the State of Victoria, 2003-04*, we detailed the government's wages policy for all new enterprise bargaining agreements. This included:

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

Members of the Police Association, Intellectual Disability Services Union and Metropolitan and Rural Ambulance Services' employees were covered by key agreements that expired in 2004-05.

In November 2001, the government entered into an enterprise bargaining agreement with the Police Association of Victoria, covering sworn police officers, protective service officers and recruits. Although the agreement was for the period December 2001 to December 2004, both parties stated that they would take up the option in the agreement to extend the period to December 2006.

The exercise of this option bypassed the requirement to comply with the government's wages policy for all new enterprise bargaining agreements. Accordingly, Police Association of Victoria members covered by the enterprise bargaining agreement received increases of more than 4 per cent per year for the additional 2 year period (excluding progression increments).

In July 2005, the new Intellectual Disability Services agreement commenced and will expire in December 2007. It provides for 3 per cent pay increases to be paid in July 2004, January 2005, January 2006 and January 2007, additional increment levels and for pro-rata long service leave after 7 years of continuous service. The additional service delivery improvements included efficiencies in rosters and in the management of WorkCover-related issues.

The Metropolitan and Rural Ambulance Services' agreements expired in May 2004. As the service and the government failed to agree on a new agreement, the Australian Industrial Relations Commission terminated the bargaining period and dealt with the issue. It handed down its decision in July 2005, to be implemented in August 2005. This agreement had no impact on salary costs in 2004-05.

Key agreements to be negotiated in 2005-06 include those covering public hospital medical staff (Australian Medical Association), hospital support staff, and metropolitan and country fire fighters.

In 2004-05, the Commonwealth Government announced its intention to make major changes to Australia's workplace relations system. These changes may have implications for future state enterprise bargaining agreements.

Initiatives in 2005-06 Budget Papers

In the *2005-06 Budget Papers*, the government announced 3 new initiatives that will have a substantial impact on employee costs in future years. Two of the initiatives were in the education and training sector, (*Additional Resources for Schools* and *Equity in Education and Training)* which will add costs of $48.8 million in 2005-06 and $192 million over the following 3 financial years. The third initiative in the human services sector (*Hospital Futures)* will add $104.3 million onto employee entitlements expenditure in 2005-06 and $290 million over the following 3 financial years.

Impact of industrial agreements and budget initiatives

Figure 6C shows the estimated net additional costs of major public sector industrial agreements and associated budget initiatives since 2000-01. In 2004-05, these costs were estimated at $2 485 million, compared with $1 927 million in 2003-04. This was an increase of $558 million for the year. These costs are expected to increase to $3 043 million in 2005-06.

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

Salaries and on-costs	2003-04	2004-05	2005-06	2006-07
Agreements cost				
Impact of major prior year agreements (b) (c) (e) (f)	1 557 355	1 996 244	2 344 719	2 657 833
Impact of major agreements entered in 2004-05 -				
DHS Disabilities EBA	-	17 585	23 533	31 733
Sworn Police Officers (included in the impact of major prior year agreements)	-	-	-	-
Total estimated cost of major agreements	**1 557 355**	**2 013 829**	**2 368 252**	**2 689 566**
Less redirection of existing funding towards agreements and savings resulting from redundancies and attrition rates -				
Redirection and savings requirements for prior year agreements(c)	84 300	91 900	91 900	91 900
Total net cost to the state of new agreements, excluding impact of policy decisions (e)	**1 473 055**	**1 921 929**	**2 276 352**	**2 597 666**
Major policy decisions – additional permanent staff -				
Prior year decisions (c)	**453 800**	**563 160**	**613 193**	**657 944**
Major new funding decisions arising from 2005-06 Budget initiatives -				
DET – Additional resources for schools	-	-	38 142	42 791
DET – Equity in Education and Training	-	-	10 730	21 460
DHS – Hospital Futures	-	-	104 300	96 200
Total estimated cost of new budget initiatives	**-**	**-**	**153 172**	**160 451**
Total estimated cost of policy decisions	**453 800**	**563 160**	**766 365**	**818 395**
Total net cost including additional staff (d)	**1 926 855**	**2 485 089**	**3 042 717**	**3 416 061**
Net increase on prior year	**-**	**558 234**	**557 628**	**373 344**

(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 *Report of the Auditor General on the Finances of the State of Victoria* for 2001-02, 2002-03 and 2003-04 for further details.

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

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

(f) Includes the financial impact of extending the sworn police officers enterprise bargaining agreement.

Source: Victorian Auditor-General's Office.

Impact on unfunded superannuation liability

Each year, superannuation fund actuaries estimate the state's unfunded superannuation liability taking into account among other things the estimated increases in the consumer price index, rate of investment returns and rate of general salary escalations. The actuary for the State Superannuation Fund (which accounts for 97 per cent of total unfunded superannuation liabilities) estimated that the impact of salary increases above the 4 per cent actuarial assumption, was an increase of around $39 million on the unfunded superannuation liability for the 12 month period ending 30 June 2005.

RESPONSE provided by Treasurer

The Government has committed additional resources to improving outcomes for Victorians, particularly in high priority areas such as health, justice and education. As a result of the increase in the delivery of Government services, and the impact of public sector industrial agreements, employee costs increased during 2004-05.

The benefits of the Government's increased investment in the community continued to occur during 2004-05. Since 1999 this has included:

- *an additional 5 300 full-time teachers and other staff*
- *an additional 5 766 nurses*
- *an additional 1 283 full-time equivalent sworn police.*

Employee benefits are one component of Government initiatives, and are approved as part of the Government's budget strategy. These initiatives fit within the Government's annual target of a $100 million surplus.

6.1.2 Supplies and services

State expenses	2003-04	2004-05	Movement	Movement
	($m)	($m)	($m)	(%)
Supplies and services	12 812	13 860	1 048	8.2

In 2004-05, the state's expenditure on supplies and services increased by $1 048 million, or 8.2 per cent. This was mainly the result of transactions associated with the EastLink tollway, the state's contribution towards the Royal Melbourne Showgrounds redevelopment, increases in accident claims for the Transport Accident Commission, and the indexation of payments under public private partnership arrangements and service contracts in line with movements in the consumer price index.

EastLink tollway

In October 2004, the state signed a contract with the ConnectEast Consortium to design, build, operate and maintain EastLink (previously known as the Mitcham-Frankston Freeway). The tollway will connect Melbourne's eastern suburbs to Frankston and surrounding suburbs with approximately 40 kilometres of non-stop roadways. The consortium will construct the roadway over a 4 year period and operate the tollway for 35 years, and is required to build and maintain all infrastructure to achieve a design life of up to 100 years. At the end of the 39 year period, the tollway will revert to the state at no cost.

The state is not required to make any payments to the consortium during the 39 year period. The project is being constructed on state-owned land, leased to the consortium for nominal consideration. The state is, however, required to contribute some state-owned works, including the Eastern Freeway extension beyond Springvale Road, which will form part of the tollway. In return, the consortium will provide a tollway and is also required to construct certain connecting works which will not form part of the tollway.

The financial impact of this project on the state's finances in 2004-05 was an overall net cost of $282.4 million, consisting of:

- the value of state land ($218 million) leased to the consortium for the 39-year period for nominal consideration was expensed when the construction commenced
- the value of state works ($100 million) contributed to the consortium were expensed

- an amount equivalent to the impact of favourable movements in interest rates on the consortium's financing arrangements up to the point of financial close was paid to the state ($15.6 million)
- a contribution by the consortium was due to the state ($20 million) and was subsequently received and paid into the Public Transport Trust Fund to be used by the state to provide public transport and other facilities in the Mitcham-Frankston corridor.

The financial impact of the project on the state's finances in future years will be:

- works completed by the consortium and contributed to the state will be recognised as a state asset when construction is complete (expected in 2008)
- the freeway and associated land will be recognised as a state asset when the contract expires in 2047. In the meantime, it will be disclosed as a contingent asset in the government's Annual Financial Report.

A report by my Office on the results of a review of the progress of this project will be tabled in parliament at a later date.

2006 Commonwealth Games

The 2006 Commonwealth Games will be one of the largest international sporting event ever hosted by the state. With less than 4 months before the commencement of the 2006 Commonwealth Games, we continued to examine its progress, given the significant demand on the financial resources of the state required to host the games.

Revisions to the games' budget

In 2002-03, the government announced that the whole-of-games' budget would be $1 142 million, including the cost of related capital works. At that time, the government also capped the state's contribution to the cost of hosting the games, excluding the cost of capital works, at $474 million. This contribution includes additional costs associated with staging of the games, but does not include costs of existing services operating during the games. These will be met from agencies' existing budget allocations.

Although the government has capped its contribution towards the games, it is required by the terms of the host city contract signed in 1996 to underwrite any shortfall between revenue and expenditure incurred by the organising committee (the Melbourne 2006 Commonwealth Games Corporation). In addition, the state has also provided a range of guarantees and indemnities for the Melbourne Cricket Ground Northern Stand redevelopment, and a loan facility to the Melbourne Cricket Club via the Treasury Corporation of Victoria. We intend to examine the financial implications of these guarantees and indemnities on completion of the redevelopment.

It is not an easy task to estimate games revenues (such as ticket sales, sponsorship, and domestic and international broadcast rights), given the many factors that affect these revenue sources.

In the 2004-05 financial year, 1 248 862 tickets were made available Australia-wide through a public ballot and special ticket offer. Of these tickets, 64 per cent were sold (793 610 tickets). The remaining public tickets were made available for direct sale commencing in October 2005. The tickets made available to the Australian public represent around 64 per cent of the total tickets. The balance of ticket allocations are required for commercial arrangements (tickets for athletes' families, past athletes and promotional activities), contractual arrangements (including sponsors, licensees, broadcast right holders) and travel packages (domestic and international). At the time of preparing this report, these ticketing arrangements were being finalised.

Sponsorship revenue remained below the sponsorship marketing contract milestone for 30 June 2005. The organising committee, however, remains confident of achieving the forecast revenue targets.

The expenditure forecasts reflect the impact of a number of key assumptions, including the number of available volunteers, projected security requirements and transportation services.

The games' work force is the largest single item of budgeted operating expenditure. At the height of the games, it is estimated that there will be approximately 1 200 employees (most of them temporary), around 20 000 contractors and 15 000 volunteers. In addition, emergency services personnel will be engaged. Arrangements for the volunteer program started in January 2005, with the number of applicants exceeding the required number of positions.

The transportation budget is intended to meet the transportation needs of the athletes, officials, media, volunteers and spectators. While spectators and volunteers will make use of the public transport system, the other groups will have dedicated transportation services. The transport plan and associated cost estimate are in the process of being finalised.

The perceived risk of a security incident occurring during the games and the mitigation strategies in relation to that risk is a key cost driver for security. The original estimate was based on a preliminary assessment of the threat level likely to be faced if the games were held at the time when the whole-of-games' budget was prepared – that is, at 2003 threat levels. The budget was struck at a time when "AFL Grand Final" level security, plus dignitary protection, was considered an appropriate response to the level of threat at that time. At the time, the government acknowledged that security costs may need to be reviewed in the event of an increase in the threat level. Subsequently, the government announced extra funding for security as part of the 2005-06 budget cycle. This is in addition to the $84.8 million contribution made by the Commonwealth Government towards the cost of security announced in May 2004. A further upgrade in the security threat level will require further funding.

As security risks are considered to be outside the state government's control, the government has removed an amount equivalent to the funding to be provided for security from the amount it agreed to contribute to the games (government's contribution cap). As a result, we would expect that the whole-of-games' budget will also be adjusted downwards by the amount previously allocated towards security[3].

Economic impact study

Most major international events raise significant financial commitments for the government, and in most cases, the cost of hosting such events will exceed the direct revenue received from ticketing sales, broadcasting rights and sponsorship. The government hopes to achieve a return on its investment through the games' stimulus to the state economy. Despite inherent measurement difficulties, these benefits are sought to be measured by economic impact studies. There are also longer lasting and intangible benefits to the state, which are not measured by the economic impact studies, such as social and environmental benefits and improved reputation for hosting world class events, and an opportunity to foster long-term business relationships.

