Buy-back of the Regional Intrastate Rail Network

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Victorian Auditor-General's Office

Auditing in the Public Interest

The Hon. Robert Smith MLC
President
Legislative Council
Parliament House
Melbourne

The Hon. Jenny Lindell MP
Speaker
Legislative Assembly
Parliament House
Melbourne

Dear Presiding Officers

Under the provisions of section 16AB of the *Audit Act 1994*, I transmit my performance report on the *Buy-back of the Regional Intrastate Rail Network.*

Yours faithfully

D D R PEARSON
Auditor-General

24 June 2009

Foreword

This audit examined the state’s decision to buy back the non-metropolitan intrastate rail network. This is a significant state asset, especially for the regional communities that rely on it for passenger and freight services. In 1999, the state granted a 45-year lease over the network to a private company as part of its broader rail privatisation reforms.

When leased, the network was run down and the maintenance backlog worsened because the lease failed to impose effective maintenance obligations on the lessee. Successive lessees took a contractually compliant, minimum maintenance approach on freight-only lines. Some lines were allowed to deteriorate further and others to effectively fall out of service.

There is little doubt that the buy-back unwound a lease which was ineffective in maintaining the asset. It also improved the state’s capacity to carry out major investments in upgrading the network. In negotiating the buy-back the state made other strategic gains of broader significance to Victoria’s freight and logistics network, primarily related to freeing up rail access to the Port of Melbourne.

However, no assurance can be given that the state paid the lowest reasonable purchase price obtainable in the circumstances. This is largely because at the time the state committed to the buy-back sufficient advice had not been obtained to support its decision about how much to pay, for example there was not an adequate business valuation. Further, it is clear that the cost of the buy-back exceeded the publicly announced cost. The full cost is likely to exceed $200 million, compared with the announced cost of $133.8 million.

D D R PEARSON
Auditor-General

24 June 2009

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1.1 Introduction

1.1.1 The intrastate rail network

The non-metropolitan intrastate rail network is a significant state asset, particularly for regional communities that rely on it for passenger and freight services.

One of the aims in the government's *Growing Victoria Together* policy is to increase the proportion of freight transported to ports by rail on this network from around 10 to 30 per cent by 2010. To achieve this, the network needs to be well maintained and efficiently run.

In 1999 the state leased the network to a private company for 45 years as part of the sale of the V/Line Freight Corporation. The state was paid $70.4 million for the 'above-rail' freight business and $89.7 million for the rail network lease. The lease did not require the lessee to maintain the network other than for the last five years of the lease.

In August 2004 the lessee was taken over when its business, including its plant and equipment and the infrastructure lease over the intrastate rail network, was acquired for $285 million. The state consented to this transfer of control over the lease. The new lessee was owned jointly by two major corporations operating in the Australian freight and logistics sector.

There was a maintenance backlog on the network when the first lessee took control from the state in 1999. The lessees took a contractually compliant, minimum maintenance approach on freight-only lines, and effectively allowed some lines to fall out of service. This arose from the ineffective maintenance obligations in the lease combined with lower than expected revenues from freight services because of the drought, especially for grain. The infrastructure deteriorated further, which added to the maintenance backlog. The state responded in 2005–06 when it began directly funding the lessee for maintenance work over and above contractual requirements.

In 2006 the Essential Services Commission confirmed that maintaining the intrastate freight network at reasonable levels of service was unsustainable without ongoing government financial support.

In August 2005 one of the joint owners of the second lessee announced it intended to acquire the other joint owner, which it did in May 2006. This triggered another change in control over the network leaseholder, but the state's consent was not obtained triggering a termination event under the lease. This allowed the state to consider the future of the network and the lease.

The lease presented a number of practical concerns. In addition to the inadequate maintenance expenditure, having the network leased to and controlled by a third party added to the complexity, time and cost when the state sought to do major capital works such as the regional fast rail project. The state was also the key revenue source for the lessee through access fees paid by V/Line Passenger Corporation (V/Line).

The lessee also ran its own 'above-rail' business, running rail freight services on the network. Control of the network by a private company that also ran an above-rail business was perceived as a limiting factor in encouraging greater use and competition on the network. The state also saw this as a risk to its ability to run regional fast rail services at their maximum intended speeds.

1.1.2 The buy-back

In April 2007 the government announced it had reached agreement to 'buy back' the intrastate regional rail network from the lessee for $133.8 million. This confirmed an earlier 'in principle' sale agreement announced in November 2006 at the start of the caretaker period before the state election.

The state determined that a buy-back of the network would result in savings and other benefits including:

- greater flexibility to develop and deliver integrated transport plans to achieve government objectives for regional rail
- aligning the interests of the below-rail network with the government's interests rather than a private access provider's commercial interests
- cost savings through competitive outsourcing of maintenance and by removing the state's obligation to make margin payments to the lessee on infrastructure maintenance on the network
- improving track maintenance and major project delivery on the network without having to negotiate with a third party leaseholder on matters such as track access and safety issues
- facilitating progress on an open access regime to create competition from other rail freight operators and for greater freight efficiency
- allowing the government to make rail services in and around the Port of Melbourne more efficient to improve direct rail access to the port
- enabling the government to increase capacity on certain rail lines through expanding and converting selected track to standard gauge leading to greater efficiency for interstate rail freight.

1.2 This audit

The objective of the audit was to examine whether the state's decision to buy back the regional intrastate rail network was adequately informed and whether the transaction was effectively managed.

This involved examining the advice given to government on the buy-back, assessing whether the state paid a fair and reasonable price based on sound valuation and other relevant advice and analysis, its management of the transaction and negotiations, and the state's risks, benefits and future obligations arising from the buy-back.

1.3 Conclusions

There is little doubt that the buy-back unwound a lease which was ineffective in maintaining the asset. It also mitigated financial and other impediments to the state's capacity to carry out major investments in upgrading the network.

In negotiating the buy-back the state also made other strategic gains of broader significance to Victoria's freight and logistics network. This primarily related to freeing up rail access to the Port of Melbourne.

However, the audit cannot give any assurance that the state paid the lowest reasonable purchase price obtainable in the circumstances for the buy-back and it is clear that the cost of the buy-back exceeded the cost publicly announced in April 2007.

The announced cost was $133.8 million. The full cost is likely to exceed $200 million. Further, in addition to direct payment for the buy-back, the lessee also secured other significant benefits from the transaction including extended lease terms for the South Dynon inter-modal terminal and over a small part of the Tottenham Yard, and reduced rates for access charges for its above-rail business.

Once the decision to seek a buy-back was taken the terms were negotiated and agreed soon after. A non-binding buy-back agreement was signed on 31 October 2006 immediately prior to the start of the caretaker government period for the 2006 state election. The terms of that agreement including the purchase price did not materially change in the final agreement of May 2007.

When the state signed the non-binding agreement, sufficient advice had not been obtained to support its decision about how much to pay, for example there was not an adequate business valuation. In addition, gaps and deficiencies in the advice given to government on the buy-back included the lack of a robust and agreed business case and a failure to advise government on the limitations of some external advice.

These matters, however, do not necessarily mean that the buy-back failed to represent value for money to the state. There were clear arguments to have the network back under state control and opportunities to save and/or avoid future costs and delays on routine maintenance and capital upgrades of the network.

The question that remains is whether such outcomes could have been achieved at a lower cost had the state:

- offered less for the below-rail business based on its market value not its book value
- negotiated an amended infrastructure lease with incentives for the lessee to work cooperatively with government, or
- terminated the lease and contested any legal challenges mounted by the leaseholder.

V/Line managed the transition of the network to state control well. However, there is potential conflict between its roles as both access provider and rail passenger services provider. Furthermore the 2006 government decision that a separate entity be established to control the network has not been acted on.

The government has commissioned a review of the freight network since the buy-back and has started an investment program for the regional rail network to improve regional passenger and freight services.

1.4 Findings

1.4.1 Cost of the buy-back

In April 2007 the government announced it had agreed to buy back the regional intrastate rail network lease for $133.8 million. This was not the full known cost of the buy-back. The state estimated the full cost to be $164.4 million excluding estimated transaction and transition costs of $9.7 million. The full cost of the buy-back is likely to exceed $200 million based on more realistic assumptions about the cost of reduced network access fees for the vendor agreed as part of the transaction.

One hundred and fifty million dollars was approved as the upper limit for the buy-back negotiations. This ‘remit’ was defined to exclude certain costs which were nonetheless incurred. Under this restricted definition the purchase price of the buy-back was within the approved remit.

However, the cost to the state is not just what it paid directly, but also the lower rail access fees agreed as part of the buy-back. The difference between access revenue from the lessee and other users and the cost of running the network is a cost to the state. The state agreed to access rates for the lessee that would earn $15.3 million in an ‘average grain year’. While these rates were higher than those sought by the lessee, they were also well under break-even and would not cover the efficient cost of running the below-rail network.

At the time of the buy-back the state estimated this additional access fee 'subsidy' was $27.6 million over 10 years in net present value terms, assuming average grain years. This was not a realistic assumption based on information available at the time about the continuing drought. Experience since the buy-back shows that the actual additional access fee subsidy will be at least $40 million more than the state's estimate in net present value terms.

1.4.2 Determining how much to pay

The value of the assets acquired

The state accepted the lessee's position that the 'book value' of the assets to be acquired by the state should be the reference for determining the purchase price for the buy-back. Audit was informed that this was based on undertakings given by the joint owner of the lessee to the Australian Competition and Consumer Commission (ACCC) about its proposed acquisition of the other joint owner. The government was advised that the book value of the assets was $120 million.

The undertakings given to the ACCC included a commitment to selling key assets to address concerns about a loss of competition resulting from the proposed acquisition. One of those assets was the lessee. The commitment required the joint owner of the lessee to protect the value of assets to be sold by maintaining their trading and financial position and not making any material adverse changes to the nature or key features of the business. The lessee's lease over the intrastate rail network was a key asset.

Audit was advised that given these commitments the state considered it had to 'act reasonably' when negotiating the price for the buy-back with the lessee. Audit considers that the ACCC undertakings were aimed at preventing substantive changes to the business that could have undermined competition in the freight forwarding sector, and need not have limited the state in seeking to negotiate a purchase price less than book value. Of course, even without the ACCC undertakings the vendor was motivated by commercial considerations to achieve a sale price at least equal to book value.

The state did not try to secure a purchase price which was substantially below the book value of the assets despite advice from two expert external advisers that the market value of the relevant assets was likely to be significantly less than book value.

The book value of assets acquired by the state was $75 million for the infrastructure lease and $58.8 million for the physical assets. The state had legal advice saying it had no legal obligation to pay back the value of the remaining 37 years on the infrastructure lease but did not pursue termination of the lease to avoid legal dispute and the likelihood of severe disruption to passenger and freight services.

The state commissioned a due diligence review of the lessee's financial records on the book value of assets to be acquired but it was qualified because of difficulties in obtaining the required information from the lessee.

The value of the business as a going concern

Two preliminary 'desk top' market valuations of the lessee's below-rail business using unverified data but based on conventional discounted cash flow analysis, were considerably less than the book value of the assets. One valuation was from $57.6 million to $65.3 million. The second valuation was between $70 million and $96 million.

Advice to government in September 2006 included these valuations but did not set out their limitations. One of the valuations was also used by the then Department of Infrastructure (DOI) in the development of assumptions for its business case about the range of potential purchase prices for a buy-back.

The acquisition's 'special value' to the state

The price for the buy-back was justified on the basis of potential cost savings to the state from owning the below-rail business. The savings were based on advice from DOI and external consultants on the 'value to the state' of acquiring the below-rail business. The government was advised that the state could realise savings of $204–250 million in net present value if it bought back the network. The robustness of some assumptions underlying these estimated savings, including whether there was evidence to substantiate the assumption that once the state ran the network it could achieve ongoing savings on maintenance, is questionable.

Conclusion

The full cost of the buy-back will likely exceed the special value or future savings to the state in regaining control of the intrastate network depending on the assumptions adopted about costs and savings. The state will pay over $200 million for assets of $58.8 million and for control of the network from which future 'savings' can be derived, but only by incurring significant expenditure.

There is a lack of data to demonstrate whether the new operator, V/Line, is doing maintenance more efficiently than the lessee.

1.4.3 Advice to the government on the buy-back

Nature of advice

Between late 2005 and late 2006 the government was advised on options and strategies for negotiations with the lessee. Options included negotiating a revised infrastructure lease, terminating the lease, or buying back control of the network.

The government was not provided with consolidated advice which robustly analysed and assessed all the options available to the state despite repeated requests, and assurances that such advice would be supplied. While a business case was developed by DOI, the three departments involved in advising the government did not agree on and nor did they present the results of a comprehensive business case for the buy-back to government.

The business case prepared by DOI to analyse buy-back options was based on data sources from the Essential Services Commission (ESC) 2006 regulatory process to establish a rail access arrangement for the regional intrastate network. Those data sources included information prepared by the lessee and the ESC and its advisers. The departments advised that they accepted the veracity and reliability of the ESC data and that the state had no other option or alternative sources of data available.

Audit does not question the veracity of the ESC data set, or suggest that there was a more credible pre-existing set of data available at the time of the deliberations. However, the ESC data was prepared for a different purpose and did not directly examine the likely cost of network operation under government ownership. Therefore it is questionable whether the ESC data set should have been solely relied on. In addition, the departments had explicit external advice noting limitations in the available data set and recommending that a more detailed valuation process, based on more comprehensive information sourced directly from the lessee, be undertaken in order to support a decision on a buy-back.

Advice to government at various stages by DOI and the Department of Treasury and Finance indicated that the financial outcome of a buy-back was uncertain. These departments used different assumptions when estimating the net present value of a buy-back to the state and consequently their estimates varied widely and ranged from positive to negative returns to the state.

Using the work of experts

Advice from external consultants and advisers was central to the government's final decision to buy-back the network and the price it was prepared to pay. DOI wrote a business case in 2006 which was the main source of information and assumptions for the consultants and advisers. Audit identified issues both with the robustness of this business case and the advice from external consultants that the government relied on when approving the buy-back and deciding on the price.