---

[3] Excluding the Victoria Police costs to be met from the existing allocated budget for Victoria Police.

A 1998 government study identified that the economic impact of hosting the games would be to increase Victoria's gross state product (in 1998 dollars) by around $373 million.

The government did not revise the 1998 study as part of the 2003-04 State Budget process, when it endorsed the games' budget. Instead, it relied on economic impact studies done for the Sydney 2000 Olympic Games and the Manchester 2002 Commonwealth Games. The studies estimated an economic benefit multiplier of 2.50 and 2.40, respectively. That is, for every $1 spent on the 2006 Commonwealth Games by the government, around $2.50 in economic activity is expected to be generated within the state.

In March 2005, 2 years after the revised budget was approved, the government commissioned an updated economic impact study. The study used 2 forecasting models. The first model (CGE analysis[4]) estimated an increase in gross state product (GSP) of $1 538 million (net present value) and 13 514 extra jobs around the state. The second model (I-O analysis[5]) estimated an impact of $1 041 million and an increase in employment of 9 756 jobs.

The advice of the economic consultants conducting the study was that the CGE model is more appropriate for estimating the impact of events such as the games because it explicitly accounts for linkages between the Victorian economy and the national economy, and so is better able to account for the impact of an event of the scale of the games. The higher result in the CGE model compared with the I-O model is mainly attributable to the assumption that the games' infrastructure assets will be financed from borrowings which will be repaid after the event occurs.

About half of the estimated expenditure in the economic impact study was for capital works (including the MCG Northern Stand Redevelopment, Melbourne Sports and Aquatic Centre Stage 2 and the Athlete's Village). The economic impact study reflects that these are "new" dollars brought into the state by hosting the games. However, the government has stated that a number of these works were to be undertaken under its long-term asset plan, whether or not the games were held - the games in essence accelerated the timetable of construction and spending.

[4] CGE – Computable General Equilibrium forecasting model.

[5] I-O – Input-Output forecasting model.

6.1.3 Superannuation

State expenses	2003-04	2004-05	Movement	Movement
	($m)	($m)	($m)	(%)
Superannuation	364	**645**	281	77.2

The state's expenditure on superannuation increased by $281 million, or 77 per cent. The increase in superannuation expenses mainly resulted from higher employer contributions partly offset by the impact of gains on superannuation investments. Part 8 - *Liabilities, commitments and contingencies trends* of this report comments on the state's unfunded superannuation liability.

6.1.4 Other expenses

State expenses	2003-04	2004-05	Movement	Movement
	($m)	($m)	($m)	(%)
Other expenses	1 559	**59**	(1 500)	(96.2)

The decrease in other expenses is mainly attributable to the one-off transaction in the prior year relating to the write-off of $1 140 million receivable from the abolition of the smelter reduction levy used to assist in the funding of flexible electricity tariff arrangements.

Part 8 - *Liabilities, commitments and contingencies trends* of this report comments on the flexible electricity tariff arrangements.

Other expenses in 2004-05 mainly related to the impact of writing-down the value of native forests to be made available for commercial timber harvesting. Native forests are recorded in the financial statements of the Department of Sustainability and Environment and VicForests.

VicForests commenced operations in August 2004 with the primary objective of managing the sale of timber resourced in Victorian state forests on a commercial basis. It separated the commercial timber harvesting functions from the policy, regulatory and stewardship functions that were undertaken by the Department of Sustainability and Environment (DSE).

Under the arrangements, DSE issued a permit to VicForests to harvest native forest over a 15-year period. The initial release of native forest to VicForests covered an area sufficient for 3 years of harvesting. This area was previously valued by DSE at $34.1 million. Subsequent to the changes being made, this area was revalued at $14.6 million based on the estimated discounted cashflows to be received from the sale of the timber. An amount equivalent to the $19.5 million decrease in value was disclosed as an expense in the financial year.

DSE retains control over the native forest earmarked to be transferred to VicForests over the remaining 14-year period. This area of native forest was revalued in 2004-05 at $72 million. This represented a $35 million decrease in value. An equivalent amount was disclosed as an expense in the financial year.

Director of Housing debt forgiveness

During 2004-05, the government decided to forgive the repayment of an interest-free advance provided to the Director of Housing. This had the effect of increasing General Government Sector expenditure.

In our *Report of the Auditor-General on the Government's Annual Financial Statements, 1997-98,* we outlined that in July 1997, the debt portfolio held by the Director of Housing was centralised and then managed as part of the budget sector debt portfolio under the state's centralised treasury management policy. At that time, the Department of Treasury and Finance assumed responsibility for some $1 100 million of housing rental borrowings and converted $873 million of home finance borrowings into an interest-free advance.

Under the arrangements, the Director of Housing was required to repay to the Department of Treasury and Finance the interest-free advance from surpluses arising over future years from mortgage repayments within the home finance portfolio. Over the years, the repayment profile of the Director of Housing has varied depending on financial considerations.

In March 2005, the government decided to forgive the repayment of the remaining interest-free advance, valued at $130 million. It did so to alleviate financial pressures on the Director of Housing, and to enable the director to meet service delivery obligations without increased funding from the government.

As the forgiveness of the interest-free advance was between 2 state government agencies, it did not impact on the overall financial result for the State of Victoria, however, it did impact on the operating result for the General Government Sector, increasing expenditure by $130 million, and accordingly reducing the net result by the amount forgiven.

7. Asset trends

7.1 Asset trends

State's financial position (at 30 June)	2004	2005	Movement
	($m)	($m)	($m)
Assets	109 114	**122 621**	13 507
Liabilities	48 169	**48 060**	(109)
Net assets	60 945	**74 561**	13 616

State assets totalled $122 621 million at 30 June 2005, an increase of $13 507 million on the previous year. Figure 7A shows the major variations in assets from 30 June 2004.

FIGURE 7A: STATE ASSET MOVEMENTS, AT 30 JUNE ($M)

Asset Item	2004	2005	Movement
	($m)	**($m)**	($m)
Cash and investments (a)	24 478	**26 919**	2 441
Physical assets	79 476	**90 769**	11 293
Receivables	4 352	**4 137**	(215)
Prepayments	158	**145**	(13)
Inventories	650	**651**	1
Total	**109 114**	**122 621**	**13 507**

(a) Disclosed in Annual Financial Report as "Cash assets" and "Other financial assets".

Source: 2004-05 Annual Financial Report.

7.1.1 Cash and Investments

State assets (at 30 June)	2004	2005	Movement	Movement
	($m)	($m)	($m)	(%)
Cash and investments	24 478	**26 919**	2 441	10.0

Note: Disclosed in Annual Financial Report as "Cash assets" and "Other financial assets".

The state's investment portfolio (including cash) totalled $26 919 million at 30 June 2005, an increase of $2 441 million on the prior year. This was mainly due to across-the-board increases in the value of investments.

Around 95 per cent of the state's total cash and investments are held by 4 separate agencies:

- Transport Accident Commission (TAC), which manages third party motor vehicle insurance liabilities
- Treasury Corporation of Victoria (TCV), which manages state debt and invests deposits lodged by public sector agencies
- Victorian Managed Insurance Authority (VMIA), which manages general insurance liabilities
- Victorian WorkCover Authority (VWA), which manages workers' compensation insurance liabilities.

While State Superannuation Fund investments are not recorded in the state's annual financial report (because they are not assets of the state), they do have a direct impact on the state's financial position as the state has a liability associated with their unfunded superannuation obligations.

The Victorian Funds Management Corporation manages the investments of the TAC, VWA, VMIA and the State Superannuation Fund. While each agency is responsible for setting its investment strategy and for asset allocation[1], the corporation selects and monitors the performance of fund managers. Asset allocation strategies vary among agencies, according to their type of business objectives and tolerance for risk. Strategies must conform to legislative requirements and government policy, which ensures that agencies do not exceed acceptable levels of risk.

[1] Asset allocation is the practice of dividing an investment portfolio across different asset classes (such as equities, property and bonds). It is the single most important determinant of long-term returns. Common investment practice is to spread a portfolio across asset classes, to reduce the variability of returns as all classes are most unlikely to rise or fall together.

In July 2005, the government announced moves away from the decentralised approach to investment strategies towards a centralised approach. Under proposed changes to apply from June 2006, agencies will set their investment objectives and the Victorian Funds Management Corporation will determine and implement investment strategies to meet those objectives. Agencies will be consulted about investment strategies but will not be required to approve them. The corporation will also be required to prepare investment risk management plans for each agency.

TCV will continue to manage its own investing activities in accordance with current practices.

Figure 7B shows the asset allocation for the 4 main investing agencies, and by the Department of Treasury and Finance, at 30 June 2005. In the 12 months, the value of the agencies' investment portfolio increased by a total of $2 095 million.

FIGURE 7B: CASH AND INVESTMENTS HELD BY MAJOR STATE AGENCIES, AT 30 JUNE ($M) (a)

Type of investment	TAC	VWA	VMIA	DTF (b)	TCV (c)	Total value at 2005	Movement in value from 2004	State Super Fund 2005 (d)	Overall fund allocation 2005 (e)	Overall fund allocation 2004 (e)
	($m)	($m)	($m)	($m)	($m)	($m)	($m)	($m)	(%)	(%)
Domestic equities (f)	1 753	2 766	162	-	-	**4 681**	747	3 870	26	23
International equities	1 886	2 225	196	-	-	**4 307**	463	2 452	20	20
Total equities	3 639	4 991	358	-	-	**8 988**	1 210	6 322	46	43
Fixed interest	2 351	1 651	179		1 894	**6 075**	522	1 394	22	25
Bonds - indexed	319	758	64	-	558	**1 699**	207	313	6	6
Property	676	818	-	-	-	**1 494**	272	556	6	7
Floating rate securities	-	-	-	-	736	**736**	189	-	2	2
Short-term deposits	6	11	39	-	4 463	**4 519**	(305)	1 463	18	17
Total investments 2005	**6 991**	**8 229**	**640**	-	**7 651**	**23 511**	**2 095**	**10 048**	**100**	**100**
Total investments 2004	6 353	6 799	455	382	7 427	**21 416**	-	8 686		
Movement from 2004	638	1 430	185	(382)	224	**2 095**	-	1 362		

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

(b) The balance of the Budget Sector long-term investment fund held by the Department of Treasury and Finance was transferred to the Treasury Corporation of Victoria.

(c) Includes $414 million of the investments guaranteed by the Treasurer, including investments in Melbourne Cricket Club ($326 million) and St Vincent's Hospital (Melbourne) Limited ($88.5 million).

(d) Public sector superannuation funds are not recorded in the *2004-05 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.

(e) Including the State Superannuation Fund portfolio.

(f) Includes equity in unlisted companies.

Source: Investment reports from the respective agencies, June 2005 and Treasury Corporation of Victoria Annual Report for 2004-05.

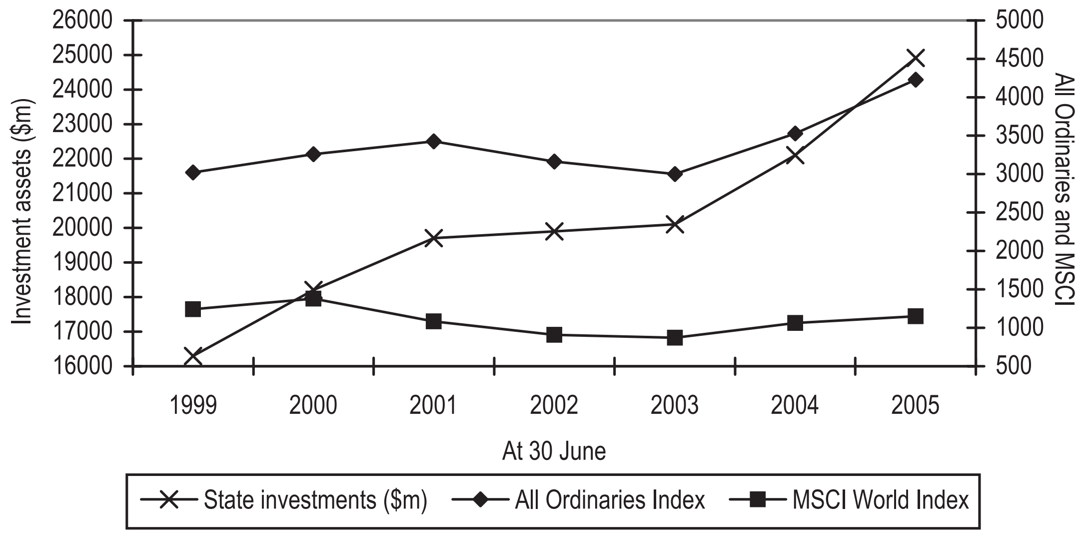
Compared with the previous year, there has been a move away from fixed interest deposits into domestic equities to take advantage of continued growth in the domestic equity market.

Overall there has been a significant increase in the value of investments held by the state across all classes of the portfolio. The value of equity holdings has increased by $1 210 million ($747 million domestic equities and $463 million international equities) through a combination of increased market values and additional investment. The Australian share market has posted its best returns since 1996-97. International equities also increased in value, however, the gain was offset by the impact of the increasing value of the Australian dollar.

The State Superannuation Fund investment portfolio increased by $1 362 million, mainly as a result of an increase in the value of its equity holdings and a $600 million additional payment made by the state on 30 June 2005[2]. Due to the timing of the additional payment which was received on 30 June 2005, it was invested in short-term deposits.

Figure 7C illustrates the movements in international and domestic equity markets relative to the state's financial asset holdings. Approximately 38 per cent of the state's investments are in equities (excluding investments held by the State Superannuation Fund). Thus, the rate of increase in the state's financial asset holdings is heavily influenced by movements in the international and domestic equity markets.

FIGURE 7C: MOVEMENTS IN THE DOMESTIC AND INTERNATIONAL SHAREMARKET AND LEVEL OF STATE FINANCIAL ASSETS



Note: Morgan Stanley Capital International (MSCI) index covers the major international share markets.

Source: All Ordinaries – Australian Stock Exchange, Morgan Stanley Capital International (MSCI) World Index, Investments (excluding cash) - government's Annual Financial Report.

[2] Refer to Part 8 - *Liabilities, commitments and contingencies trends* of this report for further commentary.

7.1.2 Physical assets

State assets (at 30 June)	2004	2005	Movement	Movement
	($m)	($m)	($m)	(%)
Physical assets	79 476	**90 769**	11 293	14.2

Physical assets are assets that are not normally converted to cash. At 30 June 2005, the state's physical asset portfolio was $11 293 million higher than the previous year. Figure 7D shows the major variations for the year.

FIGURE 7D: STATE PHYSICAL ASSET MOVEMENTS ($M)

Opening balance 1 July 2004	**79 476**
Revaluations	9 542
Disposals	(644)
Additions	3 803
Depreciation and amortisation	(1 909)
Other	501
Closing balance 30 June 2005	**90 769**

Source: 2004-05 Annual Financial Report.

Major movements include:

- revaluation of a number of asset categories, including land ($6 480 million) (Crown land, national parks, conservation reserves), schools ($472 million), road infrastructure ($521 million), works of art collections ($721 million), water infrastructure ($282 million) and health facilities ($183 million)
- additions including those relating to hospital buildings ($380 million), public housing ($276 million), education buildings ($271 million), land relating to road projects ($494 million), medical equipment ($215 million), water infrastructure ($179 million) and computer acquisitions ($166 million)
- assets acquired under finance lease arrangements including Casey Hospital ($83 million) and the delivery of new rolling stock ($127 million)
- assets contributed by developers to water authorities ($418 million)
- rail infrastructure works and improvements, including those generated by the Regional Fast Rail project ($366 million).

Infrastructure spending

The state government spends significant sums of money on infrastructure to provide and administer public services. The main purpose of this spending is to meet the heavy and rising demands imposed by population and business growth, to stimulate the economy and produce growth, and to upgrade, modernise and replace worn-out assets.

Figure 7E shows that over a 5-year period, there has been a gradual increase in the purchase of property, plant and equipment. However, as a percentage of gross state product (GSP)[3], there has been a marginal reduction in capital spending from its peak in 2002-03 (over the 5-year period).

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

	2000-01	2001-02	2002-03	2003-04	2004-05
Purchase of property, plant and equipment (a)	2 399	2 499	3 274	3 413	**3 632**
Depreciation (a)	(1 316)	(1 407)	(1 515)	(1 637)	**(1 793)**
Net addition to state's asset base	1 083	1 092	1 759	1 776	**1 839**
Purchases as a percentage of GSP (b)	0.63	0.60	0.91	0.86	**0.84**

(a) Annual Financial Reports.

(b) Australian Bureau of Statistics, 1999-2004; Department of Treasury and Finance estimate of gross state product for 2004-05.

The cost of constructing, maintaining, and operating infrastructure is a significant undertaking by the state. Generally, infrastructure is funded in 3 ways, namely, from tax revenue (raised by the state and Commonwealth Government), borrowings or leasing arrangements including public-private partnerships.

[3] Gross state product (GSP) is the total value of final goods and services produced within the state over a financial year.

The decisions on which capital works projects will be undertaken and how much will be spent on such projects are policy issues, and the responsibility of the government of the day. However, it is the responsibility of the Department of Treasury and Finance to develop an orderly capital budgeting plan to help the government make capital program decisions that foster economic and social development while minimising the effects of an increasing financial burden. In April 2005, the department issued a revised Asset Management Framework, with a focus on addressing medium to long-term asset management issues.

There are a number of financial risks associated with infrastructure at all the key stages of the asset's life cycle. These include the risks associated with construction (e.g. cost and time overruns), maintenance (e.g. unforeseen upkeep expenditure and changes in technology) and operating (e.g. usage and capacity constraints).

We comment on the key risks associated with the construction stage of the infrastructure. Based on the government's *Budget Information Paper 1, 2004-05*, there were around 1 570 capital works projects in progress, or planned to be commenced across the state public sector during 2004-05, with a combined value of $10 200 million.

A summary of the state's major individual capital works projects with actual capital outlays in 2004-05 of at least $10 million less than forecast for the year, is outlined in Figure 7F. It shows that for the projects outlined, the capital outlays for 2004-05 were $157.9 million less than forecast.

FIGURE 7F: MAJOR 2004-05 CAPITAL WORKS - BUDGET TO ACTUAL VARIANCES ($M)

Projects (a)	Published completion date	Expected completion date	Original budget	Revised budget (b)	Forecast capital outlay in 2004-05	Actual capital outlay in 2004-05	Shortfall in capital expenditure in 2004-05
Classroom replacement program	Feb. 07	Jun. 07	50.0	50.0	18.0	0.4	(17.6)
Health ICT strategy	Jun. 07	Jun. 07	138.5	138.5	38.0	10.8	(27.2)
Pakenham Bypass	Dec. 07	Dec. 07	221.2	242.2	55.0	10.7	(44.3)
Road safety infrastructure program	Jun. 06	Jun. 06	130.0	130.0	65.0	47.6	(17.4)
Calder Highway – Kyneton Faraday section	Dec. 06	Feb. 09	70.0	172.0	15.6	4.5	(11.1)
Melbourne Convention Centre	Dec. 08	Dec. 08	366.9	368.9	25.8	4.8	(21.0)
State Library Redevelopment	Dec. 01	Dec. 06	91.4	91.4	24.3	5.0	(19.3)
Total			**1 068.0**	**1 193.0**	**241.7**	**83.8**	**(157.9)**

(a) Projects selected have approved total revised budgets greater than $30 million.

(b) Revised budget as per *Budget Information Paper 1, 2005-06*.

Source: Department of Treasury and Finance.

The reasons for the shortfall in capital expenditure in 2004-05 for the above projects include project delays attributed to a wide range of factors, such as poor planning, delays in finalising tender processes, contractual disputes, access difficulties and an "over heated" construction sector.

In relation to the General Government Sector, the government has approved the carry forward of funding for asset additions to 2005-06 of $307 million, an increase of around 113 per cent compared with the previous year.

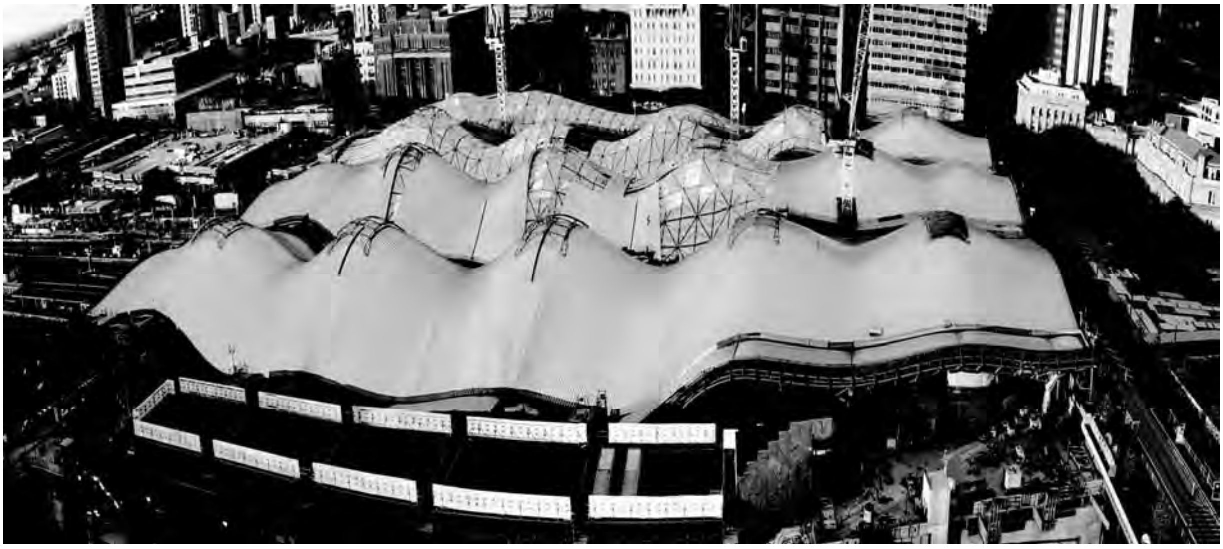
The risks associated with infrastructure construction are expected to increase, given the continuing strong performance of the construction sector and competition for resources. Further, the 2005-06 Budget Papers, announced the delivery of the largest major projects program in the state's history. As detailed in Part 8 - *Liabilities, commitments and contingencies trends* of this report, a portion of this increased capital works program is to be funded through debt. This significant program brings with it increased risk which will need to be carefully managed by the state to avoid lengthy delays and additional financial exposures, including paying premium construction costs during a period of high demand in the construction industry.

A key project undertaken by the government under the public-private partnership framework is the Spencer Street Station redevelopment. One of the main reasons for following a public-private partnership arrangement is the transfer of construction risk to the private sector. In our *Report of the Auditor-General on the Finances of the State of Victoria, 2003-04* we commented on the status of the redevelopment and claims lodged by the developer to recoup construction cost overruns. Given, not only the importance of the redevelopment, but also due to the underlying principles of risk transfer under public-private partnership arrangements, we revisited its progress.

Progress of the Spencer Street Station redevelopment

In July 2002, the state entered into a public-private partnership agreement with Civic Nexus Pty Ltd, a consortium comprising ABN AMRO Australia Pty Ltd, Leighton Contractors Pty Ltd (Leightons) and a number of other sub-contractors to redevelop the Spencer Street Station. The redevelopment covers an area of around 21 hectares and involves the construction of the main public transport interchange facility and residual works, including rail modifications and signal upgrades.

Under the terms of the agreement, the consortium was granted a 30-year lease to operate the facility. The Spencer Street Station Authority was made responsible for overseeing the redevelopment and subsequent operations. The consortium is responsible for designing and constructing the facility, and for its ultimate operation, and has assumed all key risks associated with these phases. The original arrangements provided for the construction to be undertaken in a manner that would not disrupt the daily operations of the station. Compensation was to be provided to the regional and metropolitan train operators where their daily operations were disrupted and to the state in the event that final construction milestones were not achieved.



Construction progress of the Spencer Street Station redevelopment.
(Photo courtesy of the Spencer Street Station Authority.)