The departments had clear advice from external consultants that the state should obtain a formal and unrestricted business valuation of the network and below-rail business before committing to a purchase price. There is no evidence that this advice was passed on to the government.

The consultants clearly explained the qualifications and caveats on their analysis and opinions to the departments. However, in some instances government decisions were at least in part based on this external advice without being advised of these limitations.

Timing of advice and announcements

The terms of the buy-back including price were negotiated and agreed within a very short timeframe after the government decided on 21 September 2006 to pursue a buy-back. The buy-back was agreed 'in principle' on 31 October 2006 and it was announced at the start of the caretaker government period for the 2006 state election. Sufficient advice, most notably an adequate business valuation, was not obtained or provided before committing to the buy-back.

The public announcement of the non-binding agreement and the purchase price placed the future government in a weakened negotiating position during preparation of the final binding agreements. Publicly announcing the 'in principle' agreement effectively committed the state to the buy-back and limited its capacity to withdraw or renegotiate key aspects of the agreement.

Valuation procedures undertaken after the signing of the non-binding agreement focused only on the value to the state of the transaction, and did not demonstrate bringing into consideration the value of the business itself.

Limited action was taken in response to adverse due diligence findings received after the signing of the non-binding agreement and documentation indicates those findings were not passed on to government decision makers when the departments sought approval of the buy-back agreements. This was countered by the outcomes of a completion accounts process included in the agreement which resulted in net adjustments in favour of the state, reducing the base purchase price by $890 000 to $132.9 million.

1.4.4 The negotiation process

The departments administered the negotiations adequately. The state obtained appropriate expert external advice and engaged a commercial adviser to lead negotiations with the lessee.

DOI documented the process adequately.

1.4.5 Transition of the network to state control and management

At the time of the buy-back V/Line was best placed to take immediate responsibility for running the below-rail network. V/Line became the access provider for the intrastate regional rail network on 4 May 2007.

V/Line managed the transfer of the network back to state control effectively and within the approved budget of $5.2 million. A further $1.3 million was allocated for V/Line's accreditation to operate the network under the state's rail safety legislation. V/Line developed and implemented a thorough plan for the transition and there was minimal disruption to the day to day running of the network or to V/Line operations.

V/Line was endorsed as the agency responsible for the below-rail business on an interim basis, due to concerns about having a rail services operator also providing access to the network to third parties. The view was that V/Line's operation of the below-rail business on a long term basis had the potential to take its focus away from its core business, the delivery of passenger rail services. Also, as for the former lessee, V/Line could not be seen as an impartial and independent party in providing network access.

In December 2006 the government directed that a new body be established under the *State Owned Enterprises Act 1992* (SOE) to enable transfer of the below the rail network from V/Line to the new body at a date promptly following its safety accreditation.

In September 2007 the Treasurer approved the postponement of the establishment of the new state body and the declaration of V/Line as a state body under the SOE.

The new body has yet to be established. In October 2008, V/Line was declared a state body under the SOE to provide a shared governance role for the Treasurer and the Minister for Public Transport.

V/Line management advised they consider it is the appropriate entity to run the below-rail business and do not believe that rail operators on the network are concerned about V/Line's dual role as access provider and access taker.

1.5 Recommendations

- That the 2006 decision to establish a state body under the *State Owned Enterprises Act 1992*, independent of VicTrack and V/Line, to operate the below-rail business for the intrastate rail network be revisited and actioned or set aside (**Recommendation 6.1**).
- That the actual cost savings achieved compared to the business case be determined and a full accounting of the transaction, based on actual costs, be disclosed (**Recommendation 6.2**).

2 Audit Act 1994 section 16—submissions and comments

2.1 Introduction

In accordance with section 16(3) of the *Audit Act 1994* a copy of this report was provided to the Department of Premier and Cabinet (DPC), the Department of Treasury and Finance (DTF), the Department of Transport (DOT), as the successor of the Department of Infrastructure, and the V/Line Passenger Corporation (V/Line) with a request for comments or submissions.

The comments and submissions provided are not subject to audit nor the evidentiary standards required to reach an audit conclusion. Responsibility for the accuracy, fairness and balance of those comments rests solely with the agency head.

2.2 Submissions and comments received

***RESPONSE* provided by the Secretary, Department of Transport**

Thank you for the report on the results of your office's performance audit on the buy-back of the regional intrastate rail network.

I note that you also wrote to the Secretaries of DPC and DTF. As the Secretary responsible for the transaction, I am responding on behalf of agencies. In general, DOT observes that prior to Government deciding to commence a buy-back, all Departments vigorously presented a range of views and analysis related to the costs and benefits of re-acquiring the network.

The various views ultimately assisted the Government in relation to a single viewpoint. DOT observes that effective executive Government requires all Departments to provide 'frank and fearless' advice, not necessarily to reach a consensus view through that process.

I also note that VAGO concluded '…the Departments administered the negotiations adequately. The state obtained appropriate expert external advice and engaged a commercial adviser to lead negotiations with the lessee….', further, '…DOI documented the process adequately.'

In respect of Recommendation 6.1 to revisit action or set aside the 2006 decision to establish a state body under the State Owned Enterprises Act 1992, DOT will consider this recommendation in consultation with DPC and DTF within calendar year 2009 and advise Government on long term governance and network operations.

RESPONSE provided by the Secretary, Department of Transport – continued

For Recommendation 6.2 DOT will undertake a review to quantify the value of cost savings associated with the buy-back of the below-rail business, and in particular those factors it considered in determining the value to the State of the buy-back.

As a practical matter it is noted that the scope of the 'below-rail' business has changed since the time of the buy-back. For example, responsibility for the North Eastern corridor and the Portland to Maroona corridor has been transferred to the Australian Rail Track Corporation (ARTC) and will be operated on Standard Gauge. These are material components of the network. The 'below track' maintenance program is also now influenced by the findings of Rail Freight Network Review. This means the scope and cost of operating the business is not comparable with that acquired from the lessee at the time of the buy-back.

Nonetheless, DOT will seek to quantify the value of cost savings associated with avoiding the payment of items the lessee previously sought to recover from the State including: profit margin, Primary Infrastructure Lease prepayment amortisation, and other non-cash charges such as depreciation and capital contributions.

There are other strategic benefits associated with the buy-back that the Government will attempt to estimate, such as the ability to more easily affect major renewal programs and the margin that the Government would have otherwise paid a private operator to allow track access or participate in project co-ordination. It is understood that strategic benefits are difficult to estimate due to the timing and scope of future works, but nonetheless are important to provide a broader picture of the benefits accruing from the buy-back.

3 Background

3.1 Introduction

In April 2007 the government announced it had agreed to ‘buy back’ the intrastate regional rail network for $133.8 million. Under the buy-back agreement the lessee surrendered its lease over the rail network and transferred associated track infrastructure assets to the state.

It is necessary to know what preceded the buy-back to understand the terms and final outcome. This part of the report sets out the main elements of the ‘above’ and ‘below’ rail arrangements up to May 2006, when a change in control of the lessee prompted the government to consider buying back the network.

‘Above rail’ refers to train and rolling stock operations on a rail network such as passenger and freight train services. ‘Below rail’ refers to the management of rail network infrastructure including the rail tracks, sleepers, ballast, and signalling assets.

3.2 Victoria’s rail system

Victoria’s rail system is important for moving passengers and freight around Melbourne and the state.

The three rail networks in Victoria comprise:

- **metropolitan**—17 routes serving metropolitan Melbourne
- **intrastate**—moving freight and passengers within Victoria
- **interstate**—the Victorian sections of the interstate rail system between Albury, Melbourne and the South Australian border, used mostly by freight trains with some interstate passenger services.

3.2.1 The intrastate regional rail network

The intrastate regional rail network is mainly ‘broad gauge’ track, but also includes narrower, ‘standard gauge’ track for freight services.

The network route is about 3 900 kilometres long, including track in southern NSW connected to the Victorian broad gauge network. It also includes sidings, marshalling yards and terminals.

Sixty per cent of the intrastate network carries only freight services, with the remainder carrying both freight and passenger services.

Activity is measured by the weight of rolling stock run over the network (gross tonne kilometres) and the distances travelled by rolling stock (passenger and freight kilometres).

Total train journeys cover around 6.8 million kilometres each year, made up of passenger services (71 per cent), grain (11 per cent) and other freight (18 per cent). The network carries around 4 070 million gross tonne kilometres (GTK) of rolling stock per annum, comprising passenger (23 per cent), grain (37 per cent) and other freight (40 per cent).

Victoria's regional rail freight services transport between five and six million tonnes of freight each year.[1] The intrastate rail system has historically carried a large proportion of Victoria's grain production, as well as a portion of New South Wales' production. The volume of grain carried fluctuates with production. To 2006–07, the five year average Victorian grain harvest was 3.5 million tonnes each year .[2]

Control of the intrastate regional rail network

In July 1997 the V/Line Freight Corporation, and the Victorian Rail Track Corporation (VicTrack), were set up as government corporations and were separated from the Public Transport Corporation.

VicTrack 'owns' the railway land and infrastructure on behalf of the state. VicTrack leases the infrastructure to the Director of Public Transport, but is responsible for some active rail sidings and yards and for rail infrastructure not in use. It also accounts for rail assets including leased assets in its annual financial statements.

Since 1999 the Director of Public Transport has leased out control over the state's rail infrastructure, including the intrastate regional rail network, to various parties.

In April 1999 a private operator paid the state $70.4 million to acquire the V/Line Freight Corporation 'above-rail' freight business and $89.7 million for a 45 year infrastructure lease of the intrastate regional 'below-rail' network to operate and maintain it. This private operator was the initial lessee of the network.

In August 2004 the initial lessee was taken over when its business, including its plant and equipment, and the infrastructure lease was acquired for $285 million. The new lessee was owned jointly by two major corporations operating in the Australian freight and logistics sector.

The change in ownership of the initial lessee meant a change in control of the intrastate network. The terms of the lease required the Director of Public Transport to consent to any such change or it could be terminated. The transaction did not proceed until the Director consented.

[1] *Victorian Rail Freight Network Review Submission,* August 2007, Department of Innovation, Industry and Regional Development, p.3.

[2] *Australian Bureau of Agricultural and Resource Economics Australian Crop Report at 11 July 2008*. Commonwealth of Australia.

The Director consented after the new lessee agreed to a number of amendments to the lease. These amendments did not redress deficiencies in the lease over maintenance obligations.

In August 2005 one of the joint owners (the acquirer) of the second lessee announced it intended to acquire the other joint owner. After consideration the Australian Competition and Consumer Commission (ACCC) decided not to seek to prevent this acquisition on condition that the acquirer would, amongst other things, sell 50 per cent of its share in the lessee. In May 2006, the acquirer announced that it had taken control of the other joint owner of the lessee, having acquired 52 per cent of its shares.

This represented a change in control over the lessee of the intrastate network. The Director of Public Transport had not consented to the change of control in the lessee. A termination event then arose both for the Primary Infrastructure Lease (PIL) and the South Dynon lease. A number of moratorium agreements preserving the state’s termination rights, while agreeing they would not be exercised while the moratorium agreements were on foot, were executed to allow a negotiated solution to these issues.

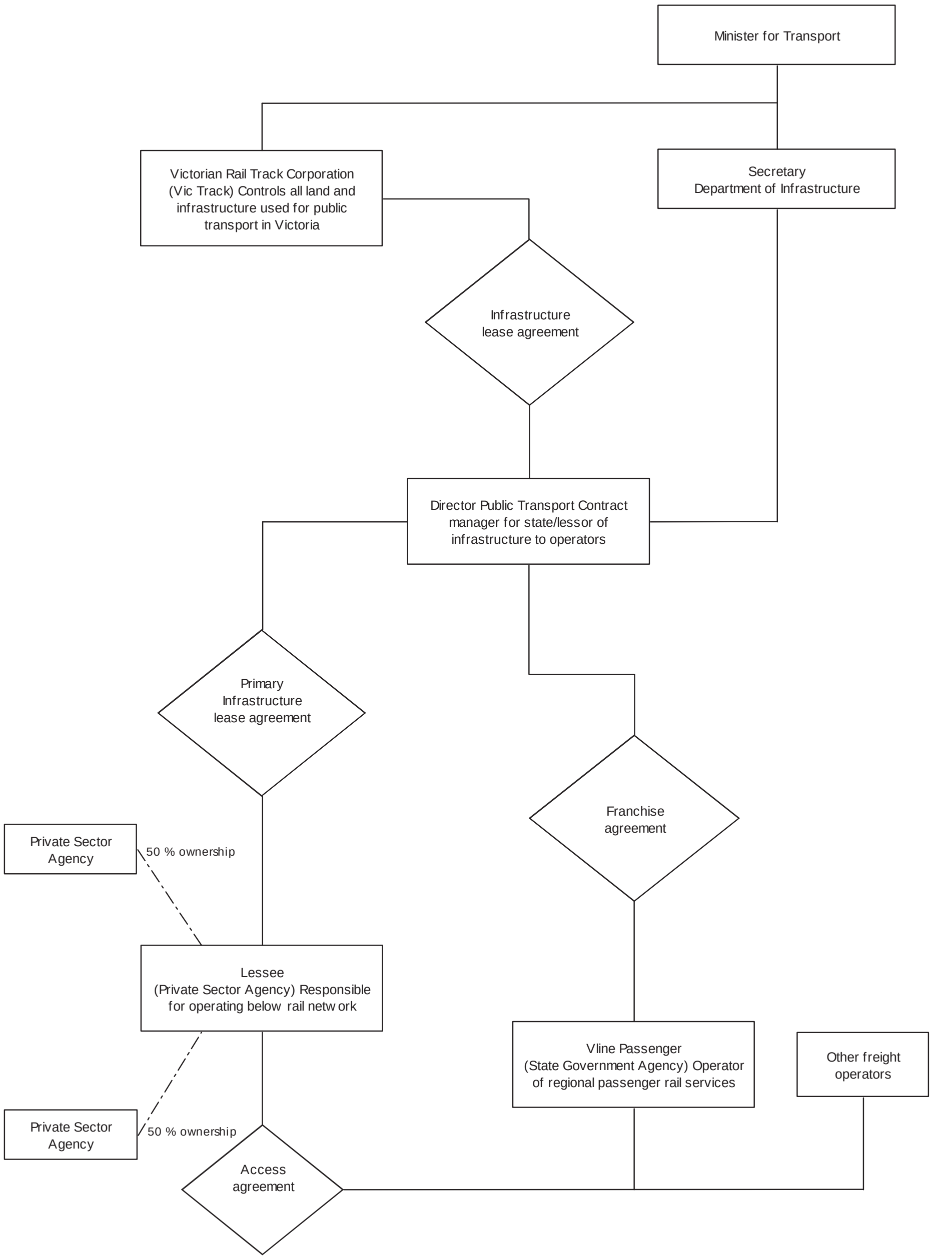
If the acquirer had subsequently divested 50 per cent of its shareholding in the lessee, as agreed with the ACCC, this may have constituted another change in control of the lessee although the state’s legal advice indicated that divestment was unlikely to contribute a further change of control event. In April 2007 the ACCC accepted a variation that allowed the acquirer to transfer 100 per cent ownership of the lessee to another entity. This occurred in June 2007.