Our *Report of the Auditor-General on the Finances of the State of Victoria, 2003-04* identified that, following delays in the construction of the facility and dispute resolution action commenced by Leightons, the state entered into a settlement deed with Leightons in November 2003. Under the settlement deed, the state agreed to pay $3.05 million on completion of certain additional works, and modified or cancelled progress milestones for the main interchange facility. In addition, completion milestones for residual works were also changed. The state also waived its right to seek compensation from Leightons for not meeting the original construction milestone targets. In addition to the settlement deed, in September 2004, the state and rail operators agreed to give Leightons improved access to facilitate roof works. In 2004-05, Leightons paid around $6.5 million in occupation costs (2003-04, $3.2 million) to regional and metropolitan train operators.

As illustrated in Figure 7G, based on the June 2005 project report, the completion of the main interchange facility has been delayed by 307 days compared with that agreed in the 2003 settlement deed. It is now expected that the main interchange facility will be operational by 28 February 2006, in time for the 2006 Commonwealth Games in March. However, the facility is not expected to achieve contractual completion until August 2006.

The state has no obligation to commence making service payments until the main interchange facility is 100 per cent complete. Accordingly, no service payments should be made in 2005-06.

FIGURE 7G: SPENCER STREET STATION REDEVELOPMENT – KEY PROJECT MILESTONES

Key project milestone	November 2003 settlement agreement revised milestones	Project report (June 2005)	Total days overdue compared with 2003 settlement deed (a)
Main facility – Final completion milestones -			
Final completion of the interchange facility works	27 Apr. 05	28 Feb. 06	307
Main facility – Final completion milestones -			
Collins Street Concourse commissioned	13 Jan. 04	21 Oct. 05	647
First platform upgrade completed	18 Jun. 04	19 Oct. 05	488
Bus Interchange facility completed	27 Apr. 05	28 Feb. 06	307
Residual works -			
Final completion of the rail modifications	27 Jul. 05	22 Jun. 05	(35)
Final completion of the signalling upgrade	27 Jul. 05	(b)	-

(a) Delays calculated on the latest estimates provided by Leightons Contractors Pty Ltd – June 2005.

(b) Timeline under negotiation at the time of preparation of this report.

Note: Refer to our *Report of the Auditor-General on the Finances of the State of Victoria, 2003-04* for details of original milestone construction dates outlined in the 2002 contract.

Source: Victorian Auditor-General's Office.

In its financial reporting obligations to the Australian Stock Exchange, Leightons announced an updated forecast total loss of $122.6 million on the Spencer Street Station redevelopment project. Leightons is seeking compensation for part of these losses from the state. At June 2005, Leightons had lodged $54.1 million in claims. The claims lodged mainly relate to delays attributable to access and pre-existing contamination issues. The state believes these to be ambit claims, and is currently in negotiations with the relevant parties to resolve all issues.

Given the size of the developer's forecast loss on the project, monitoring controls over design and quality are increasingly important. As required under the arrangements, the Spencer Street Station Authority and the developer engaged an independent reviewer to assess the designs and completed works against the requirements of the project brief and resolve any disputes between the parties. However, Leightons advised the authority in March 2005 of its intention to contest the validity of the appointment of the independent reviewer. The authority also conducts its own quality and assurance reviews over the design and construction phases of the project. The authority has advised that it has not observed any major issues concerning the design and the quality of the redevelopment.

Under the arrangements, the final design of the facility cannot be changed without the approval of the authority. Changes to the scope of the project requested by the consortium were negotiated as part of the November 2003 settlement deed. During 2004-05, additional variations to the scope of the project were requested by the authority. The authority estimates that the associated works will have a combined value of approximately $3 million.

RESPONSE provided by Treasurer

Whilst external factors, such as a heated construction market and rises in the producers price index have impacted on some projects (as identified in Figure 7F), the vast majority of government projects remain on schedule and on budget. In fact, in the context of the government's $10.2 billion capital program, the identified deviations are small.

The Government has recorded significant progress in the delivery of its asset program in 2004-05. This is highlighted by the completion of over 140 projects, worth $1.0 billion, including major transport projects (eg the $31 million Vermont South tram extension and the $32 million widening of Cooper Street, Whittlesea) and significant ICT projects (eg the $30 million ICT Strategy for Health Care and the $23 million Bridging the Digital Divide projects). In addition, major construction works were completed for the Austin Redevelopment and Mercy Hospital relocation. Public non financial corporations also completed significant asset works, including the $124 million upgrade of the Western Treatment Plant.

The Government undertakes a program of continuous improvement with respect to the planning of projects, the engagement of tender processes and the management of contracts to ensure the successful delivery of its significant asset program.

7.1.3 Receivables

State assets (at 30 June)	2004	2005	Movement	Movement
	($m)	($m)	($m)	(%)
Receivables	4 352	**4 137**	(215)	(4.9)

At 30 June 2005, the state's receivables were $215 million less than last year. Increases in fine debtors, tax payables and the value of CityLink concession notes were offset by a $716 million decrease in financial derivative receivables.

Melbourne CityLink concession notes

Our previous reports to parliament have provided a detailed analysis of the highly complex arrangements established by the government and Transurban, a private sector consortium, for the financing, construction and operation of the Melbourne CityLink.

The main contractual document for the arrangements was a concession deed entered into in October 1995. Under the deed, Transurban is required to pay concession fees to the state. Transurban does this by issuing concession notes each year (which are non-interest-bearing promissory notes). These are payable at the end of the 35-year concession deed period (at which time ownership of CityLink will revert to the state at no cost), or earlier (if specified profit levels are achieved). At 1 July 2004, the concession notes were valued at $189 million in present value terms.

In June 2005, the government and Transurban entered into a deed of assignment and a Tullamarine Redevelopment Deed to upgrade the interchange of the Tullamarine and Calder Freeways. The Tullamarine-Calder Interchange Project is being planned, designed and constructed under an alliance agreement between VicRoads, Baulderstone Hornibrook and Parsons Brinkerhoff. The associated works are planned to be completed by December 2007.

The government will fund the upgrade by redeeming concession notes to the value of the cost of works to be undertaken. During the negotiation process and drawing on updated financial forecasts, the government revalued the notes it held by $96 million in present value terms. To fund the development it intends to redeem notes to the value of $344.5 million in nominal terms (or $153.7 million in net present value terms). It will redeem the notes over the next 2 financial years.

Under the redevelopment deeds, the state and Transurban will share equally in any extra net revenue to CityLink that results from the upgraded works. The state agreed to receive an upfront minimum payment of $11 million in July 2005 from Transurban, based on a traffic impact study. The state will be able to claim further payments from Transurban if the actual traffic volume exceeds the forecast volume in the traffic impact study. The payment is conditional on the interchange works being fully completed by June 2011. If the works are not completed by that date, the state will be required to repay the $11 million together with interest, but will still be entitled to the additional payments resulting from increased traffic volumes above those forecast.

The financial transactions relating to the Tullermarine-Calder Interchange Project and the concession notes in 2004-05 were:

- the upward revaluation of the concession notes by $96 million
- recognition of a receivable and liability (deferred income) of $11 million for the state's share of expected minimum benefits arising from the interchange works
- other net movements to the value of the concession notes resulting in a gain of $33 million.

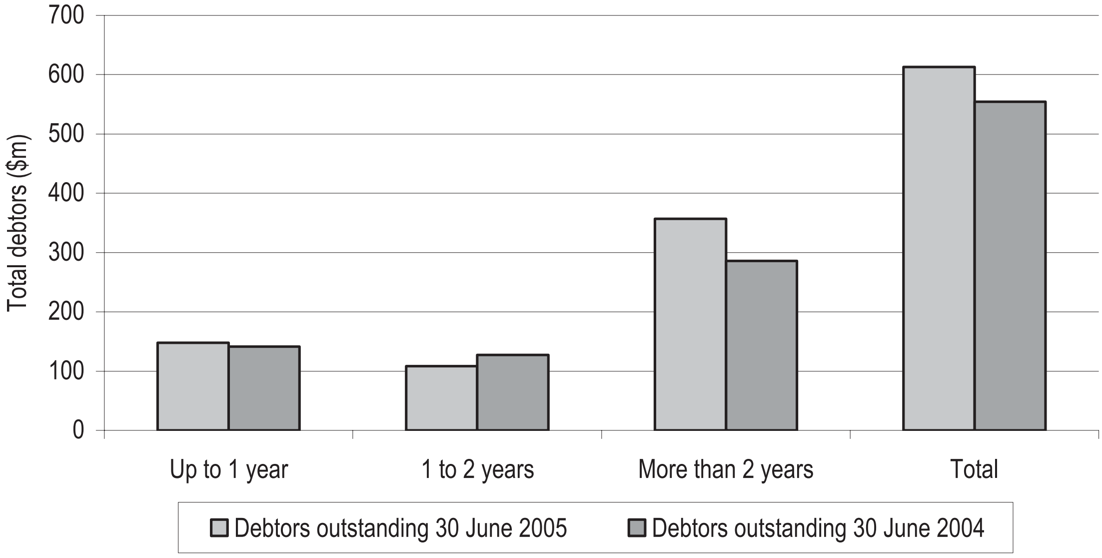
As disclosed in the notes to the government's *2004-05 Annual Financial Report*, Transurban and the Australian Taxation Office (ATO) are currently in dispute over the tax deductibility of concession fees payable to the state. In October 2004, the full bench of the Federal Court ruled that the concession fees were tax deductible, however, the ATO has been granted leave to appeal the decision in the High Court of Australia. Should the High Court confirm the Federal Court ruling, the total present value of the concession notes held by the state will increase by an estimated $23.7 million.

Uncollected fines

As detailed in Part 5 - *Revenue trends* of this report, revenue from fines increased by 7 per cent in 2004-05 compared with the prior year. This is expected to significantly increase in 2005-06 following the gradual re-introduction of traffic cameras into operation.

The Department of Justice administers the majority of the state's fines revenue. Figure 7H shows that at 30 June 2005, total uncollected fines were $613.4 million (compared with $554.3 million at 30 June 2004). Of this amount, $466 million (or around 76 per cent) has been outstanding for a period greater than 12 months.

FIGURE 7H: OUTSTANDING FINE DEBTORS BY AGE, AT 30 JUNE 2005



Source: Department of Justice 2004-05 audited financial statements.

Figure 7I shows that over the last 12 months, there has been an overall decline in the collectability of all types of fines, with the exception of traffic fines (which has remained constant).

FIGURE 7I: FINE COLLECTION RATES BY TYPE WITHIN 12 MONTHS OF ISSUE (PER CENT)

Type of fines	Collection rate 2005	Collection rate 2004
Traffic camera fines	89	89
On-the-spot fines (a)	77	79
Court orders (b)	29	32
Warrants (c)	32	34

(a) On-the-spot fines are issued by Victoria Police and other agencies.
(b) Court orders relate to unpaid local government infringement notices lodged with the PERIN Court.
(c) Warrants relate to court-imposed fines.

Note: Calculation of clearance rates based on average clearance rates per month over a 12-month period. Does not include CityLink fine clearance rates.

Source: Department of Justice.

A number of strategies have been implemented to improve low fine collection rates (in particular for warrants and court orders). These measures have included the introduction of mobile collection offices and improved reporting.

Given the further deterioration in fine collection rates, the government needs to review and adopt other measures to improve the collectability of fines.

RESPONSE provided by Treasurer

The Government has recently announced that it is considering a range of measures to address serial fine defaulters, including through vehicle licence and registration suspension, wheel clamping, garnisheeing of wages, charging orders on real property and ultimately, the sale of real property.

To ensure that the measures are fair for all Victorians, instalment payment plans will be available from February 2006 to allow people in financial hardship to pay by instalment when they first receive a fine, rather than to wait until the matter has defaulted to the PERIN Court.

It is proposed that legislation will provide for a new infringements system for Victoria from 1 July 2006. The changes will make the system fairer by improving the protection of the community's rights, and provide capacity for the vulnerable (eg: those with an intellectual or mental disability) to have their infringement notices withdrawn. The legislation will also provide for an enhanced enforcement regime to deal with the small proportion of those who repeatedly incur fines and ignore them, thereby accruing large debts to the state.