These developments allowed the government to consider the future of the intrastate regional rail network, including options to amend, terminate or buy back the infrastructure lease.

3.2.2 Pre buy-back lease and rail access arrangements

Figure 3A shows the ownership structures and the contractual relationship between the parties for the regional intrastate rail network prior to the buy-back.

Figure 3A
Pre buy-back ownership structures and the contractual relationship between the parties



Source: Department of Infrastructure.

Primary infrastructure lease

The February 1999 lease between the initial lessee and the Director of Public Transport effectively transferred responsibility for the operation of the regional ‘below-rail’ network to the initial lessee for 45 years. As the access provider it was also entitled to charge rail access fees. Under the PIL, other parties, including the state, could not physically access the network infrastructure without the lessee’s prior approval.

The initial lease term was 15 years with the lessee having the option for two further 15 year lease terms. The $89.7 million paid to the state for the PIL was a prepayment. In effect it was the present value of the rentals due over the 45 year period. Accordingly, the state treated it as unearned income, recording it as a liability in its balance sheet at the time of receipt.

Our May 2007 report to Parliament on *Maintaining Victoria’s Rail Infrastructure Assets* (2007:4) concluded that:

- the regional, intrastate network lease arrangements established in 1999 did not provide for the adequate maintenance and renewal of the infrastructure and that this situation was not substantially changed when the lease was transferred to the new lessee in 2004
- the condition of the intrastate infrastructure had deteriorated because levels of maintenance and renewal had not sustained the 1999 levels of service.

Apart from minor infrastructure maintenance, major maintenance obligations on the lessee varied depending on whether the relevant section of the track was subject to a rail access agreement.

V/Line Passenger Corporation (V/Line), the passenger service operator, had a rail access agreement with the lessee for sections of the intrastate network. The agreement required the lessee to maintain the infrastructure to a standard that would, for example, handle V/Line’s train speeds. V/Line’s access payments largely funded the maintenance to meet these service levels on intrastate passenger lines. V/Line is subsidised by the government, which meant that the state contributed to the upkeep of regional passenger lines.

At the end of the lease the lessee had to return the infrastructure used only for freight traffic in a condition consistent with its current use. The minimum requirement for those network sections not covered by a rail access agreement was for the track to accommodate trains travelling at 20 km/h with 19 tonne axle loads. This minimum standard did not support rail freight services competitiveness because the retention and growth of freight traffic on the intrastate network demands service levels above these minimums.

However, under the PIL these major maintenance obligations only applied during the last 5 years of the lease. If the lessee exercised the two 15-year options for further terms, the obligations would not arise until April 2039.

The effect of the PIL, therefore, was to give the lessee control of the rail infrastructure without an effective maintenance obligation until near the end of the lease. The initial and subsequent lessee took a contractually-compliant minimum maintenance approach on freight-only lines, which led to the deterioration of the infrastructure over time and created a growing ‘maintenance backlog’. This was due to inadequate maintenance obligations in the PIL, and lower than expected demand and revenue for freight services from the effect of the drought on grain harvests.

In response the state stepped in and agreed with the new lessee for the state to fund additional maintenance and renewals.

Our May 2007 report to Parliament on *Maintaining Victoria’s Rail Infrastructure Assets* (2007:4) found that:

- When the control of the lease transferred to the new lessee in 2004, the state did not indicate it would contribute to the maintenance and renewal of freight-only lines.
- After August 2004, the new lessee increased the number and duration of temporary speed restrictions in response to the infrastructure’s condition and flagged further extensions of these restrictions if there were no additional major track renewals.
- In 2005–06, the Department of Infrastructure (DOI) funded $59 million of additional renewals for passenger lines to avoid widespread speed restrictions affecting passenger services.
- In May 2006 the state announced an upgrade of the Mildura line for freight and funded $53 million towards the cost.

Lessee requests for additional public funding resulted in the state raising V/Line access fees to the lessee in 2006-07 by $24 million from $32 million to $56 million. The state also funded ‘major periodical maintenance’ expenditure of $30 million for each of 2006–07 and 2007–08. In addition, in mid 2006 the state agreed to fund $25 million for freight network project works in 2006–07.

The lessee did major state-funded periodical maintenance work on a cost plus margin basis under which it received a 10 per cent margin on top of its direct costs for each project.

Other features of the PIL included:

- The lessee was entitled to ‘quiet enjoyment’ of the leased assets and could seek compensation from the state for any state sponsored project or other intervention that may adversely affect it. The PIL allowed a number of exceptions to ‘quiet enjoyment’, including when state works were being done.
- At the end of the lease the infrastructure had to be returned to the state and an environmental audit had to determine liability for any contamination directly attributable to the lessee’s operations.

Rail access regime

The lessee had two streams of business from the regional intrastate rail infrastructure network leased from the state. It was an 'above-rail' operator running freight trains on the network. It was also a 'below-rail' operator giving network access to 'above-rail' passenger and freight services.

The government introduced an open access regime for freight rail lines in July 2001 to encourage competition in the rail freight industry and to increase the role of rail in carrying freight. The access regime was a negotiate-arbitrate model that allowed other operators to apply to the access provider to run services on those rail lines. Once an access arrangement was agreed other train operators paid the access provider for line use.

If the two parties could not agree, either party could ask the Essential Services Commission (ESC) to arbitrate. The ESC was established by the *Essential Services Commission Act 2001* and is Victoria's independent economic regulator of essential services supplied by the electricity, gas, water and sewerage, ports, grain handling and rail freight industries.

The ACCC, in assessing the acquisition of the initial lessee in 2004 acknowledged the difficulties accessing the Victorian rail infrastructure and reported that under this regime no freight operator had managed to negotiate an access arrangement with the initial lessee.

The government introduced reforms to the access regime during 2005–06 to address its effectiveness in promoting competition in train running. It amended the *Rail Corporations Act 1996* for the revised access regime to take effect on 1 January 2006. The ESC prepared guidelines reflecting the government's October 2005 rail network pricing order, which set out the pricing principles for the rail network under the new regime.

As an access provider the lessee was required to submit a proposed access arrangement for the regional intrastate network to the ESC for approval. Establishing the final access arrangements meant:

- setting the levels of service across the network including train speeds and axle loads
- calculating the efficient costs of providing these service levels
- setting prices to recover these costs taking account of the forecast demand for freight services.

The lessee submitted its final proposed access arrangements in May 2006 and the ESC rejected it as it did not satisfy the full requirements of the government's rail network pricing order. The ESC broadly accepted the service levels proposed by the lessee, but rejected the proposal because it disagreed with the:

- estimate of the efficient costs of operation (the ESC considered the lessee's estimate to be too high after examining the results of studies it commissioned)
- pricing differentials between grain and general freight rates

- assumption that government would meet an annual gap between revenue and costs of $31 million (the ESC considered that the government had made no commitment to do this).

In line with the legislation, in rejecting the lessee's final proposed access arrangements the ESC had to develop a three-year rail access arrangement by 1 July 2006 that set the terms and conditions for third-party access to the regional rail freight network.

On 29 June 2006, one month after the takeover of one joint owner of the lessee by the other joint owner, the ESC announced the new access arrangement that the lessee had to apply to the regional rail freight network. The ESC announced that it had:

- estimated the efficient costs of operating the rail freight network in a sustainable manner at $37 million per year based on the maintenance of an agreed level of service standards for the network to keep it in fit-for-purpose condition, and had set a revenue cap which the rail operator could recover through prices
- sought to confirm the government's intentions on network funding and had been advised that the government proposed to have discussions with stakeholders including the lessee after the release of ESC's access arrangements
- approved access prices which included a reduction in the discount level for general freight from 70-80 per cent of the grain freight rate originally proposed by the lessee to 20 per cent
- determined that it would vary the access arrangement to provide a further $2.5 million, provided the lessee committed to keeping lines in service that it had earlier said it might surrender to the government.[3]

In the announcement the ESC said that while the government's rail network pricing order prevented it from setting prices below the level which would recover the efficient costs of operating the network, it had undertaken consultation on a study of the above-rail costs of transporting grain and general freight on the rail network.

Based on that work it expressed concern about the market's ability to pay the prices needed to fund the service levels specified in its final decision. It estimated that if prices stayed at a market level the government would have to pay between $9 million and $19 million each year to maintain the service levels set by the access arrangement.

The ESC said this work was intended to inform the government's consideration of the gap between revenue raised from user access charges and the amount needed to efficiently operate the network.

[3] ESC Media Release No. 12/2006, 29 June 2006, 'ESC sets Victorian Rail Access arrangements'.

The ESC also said that following any government decision on the level and manner in which it may fund the regional intrastate rail freight network, the lessee could apply to the ESC to vary the access agreement to amend the access prices. The prices set by the ESC were maximums and it was open to the lessee to set prices below the approved prices subject to the legislative requirement that any price the lessee charged to itself or related entities, must also be offered to other access seekers.

The ESC process to establish a rail access arrangement raised a number of important issues and it offered some transparency, analysis and information about the lessee's estimates of the costs of operating and maintaining the network. Points relevant to the state's later consideration of the buy-back and other options for the network included:

- The ESC decision confirmed that maintaining the intrastate freight network at reasonable levels of service was unsustainable without government support. It estimated that if prices were to be kept at a level the market could bear, the government would have to contribute between $9 million and $19 million each year to maintain the service levels.
- The ESC reviewed the lessee's cost estimates and came up with a 25 per cent lower operational cost. The ESC estimated the efficient costs of operating the rail freight network in a sustainable manner at $37 million per year.

Outside the access arrangement process, the lessee had for some time been asking the state for ongoing financial support to maintain the regional intrastate rail network based on its estimates of the extra funds needed to maintain service levels on the freight network. The ESC decisions gave the state another source of information when assessing the lessee's estimates of costs and its case for extra funds.

Revised V/Line access agreement

The access agreement between V/Line and the lessee expired in September 2006. Under that agreement V/Line paid the lessee to access the infrastructure to run passenger services. V/Line and DOI agreed a new access agreement with the lessee starting from 1 July 2006 and ending on 30 June 2008.

However, the agreement was terminated on 4 May 2007 when V/Line took over responsibility for management and operation of the intrastate below-rail network on behalf of the state. In effect, the access seeker and access provider became the same party and the access agreement ceased.

3.3 About this audit

3.3.1 Audit objective

The objective of the audit was to examine whether the state's decision to buy back the regional intrastate rail network was adequately informed and to assess whether the transaction was effectively managed.

3.3.2 Audit scope

This audit examined the buy-back of the regional intrastate rail network.

The audit reviewed the adequacy of the advice supporting the decision to proceed with the buy-back, the state's due diligence to support the buy-back, including business valuations and the cost, and its future financial obligations for the new network operation arrangements.

Decisions on the future of the network and the final decision to buy it back were based on detailed advice provided to government. This advice, including recommendations was provided by the departments of Infrastructure, Treasury and Finance and Premier and Cabinet. Therefore this report necessarily involves describing and analysing the advice provided to the government.

The following agencies were included in this audit:

- Department of Infrastructure
- Department of Treasury and Finance
- Department of Premier and Cabinet
- V/Line Passenger Corporation.

The audit was performed in accordance with the applicable Australian auditing standards for performance audits, and included sufficient tests and procedures to enable audit conclusions to be reached.

3.3.3 Cost of the audit

The total cost of this audit, including staff time, overheads and the preparation and printing of this report, was $455 000.

4 Financial analysis of buy-back

At a glance

Background

This chapter examines whether the buy-back of the regional intrastate rail network gave value for money in purely financial terms. Value for money is defined as achieving the desired outcome at the best price obtainable in the circumstances.

Audit examined the full cost of the buy-back and the value of what was acquired by the state.

Findings

- The April 2007 announced $133.8 million cost of the buy-back, although within the approved remit of $150 million did not represent the full cost.
- The full cost of the buy-back is likely to exceed $200 million, mainly due to lower-than-expected access fee revenue since the buy-back. This is not expected to improve significantly in the short term.
- Audit can give no assurance that the state paid the lowest reasonable purchase price obtainable in the circumstances for the buy-back. The state accepted the position put by the vendor that the 'book value' of the assets be the reference point when determining the purchase price for the buy-back. This was notwithstanding there were clear indications that the market value of the below-rail business was likely to be significantly less than its book value and the state's acquisition cost.
- Potential savings to the state from owning the below-rail business were used to justify the cost of the buy-back. The robustness of some key assumptions underlying estimates of these savings is questionable.

4.1 Introduction

The buy-back of the regional intrastate rail network can be examined in purely financial terms to form an opinion on whether it represented value for money. Value for money is simply defined as achieving the desired outcome at the best price obtainable in the circumstances.

To assess whether the state paid a fair and reasonable purchase price and got value for money the audit examined the:

- total cost to the state of the buy-back
- value of what was acquired by the state.

4.2 Cost of the buy-back

4.2.1 Announced cost

In April 2007, the government announced that it had agreed to buy back the regional rail network lease for $133.8 million. The announced cost comprised:

- a negotiated purchase price of $120 million relating to the 'book value' of the net assets acquired
- the state assuming an $11.8 million liability for the leave entitlements of the employees transferring to state employment
- $2 million for the expected cost of movements in inventory and supplies from 30 September 2006 to the transaction completion date, other specific assets and a provision for adjustments on final settlement.