8. Liabilities, commitments and contingencies trends

8.1 Liabilities, commitments and contingencies trends

State's financial position (at 30 June)	2004	2005	Movement
	($m)	($m)	($m)
Assets	109 114	**122 621**	13 507
Liabilities	48 169	**48 060**	(109)
Net assets	60 945	**74 561**	**13 616**

At 30 June 2005, state liabilities totalled $48 060 million, a reduction of $109 million on the previous year. Figure 8A shows the major variations in liabilities from 30 June 2004.

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

Liability item	2004	2005	Movement
Interest-bearing liabilities	14 226	**14 527**	301
Unfunded superannuation	11 760	**10 540**	(1 220)
Other provisions	14 118	**14 859**	741
Payables	3 653	**3 363**	(290)
Employee benefits	3 184	**3 433**	249
Other liabilities	1 228	**1 338**	110
Total	**48 169**	**48 060**	**(109)**

Source: 2004-05 Annual Financial Report.

8.1.1 Interest-bearing liabilities

State liabilities (at 30 June)	2004	2005	Movement	Movement
	($m)	($m)	($m)	(%)
Interest-bearing liabilities	14 226	**14 527**	301	2.1

At 30 June 2005, interest-bearing liabilities were $301 million higher than 12 months earlier. This was mainly due to an increase in finance lease obligations associated with the provision of health facilities, the delivery of new rolling stock and an increase in domestic borrowings.

Debt impacts on government operations in the medium and over the long term. The government currently borrows to repay maturing debt and to fund its capital works program. It borrows from the domestic and international investment community, and by entering into finance lease[1] arrangements.

Domestic and foreign borrowings

In 2004-05, domestic borrowings accounted for around 94 per cent of existing borrowings (face value). Thus, the state's maturity profile is heavily influenced by the state's domestic hotstock[2] program, which accounts for 75 per cent of domestic borrowings. Hotstocks are mainly issued every 2-years by the government's borrowing agency - Treasury Corporation of Victoria (TCV). A number of hotstocks and foreign currency borrowings matured in 2004-05 and were replaced with new hotstocks, with maturities ranging from 3 to 17 years. This resulted in a significant shift in the state's domestic borrowings profile, from current to non-current liabilities[3].

In 2005-06, debt with a face value of $1 237 million is due to be repaid. TCV has large holdings of liquid assets to meet these obligations. In recent years, the government's preference has been to maintain borrowings at current levels and refinance debt as it matures. Several successive years of budget surpluses have enabled the government to do this. The government has also been helped by low interest rates over a number of years which have kept current and future interest costs relatively low. Some 90 per cent of borrowings are at fixed interest rates. In 2004-05, interest costs on borrowings represented around 3 per cent of the state's total expenditure.

---

[1] A finance lease is a lease that transfers substantially all the risks and rewards incidental to the ownership of an asset to the lessee.

[2] Hotstocks are liquid debt security, priced by the majority of the market participants.

[3] "Current" is defined as a borrowing maturing within a 12 month period and "non-current" is a borrowing maturing after a 12-month period.

In the *2005-06 Budget Papers*, the government estimated that it would need to issue $496 million of new debt in the period from 1 July 2007 to 30 June 2009 to fund its proposed capital works program. However, the actual amount of debt required will be heavily influenced by the size of budget surpluses over the next few years, and by the timing of the capital works projects.

The state's credit rating is based on an independent assessment of the state's capacity to meet its financial commitments. Its credit rating affects the interest rate it must pay on new borrowings. The state's general obligation bond rating assigned by credit rating agencies[4] remains at its highest possible level: AAA/Stable/A-1+ (Standard and Poors) and Aaa/Stable/P-1 (Moody's Investor Services).

In considering the impact of A-IFRS[5] on the state's borrowings, TCV has stated that it is yet to fully complete its A-IFRS evaluation of policy alternatives and business impact analysis. As such, the financial impact arising from the transition to A-IFRS on the state's borrowings portfolio was not disclosed in the notes to the government's *2004-05 Annual Financial Report.*

Finance lease obligations

At 30 June 2005, the state's finance lease obligations were $795 million, compared with $691 million a year earlier. The increase was mainly due to the completion of the Casey Community Hospital (a public-private partnership arrangement) and the delivery of additional new rolling stock associated with the public transport system. This increase was offset by the periodic repayment of finance lease obligations.

Finance lease obligations are forecast to increase significantly within the next 3 years as a number of public-private partnerships are completed and as a result of disclosure reclassifications arising from the adoption of A-IFRS.

The public-private partnerships to be completed within the next 3 years include the Spencer Street Station redevelopment, correctional facilities and the Metropolitan Mobile Radio Network.

---

[4] *Credit Opinion: Victoria May 2005* Moody's Investors Service and Standard and Poor's: Credit Rating Report: July 2005.

[5] In July 2002, the Financial Reporting Council announced that the Australian Accounting Standards Board would adopt Australian equivalents to International Financial Reporting Standards (A-IFRS) for the reporting periods commencing on or after 1 January 2005.

Our *Report of the Auditor-General on the Finances of the State of Victoria, 2003-04* examined the 2004 metropolitan train and tram franchise agreements and assessed 3 of the new rolling stock lease agreements as representing the acquisition of assets by the state using a finance lease arrangements. We identified that the financial reporting of the remaining new rolling stock lease arrangement (entered into by Hillside, now Connex Trains) would need to be reconsidered when A-IFRS took effect on 1 January 2005. The Department of Infrastructure and the Department of Treasury and Finance have since reassessed the lease as falling within the definition of a finance lease under A-IFRS. We agree with this assessment. Accordingly, an asset and liability of around $310 million, respectively, will be recognised from 2005-06.

8.1.2 Unfunded superannuation

State liabilities (at 30 June)	2004	2005	Movement	Movement
	($m)	($m)	($m)	(%)
Unfunded superannuation	11 760	**10 540**	(1 220)	(10.4)

At 30 June 2005, the state's unfunded superannuation liability totalled $10 540 million, some $1 220 million less than 12 months previously. This was mainly due to improved yields from investments and a $708 million additional payment made by the state to reduce the unfunded superannuation liability.

The unfunded liability relates to a number of different superannuation arrangements that operate for public sector employees, members of parliament and the judiciary.

In general, superannuation benefits may be provided on either a defined benefit or accumulation basis. In a defined benefit scheme, the benefits payable on resignation, retirement or death are determined using a formula set out in the scheme's rules which includes, among other things, the employee's salary. The contributions required to finance the benefit vary depending on factors such as investment returns, salary increases and changes in the composition of the total membership.

In an accumulation scheme, the benefit payable is the sum of contributions made by the state and the employee together with accrued interest earned on the amount invested less costs incurred in administering the scheme. The benefit, therefore, varies according to the level of employer contributions, the investment returns and the associated costs incurred over the period of membership of the scheme.

With a defined benefit scheme, risks (such as poor investment returns) rest with the state. With an accumulation scheme, members bear these risks.

The state government has an obligation to ensure that funds are available to pay defined benefits to public servants as they become eligible to receive them. Before 1994, this obligation was met from the Consolidated Fund, on an "emerging cost or pay-as-you-go" basis[6] resulting in an unfunded liability. The state now pays employer contributions for accruing superannuation costs for those employees that belong to the defined benefit schemes.

The government has now closed most of the defined benefit schemes to new members and replaced them with (funded) accumulation schemes to which it contributes the amount required under the Commonwealth Superannuation Guarantee legislation. The government closed the defined benefits Parliamentary Contributory Superannuation Fund to new members in 2004, and the Emergency Services Superannuation Scheme is now the state's only defined benefit scheme that accepts new members. The government still pays pensions to judges, but not as part of a superannuation scheme.

The superannuation funds invest state and employee contributions, as well as additional top-up payments by the state, in income earning assets. The shortfall between the funds available to pay benefits, and the value of benefits that have accrued to-date, is called the unfunded superannuation liability. The value of the liability is periodically assessed by the appointed fund actuary. The actuary makes a number of assumptions about long-term economic and demographic matters such as rates of return on investments, salaries, inflation and member longevity.

Approximately 97 per cent of the state's unfunded superannuation liability is for the State Superannuation Fund. The balance relates to the Health Superannuation Fund, Constitutionally Protected Schemes and the Local Authorities Superannuation Fund.

During the year, the Emergency Services Superannuation Scheme moved from a deficit of $36.4 million (at 1 July 2004) to a surplus position of $475 million (at 30 June 2005). The Parliamentary Contributory Superannuation Fund increased its excess of assets over liabilities to $32.5 million.

The government expects the unfunded superannuation liability of $10 540 million at 30 June 2005 to increase in real terms until June 2007. It then expects the liability to decline until it is extinguished in 2035.

---

[6] That is, the money was contributed when a benefit became payable rather than being set aside in advance.

Impact of choice of fund legislation

In 2004-05, the Commonwealth Parliament passed legislation that requires employers, from 1 July 2005, to enable their employees to choose the superannuation fund into which their superannuation contributions are paid[7].

The legislation exempts the state from offering members of public sector defined benefit schemes choice of fund arrangements.

Impact of changes to actuarial assumptions or scheme changes

In 2004-05, there were no major changes to actuarial assumptions for the various schemes. However, a change was made to the tax status of benefits paid by the Emergency Services Superannuation Scheme (ESSS). As a result of the benefit payments being able to be recognised as a tax deduction, this improved the ESSS's financial position by around $205 million at 30 June 2005.

The government has also proposed to transfer the administration of the State Superannuation Fund to the ESSS from December 2005.

Impact of investment returns

The state's unfunded superannuation liability is heavily influenced by the investment yields generated by the superannuation funds. The State Superannuation Fund actuary had forecast a 7.5 per cent investment return for 2004-05. The actual return achieved was 16.12 per cent (after fees) compared with 15.9 per cent in 2003-04. This had a positive impact on the level of unfunded superannuation liabilities of around $737 million.

In 2004-05, other state superannuation schemes achieved returns ranging from 12.51 per cent to 15.30 per cent. This was mainly due to across-the-board increases in returns for all investment assets, with the returns on domestic equities having the biggest impact. Further commentary on investment returns is provided in Part 5 - *Revenue trends* of this report.

---

[7] The legislative amendments provide that from 1 July 2005, employers must generally give their employees a choice regarding the superannuation fund that their superannuation contributions are paid into.

Impact of additional payments

To achieve its long-term objective of fully funding the liabilities of defined benefits schemes, the government makes periodic additional top-up payments to the schemes. The amount and timing of additional contributions being made is dependant on the state's cash position.

In 2004-05, the government made top-up payments totalling $708 million ($1 006 million in 2003-04) to the State Superannuation Fund and Health Superannuation Fund.

Impact of Australian equivalents to International Financial Report Standards

One of the major impacts of A-IFRS[8] has been on the valuation of superannuation liabilities. Under A-IFRS, superannuation liabilities are valued using a lower discount rate being the 10 year Commonwealth bond rate (rather than a scheme's expected long-term earning rate, typically 7.5 per cent, which was used previously).

As published in the *2005-06 Budget Papers*, the overall impact of adopting A-IFRS was to increase the General Government Sector unfunded superannuation liability by around $5 800 million. A subsequent re-examination of this estimate, taking into account actual events (including movements in bond rates, investment returns, additional contributions) up to 30 June 2005 was undertaken. A change in methodology was also considered following additional guidance issued by the Australian Accounting Standards Board in relation to tax. Overall the re-examination resulted in a decrease in the estimated impact by around $953 million.

[8] In July 2002, the Financial Reporting Council announced that the Australian Accounting Standards Board would adopt Australian equivalents to International Financial Reporting Standards (A-IFRS) for reporting periods commencing on or after 1 January 2005.

8.1.3 Other provisions

State liabilities (at 30 June)	2004	2005	Movement	Movement
	($m)	($m)	($m)	(%)
Other provisions	14 118	**14 859**	741	5.2

Other provisions increased by $741 million in 2004-05 largely as a result of increases in the outstanding claims liability of $916 million which was offset by a reduction in the provision for the flexible electricity tariff arrangements.

Outstanding insurance claims liabilities

During 2004-05, the state's outstanding insurance claims liability increased by $916 million (7.3 per cent), compared with an increase of $516 million (4.4 per cent) in 2003-04. The liability increased mainly as a result of:

- claims incurred during the year by the state's insurance bodies
- a reduction in the discount rate applied in the assessment of the liability.