4.2.2 Total cost

The announced cost of the buy-back at the time of the acquisition was not the total cost to the state. The state estimated the total cost at the time of the buy-back, including transaction and transition costs, at $174.1 million comprising:

- the announced 'up front' purchase price—estimated to be $133.8 million, but subject to adjustments on final settlement
- a subsidy to the vendor in the form of reduced rail freight access charges after the acquisition—estimated to be $27.6 million in net present value terms (NPV) over 10 years
- a one-off payment to the vendor to compensate for the future impact of the Wodonga Rail Bypass project on their freight business—agreed at $3 million
- the transaction and transition costs—estimated to be $9.7 million.

Figure 4A sets out the state's estimate of the total cost of the buy-back at the time of the transaction and audit's estimate of the likely full cost based on assumptions about the value of the access fee subsidy which reflect information which has emerged since the buy-back in 2007. The 'actual' value of the access fee subsidy and the cost of the buy-back to the state will be significantly higher if access fee revenue continues at current levels.

Figure 4A
Total cost of the buy-back to the state ($ million)

Component	Initial state estimate	Current audit estimate
Purchase price for buy-back	133.8	132.9
Access fee subsidy for the vendor (NPV over 10 years)	27.6	67.2[a]
Wodonga Rail Bypass project compensation to the vendor	3.0	3.0
Transaction and transition costs	9.7	11.4
Total	**174.1**	**214.5**

Note: [a] Estimated access fee subsidy calculated over 10 years using actual and forecast revenue from V/Line Passenger Corporation (V/Line) for the initial 4-year period then reverting to the state's assumption of annual revenue of $15.3 million. The subsidy would be valued at over $100 million if access fee revenue continues at current levels.
Source: Victorian Auditor-General's Office.

Each component is analysed below to determine an estimated full cost.

In addition to direct payments from the state, the vendor also gained the following significant benefits in the form of an extension to the lease term for the South Dynon inter-modal terminal for an additional 10 year period to 2031. Specified parts of the Tottenham yard were also leased to the vendor to 2031.

Purchase price for buy-back

The purchase price for the buy-back comprised cash disbursements and the offset of other liabilities and assets between the state and the vendor. Figure 4B shows the state's price estimate in October 2006 and the actual price following a completion accounts process which is usual for such transactions. The state prepared completion accounts as at May 2007 and settled differences between them and the vendor's accounts of 30 September 2006 which the purchase price was determined from.

Figure 4B
Purchase price for the buy-back ($ million)

Component	Estimate	Actual
The total negotiated amount for assets surrendered by vendor	120.0	120.0
Employee entitlement liabilities being assumed by the state	11.8	13.2
Cost of movements in inventory in the period up to the transaction completion date and other specific assets	1.3	1.3
Provision for possible completion adjustments	0.7	(1.6)
Total	**133.8**	**132.9**

Source: Department of Transport.

The total negotiated amount for assets surrendered by the vendor was $120 million, which was initially funded by cash of $97.9 million, liabilities foregone and assets previously contributed to the vendor of $22.1 million. The balance between these components changed as a result of the completion accounts process.

As part of the transaction 346 employees transferred from the vendor to V/Line. The state assumed responsibility for their entitlements and did not offset this liability against the assets acquired.

The buy-back also included the cash payment to the vendor of $650 000 for settlement of movements in inventory and supplies during the period 30 September 2006 and the transaction completion date of 4 May 2007. A further $650 000 was paid by the state for specific assets being a washbay at Echuca and two weighbridges at Portland and Geelong.

The state's estimate of the purchase price for the buy-back included around $700 000 for possible adjustments from the completion accounts process. This process resulted in a favourable outcome to the state, meaning that the $700 000 was not needed.

The final actual purchase price after adjustments from the completion accounts process was $132.9 million, around $900 000 less than estimated. The completion accounts process was finalised in October 2007 and resulted in the vendor paying around $6 million to the state with a net reduction of $890 000 in the total cost of the buy-back.

Access fee subsidy for the vendor

The difference between access revenue obtained by the state after it regained control of the network and the cost of running the network is a cost to the state.

The state negotiated with the vendor on the access fees that it would charge once the state regained control of the network. The vendor was seeking a 10 year access agreement at rates that would generate between $5–6 million for the state each year.

In October 2006 the state agreed access fee rates that would generate $15.3 million in an ‘average grain year’. While higher than the vendor sought, the rates were significantly less than the cost of running the below-rail network.

In mid-2006 the Essential Services Commission (ESC) confirmed that maintaining the intrastate freight network at reasonable levels of service was unsustainable without ongoing government funding.

The ESC estimated that to operate the below-rail business efficiently and maintain the freight-only network at an appropriate operational standard, the business had to earn around $39 million per year. The ESC expressed concern that the market could not afford the rates required to generate this amount. It estimated that the government would have to contribute between $9–19 million a year for desirable service levels and to address the ‘affordability gap’. This would allow the freight network operator to reduce access fees to a level the market could bear.

Based on the ESC findings, if the vendor continued to operate the below-rail business, it expected further state subsidies.

The state calculated the base subsidy at $20 million per annum. It used the $19 million difference between the $39 million cost and the $20 million base subsidy as the reference to determine any ‘additional’ cost of an access agreement that earned less than $19 million in annual access revenue.

Accordingly, the estimated ‘additional’ annual cost to the state in an ‘average grain year’ of the 10-year access agreement with the vendor was $3.7 million per annum—the difference between $19 million and the $15.3 million. The net present value of this additional cost over 10 years was calculated at $27.6 million, using an annual discount rate of 6 per cent.

Figure 4C summarises the calculations behind this cost estimate.

Figure 4C
Derivation of estimate for ‘cost’ of access fee subsidy to the lessee over 10 years ($ million)

	Nominal	NPV
Efficient cost of operating freight-only network	**39.0**	
Less: ‘Base’ subsidy assumed	**20.0**	**147.2**
Difference to be funded through access charges	**19.0**	
Less: Actual access charges agreed with vendor based on average grain year	**15.3**	
Additional ‘cost’ to the state above base subsidy[(a)]	**3.7**	**27.6**

Note: [(a)] The actual NPV is computed by audit to be $27.2 million—the state also agreed to reduce the access fees paid by the vendor in 2006–07 by $200 000 and there were some rounding errors in the calculations of the annual cost.

Source: Victorian Auditor-General’s Office.

The above analysis is hypothetical as it assumes that the state will be able to run the freight only network efficiently and that each of the 10 years in the forecast period will be an average grain year and produce around $15.3 million in freight access fees. At the time of buy-back Victoria had not seen this level of grain volumes on the freight network for a number of years and given the prevailing drought, it was unlikely that it would be achieved in the foreseeable future.

The actual cost of the subsidy will depend on how much it actually costs the state to run the network, and the actual revenue flows from access charges.

The audit did not attempt to determine the actual cost to the state of operating the freight only network, primarily because of the short elapsed time since the state regained control. However, actual and forecast data was available on the access fee revenues received by V/Line from the freight only network. The above analysis implies that access fee revenue of $1 million per annum over ten years was equivalent to $7.3 million in net present value terms. In other words, an annual shortfall in revenue of $1 million per annum over 10 years equates to an additional cost to the state of $7.3 million.

Data obtained from V/Line on access charges indicates that the state's current and estimated future access revenue is significantly below that expected in a hypothetical 'average grain year'. In 2007–08 the state received only $2.9 million in freight access revenue and it is forecasting an average of $4.1 million over the next three years. In other words, current access fee revenue is running at around 20 to 30 per cent of that assumed to be received in an 'average' grain year.

Based on this data the net cost of operating the network over and above the assumed $20 million annual base subsidy would average $15.2 million per annum over the four years to 2010–11. This alone represents $52.7 million in NPV terms. Even allowing for freight access revenues of $15.3 million per annum for the six years after 2010–11, the NPV of the 'additional' cost to the state would be $67.2 million, $40 million above the figure used in the state's calculation of the cost of the buy-back.

Another way of looking at this is that the state, assuming it can run the freight-only network for $39 million a year, was prepared to run it at an annual loss of $25.3 million, expecting only $15.3 million a year in access charges. Since it took over the network its actual and forecast losses exceed $35 million a year.

If access fee revenue is assumed to continue at current levels, an average of $4.1 million per year, for the six years after 2010–11, the NPV of the access fee subsidy would be over $100 million or around four times that estimated at the time of the buy-back.

The estimate of NPV $27.6 million given to the government in October 2006 and April 2007 when approving the buy-back was therefore significantly lower than it would have been had an ongoing drought been assumed.

Wodonga rail bypass project compensation to vendor

As part of the buy-back the state compensated the vendor $3 million for surrendering rail tracks in Wodonga to allow rail lines and level crossings to be removed from the city centre as part of the Wodonga rail bypass project. This was funded from the Wodonga rail bypass project.

The Wodonga rail bypass project is intended to free up land for planning and development, improve safety for rail passengers and road users and enable trains to operate more efficiently between Melbourne and Sydney on the interstate rail line.

As part of the project a new five kilometre rail bypass will be built in the west of Wodonga, as well as a new passenger station with a connecting bus service to the city centre. The project is jointly funded by the state and Commonwealth Governments and is expected to be completed in 2010.

Prior to the buy-back the state had difficulty negotiating with the lessee on the surrender of relevant tracks for this project.

Transaction and transition costs

In addition to the payment to the vendor for the buy-back, the state incurred costs in assessing and negotiating the transaction and in facilitating the smooth transition of the below-rail business to V/Line. These transaction and transition costs totalled $11.4 million, $1.7 million more than estimated. Figure 4D gives a breakdown of these costs.

Figure 4D
Transaction and transition costs incurred by the state ($ million)

Cost component	Estimated	Actual
Transaction costs—consultants engaged by departments	4.3	6.2
Transition costs—remitted by Department of Infrastructure to V/Line	5.4	5.2
Total	**9.7**	**11.4**

Source: Department of Transport.

4.2.3 The buy-back cost and the government approved limit

On 23 October 2006 the government approved $150 million as the upper limit for the buy-back. This negotiating ‘remit’ was defined as the sum of the purchase price for the buy-back, which was to reflect the book value of the assets to be acquired and the NPV of the 10 year government subsidy implicit in reduced access fees agreed with the vendor.

The remit excluded certain costs which were nonetheless incurred in buying back the network. They included the assumption of liabilities for employee entitlements, and compensation paid for the Wodonga rail bypass project, which was paid out of the budget for that project.

In April 2007, prior to signing the final buy-back agreement, the government was advised that the buy-back had been negotiated for $148.9 million, which was consistent with and within the approved remit. This comprised $121.3 million for the purchase and $27.6 million for the NPV of future cash flows from the government subsidy of reduced access fees. Using the government's definition, the cost of the buy-back was within the approved remit of $150 million.

4.2.4 Conclusion on cost to the state

The total cost of the buy-back to the state was higher than the announced cost of $133.8 million. The announced cost was the immediate price paid to the vendor to acquire the below-rail business.

The state estimated the cost at the time of the buy-back to be $164.4 million, excluding estimated transaction and transition costs of $9.7 million. The final cost of the buy-back, using more realistic assumptions about access fee revenue, is likely to exceed $200 million.

In addition to the acquisition price, the other significant 'cost' to the state is the fact that it acquired a loss-making business and was prepared to exacerbate those losses by reducing the vendor's access fees. Using its own estimates the state expected to subsidise the below-rail freight-only network business over 10 years by $174.8 million in NPV terms. This was made up of $147.2 million for the assumed 'base annual subsidy' of $20 million and $27.6 million for the additional government subsidy implicit in the reduced access fees. Current evidence indicates that this subsidy is going to be at least $40 million higher than estimated in NPV terms.

4.3 What did the state get?

From a financial perspective the value for money equation for a transaction of this nature has two variables—the acquisition price and the value of what was acquired.

The base purchase price paid was $132.9 million. The value of what was acquired by the state can be viewed in a number of ways:

- the 'book value' of assets acquired
- the 'fair value' (or market value) of the business acquired, and
- any 'special value' accruing to the state in regaining direct control over the network.

The first two values are references both for the seller and buyer in setting a price, however, in an arms length transaction between a willing buyer and willing seller the market value of the business is the key. The last value is relevant only to the state as buyer, and may determine how much above market value it might be prepared to pay.

4.3.1 Book value of assets acquired

Book value is an accounting term which typically refers to the value of an asset or liability on an entity's balance sheet. It is therefore one measure of value to the current owner of the assets. The carrying amount of asset and liabilities, however, does not necessarily reflect the value for a potential buyer.

The state accepted the vendor's position that the 'book value' be used as the reference when determining the purchase price. This issue is discussed in section 5.3 of this report.

In September 2006 the government was told that a commercial adviser had noted that when the lessee acquired the initial lessee in 2004 the book value of the below-rail business was around $122 million, and that it was possible the lessee would use that as a reference in negotiations for a buy-back. The documented advice to government on this did not include the adviser's observation that there may have been a potentially significant decline in the business's value since the lessee had acquired it.

The government was advised that the book value was around $120 million based on assets on the vendor's balance sheet at September 2006. The book value of assets acquired by the state included $75 million for the prepayment of the Primary Infrastructure Lease (PIL) over the intrastate network and $58.8 million for the physical assets. The value of these assets was balanced against other items to form a net book value of $120 million which was put into the non-binding buy-back agreement of late October 2006 and referred to as the 'term sheet' amount.

Prepayment of PIL

The vendor's September 2006 accounts included an asset of $75 million, which was the unamortised balance of the prepaid rent for the PIL. The state and the lessee recognised the value of the PIL in their respective accounts. The state recorded the value of the PIL as an administered liability in the accounts of the Department of Infrastructure (DOI) (managing the PIL on behalf of VicTrack). At 30 September 2006 the value was $82.9 million.

In 1999 the initial lessee paid the state around $160 million for the below-rail business (represented by the 45 year lease) and the above-rail freight business. The rental prepayment for the below-rail business was to be $89.7 million NPV at that time. However, the split of the $160 million between the PIL and the above-rail business was proposed by the principal owner of the initial lessee.

The state had professional advice in September 2006 that the amount attributed to the prepaid rental in the lessee's books 'did not represent any market based assessment of the relative value of the above rail and below-rail components'.

The state also had legal advice that it had no legal obligation to pay back the value of the remaining 37 years on the lease if the PIL was terminated. The acquisition of one joint owner of the lessee by the other in May 2006 was a change in control that required the prior written approval of the Director of Transport under the terms of the PIL. The Director didn't give approval and accordingly as the state's legal advice confirmed, this could trigger a termination of the PIL.

Property, plant and equipment, and inventories

The other major component of the book value of assets in the vendor's books was $58.8 million for physical assets. This comprised $52.7 million for the undepreciated cost of track works that the lessee and its predecessor had done on the intrastate network from 1999 to June 2005, and $6.1 million for other property, plant and equipment.

The state appointed accountants to do due diligence on the vendor's financial records for the value of the assets to be acquired. The accountant's December 2006 report was qualified because of difficulties in obtaining the required information from the vendor and included the following findings:

- They could not complete verification of the value of infrastructure track works and capitalised work in progress because the vendor supplied incomplete or no data. To mitigate this deficiency DOI staff verified the existence of a substantial amount of track works by physical inspection (valued at around $38 million).
- The vendor was unable to supply records to substantiate amounts capitalised and expensed since 1 July 2005. Consequently, there was a risk that the actual balance of infrastructure track works differed significantly from the balance included in the statement of assets.
- Only limited due diligence was performed on materials and supplies. The vendor did an inventory count of materials and spares in November 2006. However, due to timing constraints, the accountants did not review the results in detail as part of the due diligence. They verified the figure as $1.1 million. In November 2006 the vendor's stocktake recorded a value of $4.8 million for materials and supplies. Nevertheless, at the negotiations the accepted figure for materials and supplies was $1.1 million.

Conclusion on book value

The state's professional advice implied that the book value of the prepaid PIL was unlikely to represent its market value. Under one scenario the PIL could be considered to have no value, as there was the possibility that the state could terminate it without compensating the lessee. It is acknowledged however that the lessee would in all likelihood have taken legal action had the state done so.

There was a low level of comfort that the carrying amount of property, plant and equipment was accurate in cost, asset condition and remaining useful life. Further, there was a view that infrastructure track works done by the lessee and its predecessors were leasehold improvements obligatory under the PIL. The lessee's ultimate obligation under the PIL was to return the track to the state in a condition which met the standards specified in the lease without compensation for the value of the work.

The reliability and appropriateness of the book value of assets are cause for reservation given that the state accepted the vendor's position that book value be used as the reference in determining the purchase price of the buy-back.

It is also cause for concern given advice that the stated book values may not have reflected the fair values of each class of assets, and that the aggregated values of those assets may not have reflected the fair value of the below-rail business.

4.3.2 Fair value of the below-rail business

Fair value can be applied to an asset, a class of assets, or to a business as a whole. It is what knowledgeable, willing parties would pay for a business in an arms-length transaction. In simple terms fair value should broadly represent the market value of the business.

The state obtained two preliminary valuations of the below-rail business from commercial advisers using conventional discounted cash flow analysis.

A discounted cash flow analysis estimates the various expected cash inflows and outflows from the assets and business over a defined period, then discounts them to arrive at a present value. The present value is the point at which the business owners would be happy either to get the cash flows from continued ownership, or to receive a lump sum payment based on the valuation.

Both commercial advisers used 37 years as the timeframe for their indicative valuations, which was the remaining term of the PIL.

In May 2006, one adviser concluded that the present value of the below-rail business was in the range between $57.6 million and $65.3 million. In arriving at this valuation the adviser reported that:

- the freight only network had very little value in the present operating environment and was estimated at $2.5 million
- the shared passenger and freight network appeared to have a value similar to a regulated business which was estimated to be between $49.4–57 million
- the lessee earned a 10 per cent margin from the state for doing projects on the network and while project expenditure was discretionary, there was planned expenditure of $92 million on such projects over the next two years, with a present value of the margin on that expenditure of $8.2 million.

The second valuation of 19 September 2006 gave an estimate of between $70–96 million for the business. The adviser concluded that the freight-only network would have little commercial value to a buyer, but that some positive value may exist given that the owner of the PIL had an option to continue running the freight network should the state agree to future subsidies.

The two commercial advisers gave differing values because they used different discount rates for the net present value. The second adviser used a lower discount rate than the first, which increased the valuation.

While the use of a lower discount rate but a higher risk premium for project income was consistent with the rate used in the ESC access price determination in June 2006, it was not consistent with movements in the official Reserve Bank of Australia target interest rate at the time, which increased in August 2006.

Neither valuer had access to the management of the lessee, nor to its data. Both relied on data from DOI and reports published by the ESC. Consequently both valuations were qualified as indicative only and not appropriate for use in an acquisition.

Notwithstanding the limitations of both valuations, they show that the fair or market value of the business was likely to be significantly below the book value of the assets being acquired.

This is consistent with the advice given to the state that the book value struck for the prepaid PIL did not necessarily reflect its market value. It is also consistent with the fact that the value of the below-rail business is affected by the annual grain harvest, and that the lower than average harvests since the lessee purchased the PIL in 2004 would have lowered the business value.

Advice to government in September 2006 included these valuations but did not set out their limitations. One of the valuations was also used by DOI in the development of assumptions for its business case about the range of potential purchase prices for a buy-back.

Conclusion on market value of the business acquired

The state had clear advice that the market value of the below-rail business was likely to have been significantly less than its book value and acquisition cost.

The purchase price that the state paid was significantly higher than the valuations from the two commercial advisers, particularly when including the state's subsidy of future access charges for the vendor.

4.3.3 Special value to the state

The buy-back's value to the state may be higher than the fair or market value of the business based on any 'special value' of the state controlling the below-rail network. While book value and market value are references both for the seller and buyer in setting an offer price, special value is only relevant to the state as a potential buyer, and may indicate how much more than market value it might consider paying.

If the state was prepared to pay more than the fair value of the assets to buy-back the network based on advice about special value it needed to:

- have reliable advice about the nature and amount of special value from gaining control of the assets
- understand what the fair value of the assets was and whether any other potential buyers might consider the assets had special value for them and the possible amount of that special value
- take a commercial approach, using available leverage in an appropriate manner to drive down the purchase price and only pay the minimum necessary to outbid or exceed the price that other potential purchasers might be prepared to pay.

The concept of special value or an 'acquisition premium' was in the DOI business case, and underpinned the commercial advisers' assessments of the 'value to the state'. The validity of this rested on an assumption that there would be a competitive bidding process for the below-rail business and that other potential buyers might also expect special value. In a competitive process the state would only have to pay the part of special value necessary to outbid other purchasers, assuming it could assess the special value to other purchasers.

The state believed the special value lay in 'savings' it could realise in the future by controlling the asset. The agreed purchase price for the buy-back, was determined by the book value of the lessee's below-rail assets, and was justified to government based on potential savings for the state from owning the below-rail business.

DOI and commercial advisers based these savings on the 'value to the state' of it acquiring the below-rail business. The government was advised that the state could save between $204 million and $250 million in net present value terms if it bought back the network.

Audit has concerns about the robustness of some assumptions underlying these estimates, including whether there was any evidence that the state could make ongoing savings on maintenance when it ran the network.

Business case savings estimates

The DOI wrote a business case in August and September 2006 which compared the estimated cost of the below-rail business with the estimated recurring savings assumed if it was owned by the government.

Although DOI did not finalise or formally submit the business case to the government, the department used it both for submissions to the government in September and October 2006, and as a primary information source for commercial advisers assessing the ‘value to the state’ of the transaction.

The business case analysed four buy-back options, ranging from terminating the PIL and negotiating a buy-back to a consensual buy-back. The department did NPV calculations for best and worst case assumptions on each option. The NPV analysis used 37 years being the remaining term of the PIL, and a discount rate of 7 per cent. This produced NPV results varying from positive $97 million in the best case of buy-back now, to negative $74 million in the worst case being terminate the PIL and negotiate a buy-back.

In essence the business case sought to compare the estimated cost of acquiring the network and below-rail business including purchase price, transaction and transition costs with the estimated value of recurring savings on maintenance and other network operating costs with the network in state control.

DOI estimated the government could save from $7.8 million to $14.2 million per year if it owned the below-rail network. It assumed the state could save between 5 and 10 per cent on maintenance by competitive outsourcing compared with the lessee’s budgeted maintenance spending for 2006–07.

DOI assumed annual maintenance expenditure of $82.9 million to $87.4 million. Maintenance expenditure was broken into passenger and freight network components then split between routine and major periodic maintenance.

Audit identified a number of issues with this approach:

- The business case had very little analysis or substantive evidence to support its assumptions about savings from competitive outsourcing of maintenance. In September 2006 the Department of Treasury and Finance (DTF) said it did not support DOI’s assumptions about maintenance savings for a state run network. At that point, DTF assumed there would be no maintenance savings if the network was state controlled.
- There was no clear commitment to outsource maintenance activities if the state regained control over the network.
- The business case used data and analysis supporting the ESC access charge determination of June 2006. The ESC data and analysis were prepared for a different purpose from the business case and it is questionable whether DOI should have used it without a more direct analysis of the likely costs of the state running the network. The fact that the ESC concluded that the lessee’s costs were likely to be above those of a benchmark efficient operator did not necessarily mean that the government could run the network at a lower cost.

- The business case assumed ongoing maintenance expenditure on the network of between $82.9 million and $87.4 million per year for 37 years including major periodical maintenance (MPM) of between $44 million and $46.5 million per year. Irrespective of the certainty of obtaining such funding on an ongoing basis it is questionable whether this amount of money would be needed on the network after the existing maintenance backlog had been dealt with. In short, the assumption that MPM expenditure would continue at existing levels does not appear realistic if the maintenance backlog was reduced over time. It is also worth noting that the non-binding buy-back agreement signed by the government in late October 2006 imposed only a ‘minimum maintenance’ obligation on the state.
- The business case noted that the lessee’s safety accreditation requirement gave it an effective veto over any changes to the rail infrastructure on the network. It claimed that when the state was paying, the lessee had an incentive to insist on higher standard upgrades for old track or other works leading to higher costs. The business case assumed that such incentives would disappear if the network returned to state control. The business case did not record that a state owner of the asset would have similar safety obligations under the *Rail Safety Act 2006* and may have similar incentives to insist on higher standard upgrades to cut future maintenance. Although a state owned operator of the network would be expected to be more co-operative the impact of safety accreditation and commercial incentives on project expenditure would not totally disappear under state ownership.

In audit’s view the business case should have been more thorough in assessing the on-going funding needed for operations and maintenance works on the network under state control, including transition and start up costs for the new entity.

The business case proposed that the state could make savings by taking direct control and operation of the network and this formed the basis for later advice from commercial advisers which the government relied on when approving the buy-back and its price. The advisers assumed such savings then estimated very high positive values for the state from a buy-back on that basis.

Savings estimates by commercial advisers

Advice to government at the time of entering into the non-binding Heads of Agreement (HOA) from a commercial adviser who was the state’s lead negotiator for the buy-back was that it could realise savings in the order of $215 million to $240 million in NPV terms over the remaining 37 years of the PIL. A second commercial adviser suggested it could save from $204 million to $250 million in NPV when the government approved the final transaction documents in April 2007.

Audit examined this advice and identified the following issues:

General

- While the external commercial advisers were highly reputable they relied almost entirely on information and savings assumptions made by DOI. They did not have direct access to information from the lessee or its management which would have been required to enable a robust review and testing of the validity and achievability of those savings assumptions. Audit reservations about the DOI business case are outlined above.
- Neither of the advisers included sensitivity analysis beyond a valuation range in their advice.

Savings

- The assumptions about the savings realisable by the state are open to the same challenges noted above for the DOI business case. One of the advisers noted that making the savings in practice would require the state to pay vigorous ongoing attention to cost control and be willing to outsource certain activities. They further noted that in the absence of such discipline, there was a real prospect that the savings would not materialise.
- On top of assumed savings on margins paid for maintenance works, one adviser also assumed an additional 3 per cent per year saving on total operational and maintenance spending. This was inconsistent with the DOI business case that stated that it assumed the same operating costs for the network under state control in the best case but an increase in the worst case to meet potentially higher business supervisory costs. In other contexts the state tends to assume that the private sector will be more efficient than the public sector.

Assumed ongoing government subsidy of freight-only network

- The commercial advisers assumed a base line minimum ongoing government subsidy of $20 million per year. This is questionable as the government never committed to such funding. Including the subsidy meant the state offered a lower value to the lessee. The advisers left the $20 million per year implied subsidy out of the calculation on the grounds that the state would be paying it, whomever controlled the network. The omission made the transaction look more attractive when compared with the value of the potential savings to the state.

- The inclusion of the base subsidy helped justify a higher price for the buy-back because the consultants assumed the state would save a margin on it. The first adviser referred to an estimated maintenance backlog of $200 million on the Victorian freight network and said, ‘annual freight track subsidies in NSW… are running at $125 million per annum, albeit on a bigger network in a worse condition’. There was not enough detail on the NSW subsidy to establish how it was relevant to the Victorian network. Historically the Victorian government did not pay $20 million each year to maintain the freight network until MPM funding agreements began in 2005–06. The government refused to commit to extra network funding when the ESC sought its advice while setting the rail access regime in mid 2006. However, the government had agreed ‘in principle’ to a one-off $25 million freight network subsidy in 2006–07 at the time the advice was being provided.