Figure 8B shows the outstanding insurance claims liabilities managed by agencies.

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

	Total		
Agency and nature of outstanding claims managed	**2005**	2004	**Movement**
Victorian WorkCover Authority – personal work-related compensation	**7 247**	6 842	**405**
Transport Accident Commission – transport accident compensation	**5 240**	4 826	**414**
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)	**509**	396	**113**
Department of Human Services - mainly medical indemnity insurance claims (a)	**370**	379	**(9)**
Other agencies	**23**	30	**(7)**
Total outstanding claims liabilities	**13 389**	12 473	**916**

(a) The Department of Human Services assumed all the liabilities in respect of medical indemnity claims arising before 1 July 2003. The Victorian Managed Insurance Authority is responsible for medical indemnity claims incurred after that date.

Source: Agencies' annual financial reports.

The outstanding insurance claims liabilities cover claims reported but not paid, and claims incurred but not reported. These 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.

Currently, each agency decides (after considering advice from their actuaries) whether to use a prudential margin when valuing outstanding insurance claims liabilities, and the size of the margin. The prudential margins utilised by the Transport Accident Commission and the Victorian Managed Insurance Authority totalled $755 million at 30 June 2005 and represented 14 per cent of their combined outstanding insurance claims liabilities. The Victorian WorkCover Authority does not use a prudential margin, but determines its liabilities based on the central estimate determined by its actuaries and uses a risk-free discount rate.

The Australian equivalents to International Financial Reporting Standards (A-IFRS), AASB 1023 *General Insurance Contracts*, requires the use of a prudential margin and a risk-free discount rate[9] in determining the outstanding insurance claims liabilities of agencies. The expected impact on the state's outstanding insurance claims liabilities in 2005-06 is an increase of $806 million, mainly relating to the Victorian WorkCover Authority.

Flexible electricity tariff arrangements

In 1984, the state government offered a low flexible electricity tariff for the Point Henry and Portland aluminium smelters in order to attract the smelter investments. 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, the SECV entered into a hedge arrangement. Also, from 1 July 1997, wholesale electricity market participants were obliged to pay the SECV "smelter reduction amounts" which the SECV used to fund future expected losses under the electricity tariff arrangements.

---

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

The legality of the smelter reduction amount 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 from 30 June 2004 assumed an amount equivalent to the SECV's exposure under the flexible electricity tariff arrangements which is estimated at $1 036 million at 30 June 2005 ($1 232 million at 30 June 2004). To help fund the liability in the future, the state made land tax payable on transmission companies' electricity easements. This new tax generated $105 million in 2004-05.

Under the arrangements the SECV paid out $81.8 million in 2004-05, compared with $103.7 million in 2003-04. Since assuming the funding of the liability in 1997, the SECV has paid a total of $915.8 million under the arrangements.

The SECV's obligations and rights under the flexible electricity 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. As previously indicated, the estimated future liabilities from the arrangements until the smelter contracts expire in 2014 and 2016 was estimated to be $1 036 million at 30 June 2005 on a net present value basis. The revaluation of the onerous contracts provision resulted in a net gain of $114.5 million.

The initial 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, respectively.

The legal challenge to the smelter reduction amount is currently before the courts. The plaintiffs are seeking reimbursement of the amounts previously paid, together with interest and costs. The legal challenge is referred to as a non-quantifiable contingent liability in the notes to the *2004-05 Annual Financial Report*.

8.1.4 Payables

State liabilities (at 30 June)	2004	2005	Movement	Movement
	($m)	($m)	($m)	(%)
Payables	3 653	**3 363**	(290)	(7.9)

At 30 June 2005, payables were $290 million less than 12 months earlier. Despite the recognition during 2004-05 of an $87 million payable by the state for the redevelopment of the Royal Melbourne Showgrounds, total payables decreased by $290 million due to, among other things, the impact of a reduction in derivative financial instruments payable.

8.1.5 Commitments

State liabilities (at 30 June)	2004	2005	Movement	Movement
	($m)	($m)	($m)	(%)
Commitments	16 068	**16 675**	607	3.8

The government has entered into contractual commitments that require future use of financial resources. It has significant amounts of long-term lease obligations and undelivered orders. Undelivered orders represent the value of goods and services ordered that have not yet been received.

Commitments increased by $607 million mainly as a result of new contractual arrangements entered into during the year. These new commitments were partially offset by the expiration of existing contractual arrangements.

In July 2005, the government entered into a $317 million (in nominal terms)[10] contractual arrangement for the design, build and operation of a new state-wide public transport ticketing system using smartcard technology. The new system will replace the existing OneLink ticketing system, which expires in March 2007. To facilitate the arrangement, the state entered into an agreement with OneLink to provide full assistance and cooperation during the tendering, transitional and implementation phases. In return, OneLink is to receive capped performance-based payments. We intend to undertake a separate review of this arrangement. In addition to the new state-wide public transport ticketing system, the state has entered into 4 public-private partnership arrangements.

[10] The net present value of this contract was not available at the time of preparation of this report.

Major agreements that expire in 2005-06, that will require renegotiation or new contracts include the Port Phillip and Fulham prison correctional services contract, and the Victoria Police information technology contract. Accordingly, the financial obligations arising from these renegotiations or new contracts are not captured in the commitment note to the *2004-05 Annual Financial Report.*

Public-private sector arrangements

Public-private sector partnership arrangements can take various forms. A typical partnership involves the state paying the private sector to design, construct and manage, over a long period, a major public asset. Following construction, regular payments are made 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 private sector or the asset may be decommissioned. From a budgeting perspective, although the arrangements lock in future governments to the contractual obligations, it also provides certainty over the government's funding requirements and commitments.

It is the government's policy to use public-private sector arrangements where it is appropriate and where it expects to deliver value-for-money. Generally, a project is considered "appropriate" where it is a major and complex capital project with significant ongoing maintenance requirements. Value-for-money is assessed through the use of a public sector comparator. This compares the value-for-money of a private sector bid, with the most efficient form of public sector delivery.

The state has entered into a further 4 public-private sector arrangements, namely, the Emergency Alerting System, Royal Women's Hospital Project, EastLink Tollway (known as the Mitcham-Frankston Freeway) and the Royal Melbourne Showgrounds redevelopment. As indicated previously, the results of a review of the progress of the Eastlink Tollway project will be tabled in parliament at a later date.

Emergency Alerting System

In June 2004, the government entered into a 7-year contract with VEC Network Pty Limited to design, construct, operate and maintain a new Emergency Alerting System (EAS). The state-wide communication system will cover around 97 per cent of Victoria and replace the existing fragmented system which covers 50 per cent of the state.

VEC Network is a consortium comprising LSE Technology (Australia) Pty Ltd and ABN AMRO Australia Limited. LSE is an Australian company with experience in the communication industry, while ABN AMRO is an international bank and provider of structured finance for infrastructure projects.

The objective of the new system is to provide emergency service personnel in country Victoria (including the Country Fire Authority, Rural Ambulance Victoria and the State Emergency Service) with a text messaging service through a pager. The contract includes the purchase of approximately 29 000 pagers to be used by 70 000 emergency personnel and volunteers across Victoria.

VEC Network was chosen after a 24-month tender process whereby it was assessed to represent marginally better value-for-money compared with the estimate in the public sector comparator. The appointed probity auditor raised no concerns with the tender process.

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

FIGURE 8C: RIGHTS AND OBLIGATIONS OF VEC NETWORK AND THE STATE

Type of risk	VEC Network	The state
Design and construction risk	Designs (in accordance with state pre-determined key performance indicators and service deliverables), finances, constructs and commissions the network. Obtains access, approvals and leases with land owners (including Crown land). Has all relevant site risks. Assumes most financial risks, including cost overruns, construction delays and design or construction flaws. Pays liquidated damages if certain contractual milestones are not achieved on time. Meets the costs of any approved modifications not requested by the state.	Specifies the key performance parameters and service deliverables. Leases land to VEC Network if communication towers are to be erected on Crown land or provides access to existing communication towers, at the discretion of the state. VEC Network cannot enter into any site lease or any carrier site license without the approval of the state. However VEC Network is not entitled to any claims in relation to access-related delays. Compensate VEC Network for state requested modifications. The network must be tested before it is accepted by the state. State to share in any benefits arising from approval modifications requested by VEC Network resulting in reduced construction costs. Supply VEC Network customer supplied items (csi) including power requirements, space and training venues.

FIGURE 8C: RIGHTS AND OBLIGATIONS OF VEC NETWORK AND THE STATE - continued

Type of risk	VEC Network	The state
Obsolescence, including the effect of change in technology	Owns and maintains the EAS network over the service term. Ensures the EAS technology and network is designed to meet the key performance indicators and service deliverable requirements over the contract term. Upgrades the network over the service term, including replacing outdated network technology, to continue meeting the specification requirements. Maintains a stock of spare messaging devices at no additional cost to the state.	The key performance indicators established are based on the available technology at the time of tender. Pays for any state-initiated modifications to increase the technological capabilities of the network or additional functionality. Bears the obsolescence risk of the network's remaining life if it exercises the option to receive the network on termination or expiry of the agreement. Significant capital costs include the software, central equipment, communication towers and messaging devices which have a design life longer than the service term.
Potential changes in relevant costs (after final acceptance)	Pays cost of repairs and maintenance arising from the ordinary usage of the EAS facility (including messaging devices). Bears movements in forecast costs and revenues associated with the network and specification requirements, including insurance. Bears the costs associated with computer viruses on EAS network software. Bears the costs associated with loss, damage or destruction of the EAS network. Bears the costs associated with tax changes.	Bears cost increases in line with movements in the consumer price index for the operating cost component of the service payments. Movements in the consumer price index are locked in at a specified rate for the construction component of the service payments. Meets the cost of repair or replacement of messaging devices which have been lost or damaged. Meets maintenance costs where it is the result of a negligent act or omission by the state. Meets costs associated with computer viruses caused by the state contaminating the EAS network software. Shares with VEC network productivity efficiencies in managing the network's ongoing costs. Pays for modifications requested by the state.
Abatement for non-availability	Monthly service payment is subject to abatement if the specified key performance indicators are not met. The state can draw-down on separate performance bonds during design and construction phases, and operation and maintenance phases.	Pays monthly fixed service payments on final acceptance. The state has the right to temporarily take or assume total or partial possession (step-in), management and control of the EAS facility and the provision of the EAS services in the event of a default or termination or an event relating to the performance of the EAS facility or EAS services. Termination payment depends on the type of termination event, including default, force majeure or change in government policy. Default and force majeure 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 any time over the period, the state can acquire the facility for a termination payment based on capital value of the project, financing costs, an equity return plus associated costs.

FIGURE 8C: RIGHTS AND OBLIGATIONS OF VEC NETWORK AND THE STATE - continued

Type of risk	VEC Network	The state
Third party revenues	New customers introduced by VEC network can only use the network if approved by the state. VEC network is not able to propose to introduce a new customer if it will have an adverse effect on the provision of the EAS services. Has warranted that the EAS facility and EAS services are scalable in that they can be upgraded or expanded to allow for an increase in the number of users or new customers, without the need for significant replacement of existing infrastructure. However, VEC Network does not rely on third party revenue to recoup costs associated with the project.	The state can introduce a new customer resulting in an adjustment to the monthly fixed service payment. Shares benefits of VEC Network introduced customers.
Asset residual value	Does not accept any residual value risk, and, therefore, assigned a nil residual value to the project assets in pricing the lease. On expiry of the services term or termination event, the contractor must offer to sell, assign, novate or otherwise transfer to the state all its interests in the EAS facility, the sites, equipment and services, to enable the state to continue using the service. VEC Network is not obliged to transfer staff at the end of the service period. Communication towers erected on land owned by VEC Network are to be leased back to the state at the end of the term.	At the end of the service period, there will be no nominal expiry value. The state, therefore, has the option of acquiring the EAS at no cost, however, will need to meet transfer costs (legal fees). Communication towers and masts are to be maintained to ensure an effective useful life of over 25 years. The messaging devices do not have a stipulated design life, however, with proper care are expected to work for an indefinite period. EAS software and system is required to be maintained so that at the end of the service term it can continue working. Has a 5-year option to lease land owned by VEC Network at the end of the service term. Other land leased is to be novated to the state (including leases on Crown land and with other third parties). Is assigned the software licence at no cost at the end of the contract, although does not own the software licence.
Demand risk	Bears the risk that the network will not be designed and constructed to meet the capacity requirements in the agreement.	The state makes pre-determined service payments to the contractor and amounts are not based on usage. Therefore, the state bears the risk of underutilisation. Pays the cost of additional messaging devices above the specified number.