Discount rate applied to estimated savings

- Discounted cash flow analysis requires assumptions to be made about the quantum and timing of those cash flows. There will usually be a risk that the actual cash flows will be more or less than those projected. This is dealt with by factoring risk into the projected cash flows themselves or by including a risk component in the discount rate applied to the cash flows, or both.
- The first commercial adviser and lead negotiator made a risk adjustment to the projected future savings cash flows and used a risk free rate of 3.41 per cent (assumed to be equivalent to the state’s real cost of debt) to discount the ‘risk adjusted’ cash flows back to a present value.
- This may have been appropriate if the adviser used risk adjustments on the projected future cash flows for savings that resulted in ‘risk free’ cash flows. However, there was uncertainty about the savings ultimately realisable by the state according to other comment in the adviser’s report, both DOI and DTF’s previous analysis and advice, and the views of the second commercial adviser. Given this uncertainty, the adviser should have applied a higher discount rate to the forecast savings cash flows. This would have resulted in a lower NPV value for the state’s assumed savings and would have implied that in financial terms the buy-back’s value for money was marginal even without considering whether the savings could be made, or whether the annual access revenue of $15 million from the lessee was reasonable.
- The second commercial adviser who reviewed the first commercial adviser’s report said in early 2007 that if the future savings cash flows were exposed to business volatility they would expect the discount rate to move towards a real pre-tax weighted average cost of capital for the below-rail network business, which they considered to be between 6.63 and 7.5 per cent. They did a sensitivity analysis on this basis, leaving all of the first commercial adviser’s other assumptions unchanged, and showed that applying a discount rate of:
- 3.41 per cent produced an NPV of future savings to the state of $217 million
- 6.5 per cent produced an NPV of $160 million
- 7.5 per cent produced an NPV of $147 million.

- Thus, when they applied a higher discount rate to the future cash flows assumed by the first commercial adviser, the present value of future savings was reduced to levels broadly equal with the first adviser's estimate of the effective value that the state was offering to the lessee of $157 million.
- The second commercial adviser's estimate was similar even though they applied a higher discount rate. This is because they included additional savings in their analysis based on DOI advice. Audit was not convinced about how reasonable these assumed additional savings were, and considered some of them excessively optimistic.

Compensation relating to the state's Wodonga rail project

- The first commercial adviser assumed an annual saving to the state of $3 million over the remaining term of the PIL for what was described as the Wodonga rail access fee. The adviser indicated that DOI had advised that this was a realistic assumption. The state expected to pay compensation payments to the lessee to address the impacts on its above-rail business of the Wodonga rail project which involves moving rail tracks out of the centre of Wodonga.
- Audit queries the validity of this assumed saving and the amount. The DOI advised the government in September 2006 that this compensation was likely to be around $2.2 million. The state made a one-off payment of $3 million to the lessee to compensate for the impact of the Wodonga rail project on the lessee's above-rail business as part of the buy-back transaction. There is no provision in the asset sale and surrender agreement which suggests that this is anything other than a one-off payment, although the lessee was expected to continue its above-rail business.
- In these circumstances it is difficult to envisage the state agreeing to pay the lessee $3 million every year for 37 years for the effect of the same project. If some form of ongoing compensation was warranted presumably the government would have sought to pay a lump sum upfront.

Conclusion on special value

The purchase price for the buy-back was justified by the state using potential cost savings from owning the below-rail business. These potential savings were based on advice from DOI and commercial advisers on the 'value to the state' of acquiring the below-rail business.

The government was advised that the state could save from $204 million to $250 million in net present value terms if it bought back the network. Audit has reservations about the robustness of a number of assumptions underlying these estimated savings, including whether there was sufficient evidence that the state could make ongoing savings on maintenance once it ran the network.

Irrespective of the soundness of this advice, it does not follow that the state acquired the below-rail business and associated assets for the lowest reasonable purchase price obtainable in the circumstances. While the 'value to the state' analysis was useful to understand the 'special value' of the below-rail business, it should not have been the primary basis for justifying the price for the buy-back. In a competitive process, the state would have only had to pay that part of the identified 'special value' *necessary to outbid other purchasers,* assuming some assessment of the special value accruing to other purchasers could be made.

The focus on the value to the state of acquiring the below-rail business meant that it is likely the state offered and paid a higher price than needed given the likely fair market value of the business and any potential 'special value' available to other bidders.

4.4 Audit assessment of value for money

Value for money is defined as achieving the desired outcome at the best price obtainable in the circumstances.

While the government achieved its desired outcome when buying back the network, the full cost of the buy-back is likely to exceed $200 million. This is mainly due to lower than expected access fees from the vendor on the freight only network since the buy-back, which is not expected to improve significantly in the short term.

Audit can give no assurance that the state paid the lowest reasonable purchase price for the buy-back.

The state accepted the position put by the vendor that the 'book value' of the assets to be acquired by the state be used as the reference when determining the purchase price for the buy-back. The state's professional advice implied that the book value of the prepaid PIL was unlikely to represent its actual market value. There were clear indications in other advice given to the state that the market value of the below-rail business was likely to have been significantly less than its book value and acquisition cost.

The purchase price for the buy-back was justified using potential cost savings to the state from owning the below-rail business. These potential savings were based on advice from DOI and external consultants on the 'value to the state' of acquiring the below-rail business. Audit has reservations about the robustness of some of these assumptions, particularly whether there was sufficient evidence that the state could make ongoing savings on maintenance once it ran the network.

The full cost of the buy-back may exceed the special value or future savings to the state from regaining control of the intrastate network, depending on the assumptions made about costs and savings.

Rather than focussing on special value, it would have been more productive for the state to insist that the vendor co-operate in a formal, unrestricted business valuation as suggested by its commercial advisers in August and September 2006, and for the agreed purchase price nominated in the 'non-binding' HOA to be adjusted to reflect the outcome of that valuation.

5 Adequacy of advice to government on the buy-back

At a glance

Background

The government based its decision to buy back the network on advice from departments and a range of commercial advisers.

The audit examined the analysis and advice used for decision making and whether it was complete, accurate, reliable, timely, and transparent. We also assessed the management of the negotiations and the transaction.

Findings

- The government was not given consolidated advice which clearly, consistently and robustly analysed and assessed all options available despite repeated requests and assurances that it would be provided.
- The departments did not agree on and present the results of a comprehensive business case for the buy-back to the government. Nevertheless, advice to government indicated that the financial outcome of a buy-back was uncertain.
- Decisions made on the buy-back were based at least in part on advice from commercial advisers without express knowledge of limitations applying to that advice.
- The key terms of the buy-back, including price, were negotiated and agreed within a very short time after the government decided on 21 September 2006 to pursue a buy-back. The buy-back was agreed ‘in principle’ on 31 October 2006 and it was announced at the start of the caretaker government period for the 2006 state election. The state did not obtain sufficient advice before committing to the buy-back. The absence of an adequate business valuation was a particular deficiency.
- The departments administered and documented the negotiations adequately.

5.1 Introduction

The government's *Growing Victoria Together* policy includes a target for the proportion of freight transported to ports by rail to increase from 10 to 30 per cent by 2010. To achieve this, the regional intrastate rail network needs to be well maintained and efficiently run.

In late 2005 and early 2006 control of the holder of the Primary Infrastructure Lease (PIL) over the regional intrastate rail network was under question. The government took this opportunity to consider options for the network's future. There were two strategies available:

- consent to the change in control of the lessee and either leave the PIL unchanged or renegotiate it to address government concerns
- reacquire the network by either terminating or buying back the PIL.

In March 2006 the Premier asked the Minister for Transport to do a full financial, social and environmental cost/benefit analysis of all options, including the re-acquisition of the below-rail intrastate regional rail network.

The government sought advice on its options because it considered that the existing arrangements for the control and operation of the network were delivering poor outcomes. Advice to government indicated that problems included inadequate maintenance of network assets, and additional costs and delays in relation to both previous and planned future investments in the network by the state.

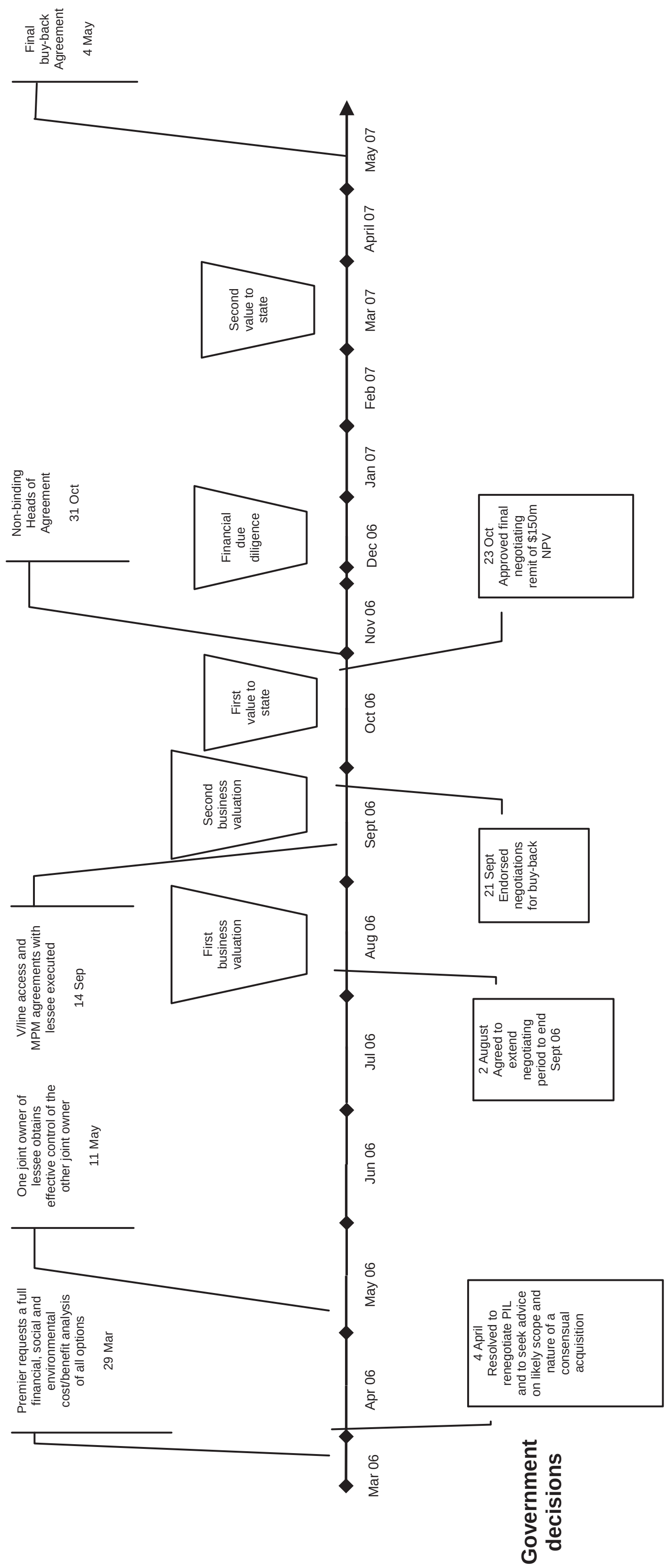
The government selected the buy-back option and had negotiated a purchase price and in-principle agreement with the lessee by the end of October 2006. This was first announced in November 2006. In April 2007 the government publicly confirmed its agreement to buy-back the regional intra-state rail infrastructure network at an announced cost of $133.8 million.

Between late 2005 and May 2007 when the buy-back transaction was completed, relevant departments provided the government with advice.

During this time the state was also trying to finalise the regional fast rail project and start running the new services in mid 2006. The regional fast rail services required interaction and cooperation between the state and the lessee.

Figure 5A is a timeline of key events and decisions in relation to the buy-back between March 2006 and May 2007.

Figure 5A
Timeline of events and decisions



Source: Victorian Auditor-General's Office.

The audit examined the analysis and advice behind the:

- review of options and decision to pursue a buy-back
- negotiation strategy to secure a buy-back
- purchase price agreed to by the state.

Audit examined the analysis and advice used for government decision making and whether it was complete, accurate, reliable, timely, and transparent. We also assessed the management of the negotiations and the transaction.

5.2 Advice on options

The Premier asked for analysis in March 2006 following a similar request in November 2005. His request suggested that the Department of Infrastructure (DOI) should do the analysis in consultation with the Department of Premier and Cabinet (DPC).

The DOI, DPC and the Department of Treasury and Finance (DTF) assessed the options for the future of the intrastate regional rail network in the context of the proposed acquisition of one of the joint owners of the lessee by the other joint owner, and gave the government advice and recommendations.

The government relied on the advice from DPC, DTF and DOI and from a range of commercial and legal advisers when making decisions between April 2006 and April 2007. During this time the government decided in:

- **April 2006**—to renegotiate the PIL with the lessee to meet its objectives for the network, while also assessing the potential for a consensual buy-back of the PIL, and the price and scope of a buy-back
- **August 2006**—to offer the lessee $25 million for maintenance on the freight network subject to the lessee's agreement to a number of state conditions
- **September 2006**—to begin negotiations for the buy-back of the network
- **October 2006**—to buy back the network
- **April 2007**—to enter into a final binding buy-back agreement.

In line with the Premier's request audit expected the departments would have robustly analysed the financial implications of all options including a buy-back.

This would include analysis and advice about what to pay and assurance that the buy-back would be value for money to the state. The departments should have done this by assessing and advising on the worth of the business and assets both in market value and any additional value to the state if it acquired the assets.

The departments should also have evaluated the reasonableness of the price sought by the vendor and the basis for it to identify the lowest reasonable cost to the state obtainable in the circumstances.

The government was given advice on the book value of the assets and liabilities, the fair value (or market value) of the below-rail business and the estimated special value to the state from regaining direct control over the network in the lead up to its approval of the buy-back.

Initial advice

In April 2006 DOI advised the government that it would give a detailed financial analysis of options later.

On 2 August 2006 the departments advised the government on the options but with no supporting detailed analysis. The government asked DOI and DTF in consultation with DPC to review the possible buy-back options and report back as soon as possible.

This request for coherent agreed analysis was reinforced in a joint submission to government from DPC, DTF and DOI dated 10 August 2006 which said there was a need for urgent advice on the cost-benefit analysis of a buy-back strategy.

DOI business case

During August and September 2006 DOI developed a business case to analyse buy-back options that was not finalised or formally submitted to government. However, it influenced submissions to government in September and October 2006 and was a primary information source for commercial advisers who advised the government later on the ‘value to the state’ of the transaction.

The business case was based on data sources from the Essential Services Commission (ESC) 2006 regulatory process to establish a rail access arrangement for the regional intrastate network. Those data sources included information prepared by the lessee and the ESC and its advisers. The departments advised that they accepted the veracity and reliability of the ESC data and that the state had no other option or alternative sources of data available.

Audit does not question the veracity of the ESC data set, or suggest that there was a more credible pre-existing set of data available at the time of the deliberations. However, the ESC data was prepared for a different purpose and did not directly examine the likely cost of network operation under government ownership. Therefore it is questionable whether the ESC data set should have been solely relied on. In addition, the departments had explicit external advice noting limitations in the available data set and recommending that a more detailed valuation process, based on more comprehensive information sourced directly from the lessee, be undertaken in order to support a decision on a buy-back.

The business case considered four options for the network’s future, namely:

- terminate the PIL and negotiate a buy-back and orderly transfer of network control, acknowledging that the lessee may take legal action
- seek a court declaration confirming the validity of the state’s right to terminate the PIL and other leases and concurrently negotiate a buy-back

- seek an immediate consensual buy-back
- seek to buy the network back in 12 months.

The business case included NPV calculations on the best and worst case for each of these options. The results varied from positive $97 million in the best case of buying back now, to negative $74 million in the worst case of termination and negotiation.

To arrive at the NPV the business case compared the estimated cost of acquiring the below-rail business to estimated recurring savings under government ownership.

A critical factor in the business case affecting the NPV analysis was the assumed purchase price for the network. DOI assumed that it would range from a best case of $80 million to a worst case of $150 million.

DOI calculated the purchase price by taking an ‘acquisition premium’ ranging from $30 million to $80 million and adding a ‘base valuation’ of $50 million to $70 million. However, the caveats and limitations on these figures were not spelled out in the business case:

- The base valuation in the purchase price assumption came from the indicative business valuation of DTF’s consultant, but the business case did not include any discussion or disclosure of the caveats and limitations on that advice.
- The purchase price assumptions included the special value to the lessee of synergies from its operation of the network, which ranged from $25.2 million to $37.8 million. However, the business case did not include the consultant’s explanation of the notional and highly qualified nature of these values.
- The acquisition premium ranged from 60 to 114 per cent of the base valuation with little explanation about the basis for it:
    - There was little or no support in the business case for the ‘low’ acquisition premium. It was said to recognise a combination of the lessee’s book value, the consultant’s assessment of special value or synergies available to the lessee from continued operation of the network and the fact that DOI’s valuation was higher than the base value. However, the lessee’s book value did not necessarily reflect market value, the consultant’s estimate of the value of synergies available to the lessee was highly qualified and no details of the basis for the DOI ‘high level valuation‘ of $85 million to $99 million were provided.
    - The ‘high’ acquisition premium was said to represent the absolute maximum including the goodwill the lessee paid when it bought the initial leaseholder. However, details of the goodwill were excluded along with any discussion on why the state might or might not be willing to pay for it. In addition, advice from the relevant consultant identified the goodwill paid by the current leaseholder as $9.3 million. Accordingly, the ‘high’ acquisition premium of $80 million cannot be justified through goodwill alone.
- The worst case scenario assumed with little explanation that the purchase price would be around $150 million, significantly above the indicative value range set by the state’s commercial advisers and consultants.

Other specific reservations about the business case included:

- In relation to the ‘buy-back later’ option, the business case analysis stated that the valuation was likely to be similar to independent valuation, but the cost benefit analysis includes the same purchase price and acquisition premium as the ‘buy-back now’ option that were well in excess of independent valuations received by the state to that point.
- The business case included additional transaction costs and contingency amounts for the options involving termination and court action. This was reasonable, however, the analysis failed to recognise and model the potential for lower ‘purchase costs/damages’ under these scenarios.
- The cost benefit analysis of the termination options included a purchase price plus an ‘acquisition premium’. Under a termination scenario, the state would be unlikely to have to ‘acquire’ the network. If termination was found to be wrongful by a court, the remedy was likely to be the restoration of the lease or the assessment of damages reflecting the value of the business to the leaseholder which would be unlikely to include an acquisition premium.

September 2006 advice

The government in September 2006 considered advice on the progress of negotiations with the lessee. At this meeting it endorsed starting negotiations for a buy-back subject to a range of considerations including a target purchase price of $122 million based on advice about the book value of the network.

This decision was not informed by agreed results of the financial analysis of possible buy-back options requested from DTF and DOI in August 2006. While DOI was developing a business case for a buy-back it was not completed in time for the September meeting and so was not available for detailed review and assessment by DTF and DPC.

Consequently, the advice provided to government in September did not include comprehensive or consistent agreed upon financial analysis of the options available to the state from the departments involved.

The DOI and DTF reached different conclusions on whether a buy-back was financially positive for the state. The main difference was over the savings that the state could make on network maintenance. DOI assumed savings of between 5 and 10 per cent, whereas DTF assumed none.

Audit queries the accuracy of the results of DOI’s discounted cash flow analysis of buy-back options presented to government. DOI had used a valuation figure that was out of date by the time the government met on 21 September 2006.

If the final valuation had been used the net present value would have ranged from a positive $77.2 million in the best case to a negative $100.5 million in the worst case. This would have worsened the best and worst outcomes by $20 million and $36.5 million respectively. Amounts of this magnitude are material and, if known, had the potential to influence decision-making.

The advice to government in September also included the various estimates of the book value and market value of the below-rail business obtained from the state's commercial advisers and consultants. There were considerable variations in these values implying a large degree of uncertainty.

The financial result of a buy-back was clearly uncertain, as shown by the wide range in NPV predicted by DOI and DTF, and likely to be negative depending on the final purchase price. It was therefore incumbent on the departments to complete and agree on a robust analysis as a matter of urgency. This was necessary to properly inform government decision making.

In addition to departmental advice, relevant ministers asked DPC to engage a commercial adviser who made a presentation to the government in September 2006. As there is no record of this advice, it appears that this presentation filled the gap in the differing advice from DOI and DTF and was sufficiently compelling for the government to authorise the start of negotiations for a buy-back. The government then appointed this commercial adviser to lead the state's buy-back negotiations.

October 2006 advice

The government met on 23 October 2006 to consider the progress of negotiations. The state's final negotiating position including a financial remit of up to $150 million in NPV terms based on advice from DPC, DTF, DOI and the state's lead negotiator was approved. From this point the state was committed to buying back the network subject to the final terms conforming to the approved remit.

The advice to government at this point was not sufficiently comprehensive or documented to support an adequately informed final decision on a buy-back. It did not include an agreed business case or robust analysis of the financial implications of the proposed buy-back or other options. The departments apparently relied on oral advice from the state's lead negotiator that a final remit of up to $150 million would be value for money to the state.

At that point there was no written advice available from the state's lead negotiator supporting the contention that a total purchase price of up to $150 million represented value for money to the state. Both DOI and DTF had said earlier that a purchase price of $150 million for the network would result in a negative financial outcome for the state in NPV terms. In addition, $150 million was far higher than earlier business valuations obtained by the state and therefore potentially above what third party purchasers would be prepared to offer.

Negotiations with the vendor continued to 31 October 2006. At that point a final negotiating remit of $150 million, excluding employee entitlements, for the proposed buy-back had been endorsed and it was agreed that a non-binding heads of agreement would be signed if the vendor agreed to an offer within the remit.

The state received advice dated 31 October 2006 from its lead negotiator on the proposed buy-back. This advice was critical in the government's decision to enter into the non-binding buy-back agreement that day. The advice:

- estimated the effective value of the state's proposed offer to the vendor at approximately $157 million, including $10.8 million for employee entitlements
- assessed the value to the state at $215 million to $240 million based on discounted cash flows over the remaining 37 years of the PIL.

There is no documented analysis of the reasonableness and adequacy of the advice provided by this commercial adviser by DTF, DPC or DOI at the time it was provided. Audit reservations with the adequacy of the lead negotiator's advice are set out in part 4 of this report.

Conclusion on advice on options

Given that a decision to buy back the network would have far reaching financial and other consequences for the state we expected to find it to be based on comprehensive analysis and advice on all available options and a compelling case showing that a buy-back at that price was value for money. This did not occur and the advice did not adequately address the Premier's March 2006 request for a full financial, social and environmental cost-benefit analysis of all options.

The buy-back was approved on incomplete analysis and advice. The government did not get consolidated advice that clearly, consistently and robustly analysed and assessed all options available despite asking for it repeatedly, and being assured that it would come. The three departments did not do a comprehensive business case that they all agreed on, notwithstanding the passage of around six to seven months deliberations.

Some of the assumptions and conclusions in the business case underlying DOI's advice to the government in September 2006 are questionable. The main reservation is that the inclusion of an overstated business valuation in the business case probably influenced government thinking on the price that it had to pay for the buy-back.

5.3 Advice on negotiating strategies

The government received advice on strategies for negotiations with the lessee between late 2005 and late 2006. Options included negotiating a revised infrastructure lease, terminating the PIL and buying back control of the network.

The state's negotiation strategy changed over time:

- The initial strategy, approved in April 2006, was to renegotiate the PIL and during negotiations assess the potential, price and scope of a consensual buy-back of the lease. The buy-back of the network was initially a fall-back position.
- In August 2006 the government sought advice on possible buy-back options because of indications that it may not be able to achieve its objectives for the network with a renegotiated PIL.

- In September 2006 the government endorsed negotiation with the lessee for the buy-back of the network and the parties reached agreement at the end of October 2006.

The initial strategy was based on adequate advice and did not lock the state into a particular course of action.

Notwithstanding this, the advice in April 2006 dismissed the option of terminating the PIL as high risk and potentially litigious and relegated it to a last resort. The advice raised a concern that the train control business and related assets might not transfer back to the state if the PIL was terminated. The train control assets were essential to the network's operation and failure to gain control of them would have severely limited the state's ability to run the network.

Initial negotiations and moratorium agreements

The state began renegotiating the PIL with the lessee in May 2006.

On 10 May 2006 the state's immediate consent to the proposed acquisition of one joint owner of the lessee by the other was requested. The state did not consent and on 11 May 2006 the acquirer announced it had taken control of the other joint owner of the lessee having acquired a 52 per cent shareholding that day. This created a potential termination event under the PIL.

On 11 May 2006 the state and the lessee agreed that they would not take immediate action pending a discussion of the legal implications arising from the potential termination, and to allow them to negotiate. They agreed to a moratorium of 90 days from 18 May 2006 to 18 August 2006 for discussions.

The moratorium, which was later extended several times, allowed the state to preserve its right to terminate the PIL and was key leverage in negotiating improvements in the PIL or a buy-back of the network. The moratorium was extended to 30 September 2006, then 8 December 2006 and 27 February 2007 and, finally expiring on 4 April 2007 when the parties agreed on the conditions of the buy-back.

As the negotiations progressed the lessee initially said it was not interested in selling its below-rail business and said it needed ongoing government funds for freight network maintenance.

August 2006 advice

In early August 2006 the government met to discuss progress on negotiations with the lessee including strategies. Its advice indicated:

- The lessee had rejected the state's proposals to reform the PIL terms on project delivery and it was unlikely the state would be able to set up a new projects regime.

- The acquirer had said in late July 2006 that it would consider selling the below-rail network after complying with its commitment to the Australian Competition and Consumer Commission (ACCC) to sell 50 per cent of its interest in the lessee business.
- A buy-back of the PIL was thought to have significant policy benefits for the state in doing major projects on the network and in regaining control of maintenance.

On this basis the government requested that DTF and DOI, in consultation with DPC, review possible buy-back options, including using commercial advisors, and report back as soon as possible.

The advice to government did not favour the PIL termination option because it was seen as high risk and potentially litigious. However, the government was not given the conclusions of relevant legal advice on the strength of the state's position over the potential termination. The state had independent legal advice in May 2006 that said:

- When the acquirer took over the other joint owner of the lessee it failed to get the government's consent for the change in control of the leaseholder so it was in breach of the lease and the state could terminate the PIL.
- The state would not have to pay any compensation or repay any of the prepaid PIL if the lease was terminated or surrendered.
- Use and control of the PIL assets would revert to the state on surrender or termination and their value would be nil. The state would have to get a normal commercial asset identification and valuation to acquire the non-PIL assets needed to run the network.
- On surrender or termination of the PIL, the lessee would retain any non-PIL assets it owned or used and this could potentially include train control assets needed to run the network.
- The state would need the lessee to cooperate so the transition of ownership and operation of the network went smoothly.

The government received detailed advice on the termination option in September 2006 but it focused mainly on legal mitigation strategies should the lessee not cooperate in an orderly hand-over of the network. The advice did not explain that the state could terminate the PIL without paying compensation. Notwithstanding this, there was clear evidence that the state understood the importance of retaining its right to terminate the PIL as leverage in its negotiations.

In addition to seeking advice on buy-back options, the government agreed to offer the lessee $25 million for freight network support on the condition that it agree to 10 conditions. This was despite advice from DTF that any payment the state made to the lessee to run the network raised the value of the lease to the lessee and therefore boosted the cost of any state buy-back.

The state knew that the value of the business to the lessee and, therefore, the likely price depended on assumptions about future state spending on the network. If it refused to commit to future expenditure, the value of the business to the lessee declined and with it declined the potential purchase price subject to the commercial dynamics of any negotiation.

Advice in September and October 2006

In September 2006 the government endorsed negotiations for the buy-back of the network subject to a target purchase price of $122 million based on a commercial adviser's advice on its book value in 2004.

The state accepted the lessee's position that the 'book value' of the assets be used as the reference when determining the price of the buy-back. There was no documented advice put to government on why book value should be used as the basis for the purchase price.

Audit was advised by DTF that the state accepted this position based on the nature of undertakings given by the acquirer to the ACCC in relation to its proposed acquisition of the joint owner of the lessee. The undertakings included a commitment to sell key assets to address concerns about a lessening of competition resulting from the acquisition. One of those key assets was the acquirer's interest in the lessee and the undertakings required the acquirer to protect the value of assets to be sold by maintaining their trading and financial position and not making any material adverse changes to the nature or key features of the business. The lessee's lease over the intrastate rail network was a key feature of its business.

Given the nature of these undertakings DTF advised that the state considered that it had an obligation to 'act reasonably' when seeking to negotiate the cost of the buy-back with the vendor and that on this basis it did not seek to secure a purchase price that was substantially below the book value of the assets, despite indicative advice from two expert external advisers that the market value of the relevant assets was likely to be significantly less than book value and the proposed acquisition cost.