Source: Victorian Auditor-General's Office.

Over the 7-year contract term, the state will pay $50 million in net present value terms ($154.5 million in nominal terms). As the majority of risks associated with the asset over its life have been retained by the state, the assets and liabilities associated with this project will be ultimately reported in the state's statement of financial position.

When construction is complete, the capital portion of the total service payments will be recorded in the statement of financial position, representing the state's obligation to finance the capital cost of the network. Until the network is complete, the associated financial commitments will be disclosed in the commitments note in the Annual Financial Report.

Royal Women's Hospital project

In September 2003, the government approved the construction of the new Royal Women's Hospital (RWH), to be located adjacent to the Royal Melbourne Hospital in Parkville.

The government selected RW Health Partnership Pty Ltd (the developer), in April 2005, to finance, design, build and maintain the new RWH over a 25-year term. The developer was also required to provide ancillary services such as cleaning, car parking, help desk and security, while the state will continue to operate the RWH.

The developer was chosen after a 17-month tender process in which the financial component of the proposal was marginally more favourable (around 2 per cent difference) than the estimate in the public sector comparator.

The probity auditor appointed to oversee the process concluded that there were no material departures from the government's purchasing policy.

The construction of the RWH is to take approximately 3 years, with a scheduled completion date of June 2008, while the operational phase of the RWH will run through to June 2033. The government expects to offer the existing Royal Women's Hospital site and car park for sale in 2008-09.

Artist's impression of the new Royal Women's Hospital.
(Photo courtesy of the Department of Human Services.)

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

FIGURE 8D: RIGHTS AND OBLIGATIONS OF RW HEALTH PARTNERSHIPS PTY LTD AND THE STATE

Type of risk	RW Health Partnerships Pty Ltd (developer)	The state
Design and construction risk	Assumes the demolition, design, construction and finance risks (including cost overruns, permit delays, site demolition and construction delays, and design or construction flaws). Meets the costs of any modification not explicitly requested by the state during construction. Pays liquidated damages if final completion does not occur by the required date.	Determines the key output requirements of the RWH. Provides the developer with a non-exclusive construction licence until completion. Provides the developer with a non-exclusive licence to provide services over the duration of the 25-year operating period. Meets the costs of any state-initiated changes requested before construction is completed. Approved modifications requested by the developer resulting in reduced costs will be captured by the state as an offset to the monthly service payments.

FIGURE 8D: RIGHTS AND OBLIGATIONS OF RW HEALTH PARTNERSHIPS PTY LTD AND THE STATE - continued

Type of risk	RW Health Partnerships Pty Ltd (developer)	The state
Obsolescence, including the effect of change in technology	Ensures facility has a design life of 50 years. Procures, installs, commissions and maintains a variety of equipment. Undertakes all refurbishment works and maintenance in accordance with the agreement and asset management plan. Maintains the facility to achieve a design life of 50 years. Maintains plant and equipment to achieve operational objectives.	Significant portion of the capital cost for the project relates to the construction of the facility, which has a design life longer than the 25-year agreement. Bears the risk of technical obsolescence of the plant and equipment after the 25-year period.
Potential changes in relevant costs (after construction completion)	Bears the risk of maintenance and refurbishment costs exceeding forecast amount. Bears the risk of labour costs and other costs associated with providing ancillary services exceeding forecast within the interval terms over the service period. Maintains all insurances over the facility, and the plant and equipment. Shares the risk of uninsurable loss, damage or destruction of the facility with the state. If an inspection (to be undertaken 6 years before the end of the contract term) shows the remaining minimum life will not be achieved, a portion of the service fee is to be paid into an escrow account, acting as a guarantee.	If refurbishment works or service standards are not satisfactorily completed, the state may deduct a pre-determined amount from the service payments until such works are complete or services resumed to the required standard. Entitled to recover a 50 per cent share of any net refinance gains made by the developer. Compensates the developer in the event of a state extension event (which includes breach by the state of the contractual terms and negligent acts or omissions by the state that prevent the developer from discharging its contractual obligations). Reimburses the developer costs associated with negligent acts or omission by the state. Pays cost increases arising from certain changes in state laws and policies above specified financial thresholds. Bears general inflation risk as certain elements of the service payments are adjusted for movements in the consumer price index. Agreed mechanisms to review ancillary services costs. Security and car park services subject to market review every 5 years and cleaning services every 8 to 9 years.
Abatement for non-availability	Service payments are subject to an abatement if certain service standards or key performance indicators are not achieved. Construction bonds provided to the state can be drawn-down to remedy defects during construction and during the defects liability period.	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 (before or after construction completion), the termination payment is based on the pre-tax market value of the facility at the date of termination, less costs and damages payable to the state. At any time over this period, the state can acquire the facility for a termination payment. Termination payment calculation varies depending if construction is completed. If not completed, the termination payment based on total construction costs less amounts owing by the developer to the state and any gains that will accrue to the developer. If construction is complete, the termination payment based on all financing costs, an equity return plus associated costs.

FIGURE 8D: RIGHTS AND OBLIGATIONS OF RW HEALTH PARTNERSHIPS PTY LTD AND THE STATE - continued

Type of risk	RW Health Partnerships Pty Ltd (developer)	The state
Abatement for non-availability - continued		In the event of a force majeure termination event, termination payment will consist of remaining debt, associated costs less proceeds from insurance received.
Third party revenues	Limited scope for third party use of the facility.	Receives all revenue generated by the facility, including revenue from the retail precinct and the car park.
Asset residual value	Has not accepted any residual value risk and, therefore, assigned a nil residual value to the property in pricing the lease. If 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 to the state at the end of the 25-year operating period for nil consideration. May draw-down on funds from the escrow account to complete any refurbishment works required at the end of the contract. If there are insufficient funds to cover the works then the state can make a claim against the developer. At 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	Liable for all repairs, maintenance and refurbishment, even if the hospital demand exceeds forecasts.	Service payments for the provision of the contracted facilities and services are predominately fixed (subject to periodic benchmarking reviews and indexation) and will not directly vary with demand or usage of the property.

Source: Victorian Auditor-General's Office.

Over the 25-year contract term, the state will make total payments of $364 million in net present value terms ($1 073 million in nominal terms). As the majority of risks associated with the asset over its life have been retained by the state, the assets and liabilities associated with this project will be ultimately reported in the state’s statement of financial position.

When construction is complete, the capital portion of the total service payments will be recorded in the statement of financial position, representing the state’s obligation to finance the capital cost of the facilities. Until the facility is complete, the associated financial commitments will be disclosed in the commitments note in the Annual Financial Report.

Royal Melbourne Showgrounds redevelopment

In October 2003, the government agreed to enter into an unincorporated joint venture arrangement with the Royal Agricultural Society of Victoria (RAS) to redevelop the Royal Melbourne Showgrounds. The joint venture is to make all operational decisions concerning the redevelopment project. In October 2004, a joint venture project company (Showgrounds Nominees Pty Ltd) was established in accordance with the *Royal Agricultural Showgrounds Act 2003* to hold the project assets.

In June 2005, following a 20 month tender process[11], the joint venture project company signed an agreement with the preferred bidder to finance, design, build and maintain the showgrounds over a 25 year period. The preferred bidder, PPP Solutions (the concessionaire), is a consortium consisting of financier Babcock and Brown, Multiplex Constructions and Multiplex Facilities Management. The preferred bidder compared marginally more favourable than the estimate in the public sector comparator.

The overall objective of the redevelopment is to "keep the show going". The redevelopments main features include refurbishment of the heritage listed buildings, the grand pavilion, town square, main entrance and boulevard, and the establishment of a new exhibition space and an outdoor animal competition area. Two-thirds of the 27 hectare site will be redeveloped for exhibition purposes, with the remaining land on the site to be commercially developed.

Artist's impression of a section of the new showgrounds site.
(Photo courtesy of the Department of Infrastructure.)

[11] From expression of interest stage.

The showgrounds redevelopment was originally forecast to have commenced in April 2002 and to be completed in time for the 2005 Royal Melbourne Show. Due to delays in the tendering and commercial arrangements, the works are now expected to be completed and ready to use for the 2006 Royal Melbourne Show.

Joint venture arrangement structure

At the time of agreeing to enter into the joint venture arrangement, the government agreed to make a cash contribution of $100.7 million. RAS was to contribute its freehold interest in the showgrounds land together with improvements with a total estimated fair value of $51 million. However, it was subsequently discovered that a significant portion of the land to be contributed by RAS was Crown land which was already recorded in the Department of Sustainability and Environment's financial statements. After taking this into account, RAS only contributed land and improvements to the value of $19.9 million. The government's contribution totalled $138.4 million which included an additional parcel of Crown land valued at around $6.6 million. The project company holds the title to the project land on a bare trust arrangement[12].

Under the arrangements between RAS and the state, RAS will continue to act as the events manager for specified RAS sponsored events, including the Royal Melbourne Show. From these events it is expected that RAS will be able to meet its financial obligations to the joint venture. RAS is also required to contribute a capped proportion of its cash flow[13] into an asset replenishment fund, which is controlled by the joint venture. The current expectation is that this fund will have sufficient funds at the end of the 25 year term to allow further capital investment in the showgrounds.

At the time of preparing this report, the joint venture was looking for an events manager to attract commercial events (non-RAS sponsored events). The joint venture would share with an events manager income generated from event hiring fees and associated commercial events.

The difference between the state contributions to the joint venture and the financial obligations to the PPP Solutions (the concessionaire) over the 25 year period is forecast to be met from:

- a further $7.9 million contribution by the state to meet pre-condition works associated with the redevelopment
- a contribution from the proceeds of the lease of surplus land for commercial development

[12] A bare trust is where the trustee has no active duty beyond conveying the property to the beneficiary at some future time.

[13] Calculated as a percentage of free cash flows (meaning the greater of the earnings from the Royal Melbourne Show or the business of RAS after deducting operating costs).

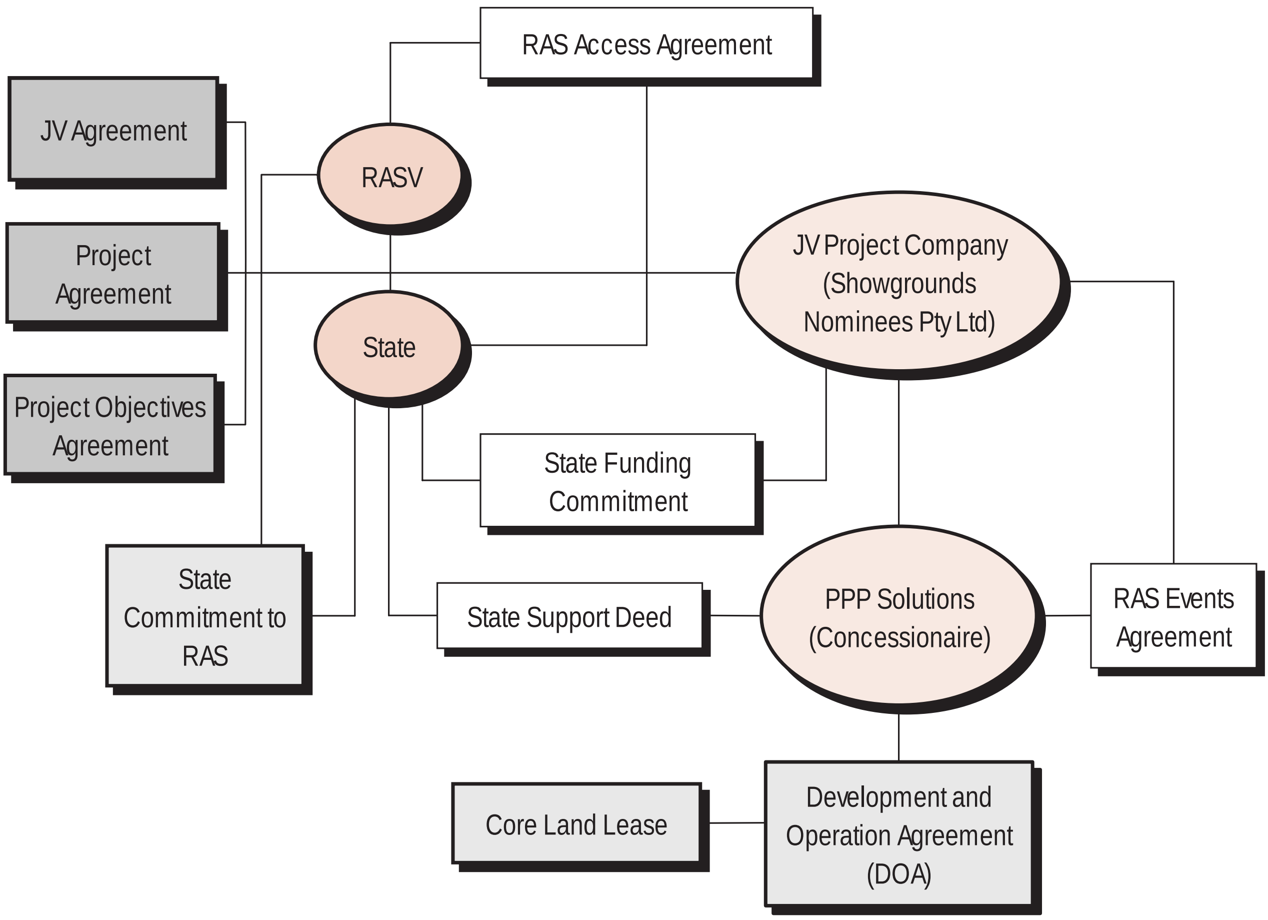
- the attraction of additional events (non-RAS sponsored events) by an events manager
- if required, the utilisation of funds from the asset replenishment fund.

In the event that RAS is unable to meet its financial contribution to the joint venture project company, the state has entered into an arrangement whereby, in essence, it has acted as the guarantor, and will provide funding to RAS via a loan facility, thereby enabling RAS to meet its financial obligations.

The parties have not yet negotiated an agreement about which party will make extra contributions, in the event that the project's financial projections are not met.

Figure 8E shows the structure of the arrangements entered into by the parties.

FIGURE 8E: CONTRACTUAL ARRANGEMENTS SUPPORTING THE ROYAL MELBOURNE SHOWGROUNDS REDEVELOPMENT



Source: Department of Primary Industries.

Figure 8F shows the rights and obligations of PPP Solutions and the joint venture participants to the arrangement.

FIGURE 8F: RIGHTS AND OBLIGATIONS OF PPP SOLUTIONS AND JOINT VENTURE PARTICIPANTS

Type of risk	PPP Solutions (concessionaire)	Joint venture participants
Design and construction risk	Designs and constructs the works in accordance with the functional brief. Assumes the design, construction and finance risks (including cost overruns, construction delays, and design or construction flaws) with the exception of delays and the associated costs caused by multi-site, multi-contractor industrial disputes. Gains planning approvals for the facilities and all heritage approvals. Meets the costs of any concessionaire-initiated modifications. Pays capped damages up to $5.5 million if construction is not completed by the required date for the staging of the 2006 show.	Determines the functional brief of the showgrounds site and endorses all design documentation against the functional brief prior to works commencement. Grants licences to occupy certain portions of the site. Meets the cost of clearing contamination during the construction phase and shares the cost of time delays (specific to contamination issues). At its cost, can direct the developer to accelerate works. During the construction, bears industrial relations risk that was not directly related specifically to the showgrounds site or the developer. Meets the costs of any project company-initiated design changes requested before construction is completed. May request additional tests (at its own cost) if it considers that the commissioning test undertaken are inadequate. Compensates the developer in accordance with a formula for capital cost increases over $200 000 because of a change in state law. Benefits in any efficiency or savings resulting from approved modifications.
Obsolescence, including the effect of change in technology	Ensures the showgrounds facilities have a design life of 40 years. Maintain the showgrounds (including all improvements on the showgrounds, plant, machinery and equipment) in accordance with an asset management plan. Inspections to be undertaken at least 3 years before the end of the 25 year contract period. If inspections reveal that the remaining minimum life of the machinery, plant and equipment will not be achieved, a portion of the service fee is to be paid into an escrow account to meet upgrade costs	Bears the risk and cost of technical obsolescence of the showgrounds at the end of the 25 year period. Bears the risk of technical obsolescence of the machinery, plant and equipment after the 25 year period. All items of plant, machinery and equipment is required to have a useful remaining life of the lesser of 50 per cent or 5 years.

FIGURE 8F: RIGHTS AND OBLIGATIONS OF PPP SOLUTIONS AND JOINT VENTURE PARTICIPANTS - continued

Type of risk	PPP Solutions (concessionaire)	Joint venture participants
Potential changes in relevant costs (after construction completion)	Bears the risk of maintenance and refurbishment costs exceeding forecast amounts. Bears the costs associated with contamination risk after construction completion. Shares in the cost of relevant insurances with the joint venture and RAS. Complies with all the requirements and conditions of the planning approvals at all times. Compensates the project company in accordance with a formula for any operating cost decreases over $20 000 because of a change in state law. Accepts industrial relations risks during the 25-year operations term apart from the period prior to a show and the period when a show is in progress.	Compensate the developer (in line with a formula) for operating cost increases over $20 000 because of a change in state law. Shares benefits with developer of any refinancing gains. Pays damages resulting from a negligent act or breach of contractual terms. Accepts industrial relation risk for a specific period of the show and the immediate period prior to the show commencing. Adjusts service payments (specific to maintenance and security) for movements in the consumer price index. Shares in cost of relevant insurances with RAS and the developer.
Abatement for non-availability	Service payments are subject to abatement if the specified key performance indicators and availability benchmarks are not met. Performance bonds provided to the project company can be drawn-down.	In consideration for the joint venture agreeing to a compromise with regard to abatement risk and other matters concerning commercial events, the developer agrees to pay the project company the sum of $250 000 for the first 3 years of the operational term. In a default event, the 25-year lease would be terminated. Termination payment depends 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 at the date of termination, less costs and damages payable to the joint venture. 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 the costs and damages payable to the joint venture. At any time over the period, the joint venture can terminate the lease (for convenience) for a termination payment based on all financing costs, an equity return plus associated costs. Step-in rights are also available to the joint venture for non-availability and abatement.
Third party revenues	No opportunity for third party revenue.	The developer grants RAS the right to have access and use of the showgrounds facilities for the purposes of running certain events specified. RAS will collect the revenues associated with these events. Opportunity to stage events outside the RAS specified events rests with the joint venture. Currently in the process of appointing an events manager to market the site, of which the joint venture will share in the income earned.

FIGURE 8F: RIGHTS AND OBLIGATIONS OF PPP SOLUTIONS AND JOINT VENTURE PARTICIPANTS - continued

Type of risk	PPP Solutions (concessionaire)	Joint venture participants
Asset residual value	Has not accepted any residual value risk. The pricing of the lease takes into account a nil residual value. Must return to the joint venture, on expiry of the contract, the buildings and plant, machinery and equipment at a condition to enable their continued use.	The joint venture owns the showgrounds, the site and plant, machinery and equipment. At the end of the contract period, the joint venture project company assumes the risks and costs associated with the remaining economic life of the buildings (around 15 years) and plant, machinery and equipment (the lesser of 50 per cent or 5 years).
Demand risk	Nil.	Generally, makes fixed payments not based on usage. Payments are not adjusted for underutilisation of the showgrounds and plant, machinery and equipment. However where patronage for the show exceeds 750 000 in any year and where it is agreed that this will occur on an on-going basis, the service fee is to be adjusted. Can seek reimbursement from RAS where changes to RAS listed specific events or additional RAS events (non-RAS sponsored events) impact on the service charge (if it impacts on the developer's maintenance obligations). Can seek reimbursement from the events manager (yet to be appointed) for hosting events that impact on the service charge (if it impacts on the developer's maintenance obligations) including hiring charges.

Source: Victorian Auditor-General's Office.

As the assets are owned by the joint venture, the capital improvements and the financial obligation to the developer will need to be reported on the joint venture's balance sheet.

Under the arrangements, despite the state contributing around 87.5 per cent of the total contribution to the arrangement up to 30 June 2005, both the government and RAS will have an equal share holding in the project company.

The state will account for its investment in the joint venture on an equity accounting basis, that is, the state's share in the investment. As the state has contributed more to the joint venture than its equity holding, the difference of around $66 million will be written-off as an expense by the state. The carrying value of the investment is to be adjusted in each year by reference to the joint venture's net assets.

A payable of $87 million has been recognised in the Annual Financial Report, relating to the state's remaining contribution under the joint venture arrangements. Further, as indicated previously, the state has committed $7.9 million to meet pre-condition works associated with the redevelopment.

8.1.6 Contingencies

Contingent liabilities involve situations where there is uncertainty of a possible loss, impairment of an asset or the incurrence of a liability. Contingencies that are assessed as probable and measurable are accrued in the financial statements. All other contingencies are disclosed in the note to the financial statements as either quantifiable or non-quantifiable.

Major new contingent liabilities in 2004-05 include the risks associated with the Royal Melbourne Showgrounds (refer to comments earlier in this section of the report), Ticketmaster7 and the Country Train Safety System.

In July 2005, the state agreed to indemnify Ticketmaster7 for any adverse financial consequences associated with the early release of ticket sales income for the 2006 Melbourne Commonwealth Games. The early release of the money enabled Melbourne 2006, the organising body of the games, to apply the funding to meet costs incurred in the preparation for the games. The usual practice is for ticket sales income to be kept in trust until the completion of the event, in case the event is cancelled, and ticket sales need to be refunded. Under the indemnity, the maximum exposure is approximately $45 million, representing the total amount of ticket sales at year-end.

The Country Train Safety System project extends the safety requirements for all country passenger trains operating in the regional fast rail corridors. The project will allow V/Line Passenger to run its high velocity trains operating on the corridors at speeds up to 160 km/h. Under the project the state has agreed to compensate the long-term leaseholder of the rail track, Pacific National (Victoria) Limited, for any adverse financial consequences arising from the project's installation.

Auditor-General's Reports

2005

Report title	Date issued
Regulating operational rail safety (2005:1)	February 2005
Managing patient safety in public hospitals (2005:2)	March 2005
Management of occupational health and safety in local government (2005:3)	April 2005
Results of special reviews and other investigations (2005:4)	May 2005
Results of financial statement audits for agencies with other than 30 June 2004 balance dates, and other audits (2005:5)	May 2005
Our children are our future: Improving outcomes for children and young people in Out of Home Care (2005:6)	June 2005
In good hands: Smart recruiting for a capable public sector (2005:7)	June 2005
Managing stormwater flooding risks in Melbourne (2005:8)	July 2005
Managing intellectual property in government agencies (2005:9)	July 2005
East Gippsland Shire Council: Proposed sale of Lakes Entrance property (2005:10)	July 2005
Franchising Melbourne's train and tram system (2005:11)	September 2005
Results of special reviews and other investigations (2005:12)	October 2005
Health procurement in Victoria (2005:13)	October 2005
Community planning services in Glenelg Shire Council (2005:14)	October 2005
Follow-up of selected performance audits tabled in 2002 and 2003 (2005:15)	October 2005

The Victorian Auditor-General's Office website at <www.audit.vic.gov.au> contains a more comprehensive list of all reports issued by the Office. The full text of the reports issued over the past 10 years is available at the website. The website also features a "search this site" facility which enables users to quickly identify issues of interest which have been commented on by the Auditor-General.

AUDITOR GENERAL
VICTORIA

Availability of reports

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

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

  Phone: 1300 366 356 (local call cost)
  Fax: (03) 9603 9920
  Email: <bookshop@dvc.vic.gov.au>

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

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