Audit considers that the ACCC undertakings were aimed at preventing substantive changes to the business, which could have undermined competition in the freight forwarding business, and need not have limited the state in negotiating a purchase price less than book value. Of course, even without the ACCC undertakings, the vendor would have been motivated by commercial considerations to achieve a sale price at least equal to book value.

When endorsing the negotiations the government appointed a commercial adviser hired by DPC to lead the state's negotiations with the vendor.

The negotiations progressed until the end of October 2006, with reports back to government on issues, including the purchase price and ongoing access fees for the vendor's continued use of the network. The secretaries of DPC, DTF and DOI met regularly to monitor progress.

The negotiations ended on 31 October 2006, when the state signed a non-binding Heads of Agreement (HOA) for the buy-back with the vendor. The HOA was publicly announced by the Australian Labor Party on 1 November 2006. The caretaker government period for the 2006 state election began on the same day. It is arguable that the public announcement of the non-binding HOA for the buy-back of the network and the purchase price placed the future government in a weakened negotiating position during the preparation of final, binding agreements.

Publicly announcing the HOA effectively committed to the buy-back and limited the capacity to withdraw or renegotiate key aspects of the agreement. Advice provided to government on 30 October 2006 indicated that publicly announcing the HOA would place it in a weakened negotiating position during preparation of the more detailed final binding agreement for the buy-back.

Conclusion on advice on negotiating strategies

The advice given to government on negotiation strategies between early and late 2006 was generally satisfactory. However, there were two exceptions. Firstly, the government was not told how strong its position was should it decide to terminate the PIL. The departments did not pass on legal advice that the state would not have to pay the lessee compensation if it terminated the lease. Secondly, there was no documented advice on why it should accept the lessee’s position that the ‘book value’ of assets should be the reference for determining the purchase price.

5.4 Advice on price and value

Advice from external consultants and advisers was critical to the government’s initial decision to pursue a buy-back, its final decision to buy-back the network and the price it was prepared to pay.

Audit has reservations regarding the completeness of information provided to government about advice received from expert commercial advisers. Specifically, advice to government in September 2006 about the value of the below-rail network as estimated by consultants engaged by DOI and DTF did not set out the limitations, qualifications and recommendations applying to that advice.

Government was advised that one consultant had valued the network at between $58 million and $65 million but not advised that this consultant indicated that although the procedures undertaken to arrive at the valuation were sufficient both to establish a broad order of magnitude and to inform policy consideration, they were not sufficient to initiate an acquisition. The adviser further indicated that it had relied on analysis by DOI and the ESC and had not undertaken additional due diligence or research and that the data and analysis to support assumptions on costs and revenues was weak.

Government was also advised that another consultant had valued the network at between $47 million and $70 million but not advised that this consultant indicated that there were significant limitations on their advice and that on the basis of those limitations the valuation conclusions were indicative only and the conclusions of a formal unrestricted valuation may be materially different.

The DOI advice to government also indicated that this consultant's total valuation range was $72 million to $108 million based on the inclusion of values of between $25 million and $38 million for synergies and additional value that may accrue to the lessee through its ownership of the network. This was potentially misleading because no context was included in the advice to government about the basis for the valuation of synergies or 'special value' attributable to the lessee's continued operation of the network. The consultant's report stated that it was not possible to estimate the extent of these synergies and placed a value on them 'purely for the purposes of discussion'. Given the context in which these potential synergies were identified and quantified, it was inappropriate for DOI to include them in advice to government without further explanation.

This consultant recommended that its indicative valuation be used for policy planning purposes only and that a more extensive and formal valuation process be undertaken if the state wished to pursue an acquisition. This recommendation was not passed onto government and was not acted on by the relevant departments when the government determined to negotiate a buy-back. Instead, advice about the 'special value' of a buy-back to the state was obtained and relied on in government decision-making.

When the government endorsed negotiations with the lessee for the buy-back of the network in September 2006 it nominated a target purchase price of $122 million based on advice from a commercial adviser about the book value of the network.

Government was advised that this adviser had identified that at the time the lessee acquired the initial lessee in 2004, the book value of the rail infrastructure assets was around $122 million and that book value may be a reference point for the current lessee in negotiations on the value of the network. However, the government was not informed that this adviser had also indicated:

- the book value of $122 million included the value of the lease rental prepayment and that there was no evidence that the prepayment provided any indicator as to the value of the below-rail operations
- the performance of the business since 2004 presented the possibility that there may have been some and potentially significant diminution in the value of the business since the acquisition by the lessee.

If this information had been passed onto government it may have led to caution about using book value as a reference point for negotiations on purchase price for the network.

Following the signing of the non-binding HOA for the buy-back on 31 October, the state took steps to secure a final, binding agreement. These steps included negotiations with the vendor, a due diligence exercise using a consultant and the securing of advice on the value to the state of the buy-back from the same consultant.

Throughout this period the new government was provided with advice on the progress of negotiations and other activities. In December 2006 the new government was advised that the results of the due diligence would be presented when the final sale agreement documentation was provided to ministers for execution.

This did not occur. The advice to the Minister for Transport, Premier and Treasurer in April 2007 did not include the results of the due diligence exercise conducted on the state's behalf which had noted that there was uncertainty in respect of materials and supplies, employee entitlements, property, plant and equipment and the level of deferred revenue.

The outcomes of the due diligence process were partly addressed by the outcomes of a completion accounts process included in the final buy-back agreement that resulted in favourable adjustments for the state.

Conclusion on advice on price and value

Advice to government on analysis and opinions provided by external consultants and advisers on the value of the network did not include sufficient information about the qualifications and caveats applying to that analysis and those opinions. Government may have made decisions based, at least in part, on this external advice without knowledge of its limitations.

The departments advising government were in possession of clear advice from external consultants indicating that the state should obtain a formal and unrestricted business valuation of the network and below-rail business before committing to a price but did not pass these recommendations on to government and did not obtain the valuation.

At the time it approved the HOA and the final binding buy-back agreements the government did not have comprehensive advice on the fair or market value of the below-rail business and was not in a position to determine whether it was paying more or less than fair value.

5.5 Timing and nature of advice

The key terms of the buy-back, including price, were negotiated and agreed in a very short time. The government endorsed the start of negotiations for a buy-back on 21 September 2006. The state entered into the non-binding HOA for the buy-back on 31 October 2006, less than six weeks from the start of negotiations. The key terms of the HOA did not materially change in the final buy-back agreement.

When setting the negotiating remit for a buy-back the government in October 2006 said it wanted a HOA agreed by 30 October 2006. The caretaker period for the 2006 state election started from 1 November 2006.

The key terms of the HOA did not materially change in the final buy-back agreement. At the time of signing the HOA, the state had not obtained sufficient advice, particularly an adequate business valuation, to support a decision, suggesting that the timeframe was not sufficient to allow proper consideration of the options available to the state.

In addition, in terms of the nature of the advice, when committing to the buy-back the government had not received definitive and agreed financial, social and environmental cost-benefit analysis of all options available to the state. This analysis had been requested by the Premier in March 2006.

In September and October 2006 the primary focus of the analysis and advice shifted away from identifying the lowest reasonable purchase price and the acquisition methods available to achieve that price to the justification of a purchase price which was driven by the lessee's assertions about the book value of its assets.

Following the signing of the HOA on 31 October 2006, the valuation procedures undertaken focused on the value to the state of the transaction, not on the value of the business and the price that should be paid.

There would have been merit in seeking a neutral business valuation on what the vendor may be offered for the business by other potential purchasers. Such advice could have been used as leverage to renegotiate the purchase price, especially in the event that it was consistent with previous advice obtained by the state that the book value of the business did not necessarily reflect its market or fair value.

Second opinion on value of the buy-back to the state

In its advice of 31 October 2006, the state's lead negotiator and commercial adviser recommended that the state get a second opinion on the value of the buy-back to the state.

In mid-December 2006 government noted this was underway and that the Premier, Treasurer and Minister for Public Transport would see the results prior to signing the binding sale documentation.

DTF engaged the adviser earlier commissioned to provide a business valuation of the network to undertake this task. The purpose of the engagement changed during its course.

The adviser was initially engaged to review the methodologies that the state's lead negotiator and commercial adviser used in his advice of 31 October 2006. The adviser was also asked to comment on an appropriate discount rate to apply to the valuation of the network and to any cost savings incorporated in the value of the asset to the state. The consultant provided a draft report to DTF on these matters in February 2007.

This draft advice was limited in scope and reviewed the state's lead negotiator and commercial adviser's methodology, analysis and advice. It concluded that the state's lead negotiator and commercial adviser used appropriate methodologies for his advice of 31 October 2006.

The draft advice clearly said it was not a valuation, and that it should not be interpreted as a valuation of the below-rail network to the state. The adviser said he had not been engaged to and had not reviewed whether the forecast cash flows used in the state's lead negotiator's advice could be achieved. The draft advice stated, 'nothing in this report represents an expression of opinion in relation to the value of the below-rail network or of any cost savings the State may enjoy as a consequence of the acquisition'.

DTF received final advice in March 2007. However, the nature and purpose of this final advice changed between February 2007 and March 2007.

The March 2007 advice which the government used in April 2007 was expressed as an 'independent valuation' that 'considers the value to the State of the proposed transaction'. This advice concluded that the state could save between $204 million and $250 million in NPV if it bought back the network. The adviser applied a higher discount rate than that used by the state's commercial adviser but included additional cost savings, based on DOI advice, thus producing a similar valuation range

The final advice was subject to a range of limitations and restrictions. The adviser did not attest to whether the forecast savings underpinning the valuation were reasonable or achievable other than saying he relied on DOI's advice and that nothing had come to his attention to indicate that DOI's information was materially misstated or unreasonable.

Audit was not fully convinced with the reasonableness of assumed additional savings underlying this valuation advice and considers that some of the assumed expenditure levels and savings assumptions were too optimistic.

Final negotiations and advice to government

The parties negotiated the final binding sale agreements between December 2006 and May 2007. The transaction was delayed for reasons attributable to both parties.

There were many issues for the parties to resolve. For example, the state had to identify an appropriate entity to take over the network operation and safety accreditation had to be obtained.

The government was kept abreast of negotiations and important developments during negotiations. Audit assessed the advice as generally adequate with the exception of the advice to the Premier, Treasurer and Minister for Transport on 12 April 2007 on the final agreements. The government had delegated to them the authority to sign the agreement.

The 12 April 2007 advice said that the NPV of the final deal was within the approved remit of $150 million with the final cost at $148.9 million. That excluded employee entitlements and included $27.6 million in NPV for the extra subsidy for 10 years implied in the access prices agreed with the vendor, assuming average grain harvest years. The advice correctly compared a final NPV calculated assuming average grain years against the remit which was specified in the same terms. However, the advice also pointed out that 2006–07 was a drought year and that access revenue of $15.3 million from the vendor was unlikely.

In these circumstances sensitivity analysis should have been incorporated into the advice to give a sense of the additional costs to government associated with the agreed arrangements in the event that poor grain harvests continued.

In addition, the advice to the Premier, Treasurer and Minister for Transport, on 12 April 2007 did not include the due diligence findings, which noted uncertainty about materials and supplies, employee entitlements, property, plant and equipment and the level of deferred revenue.

Conclusion on timing and nature of advice

The terms of the buy-back, including price, were negotiated and agreed within a very short time. The government wanted a ‘heads of agreement’ before the caretaker government started for the 2006 state election.

While timing was relevant, value for money was the overriding consideration. On that count the state did not obtain sufficient advice, particularly an adequate business valuation, to demonstrate value for money before committing to the buy-back.

When signing the HOA the government relied on advice that focused on the buy-back’s special value to the state. The advice it later sought did not address the question of whether the purpose of the analysis was appropriate and sufficient to support the intended acquisition. It is possible that this focus on value to the state encouraged the state to agree to a higher price than was required, having regard to the likely fair market value of the business.

It would have been more appropriate for the state to insist that the vendor cooperate in a formal, unrestricted business valuation as suggested by its commercial advisers in August and September 2006, and for the agreed purchase price in the ‘non-binding’ HOA to reflect that.

5.6 Management of the negotiations

The state’s negotiations with the lessee went in two stages. The first started in early May 2006 and focused on renegotiating the PIL over the intrastate regional rail network. The second began in late September 2006 and focused on securing an agreement to buy back the network in line with the government’s decision.

The state's team comprised senior representatives of DOI, DTF and DPC. The departments administered and documented the negotiation adequately.

The process took around 6 months and generated copious documentation. Each department maintained records relevant to their involvement.

The state obtained sufficiently expert external advice and once the government decided to buy back the network, DPC engaged an international investment firm for strategic and commercial advice, and to lead the state's buy-back negotiations with the vendor. The state spent about $6 million on consultants and legal advice.

Once the government decided to buy back the network in September 2006, project management was set up, incorporating:

- weekly meetings of the Secretaries of DPC, DTF and DOI to oversee the negotiations team
- regular meetings between the negotiations team and the vendor to work through the issues and develop a binding heads of agreement by 30 October 2006
- daily communication between the departmental representatives and the vendor to work through preparation tasks.

The parties reached an 'in principle' agreement for the buy-back on 31 October 2006. They then negotiated around 30 transactions, including the asset surrender and sale agreement, a network access agreement for the vendor and a transition services agreement.

Responsible ministers were briefed throughout. The secretaries of DOI, DTF and DPC also met regularly and the then Premier was closely involved in the final negotiation of the heads of agreement.

Experience and integrity of key individuals undertaking the negotiations

The negotiation team comprised senior representatives of DPC, DTF and DOI.

Following the government decision in September 2006 to buy back the network, DPC engaged an international investment advisory firm (adviser) for strategic and commercial advice and to lead the buy-back negotiations.

The audit reviewed the qualifications and experience of individuals who conducted the negotiations. The government representatives and the state's adviser were suitably qualified to negotiate with the vendor.

The *Public Administration Act 2004* and the code of conduct for public sector employees and public sector entities generally oblige public sector employees to be honest, open and transparent in their dealings and to declare and avoid conflicts of interest to help maintain community trust and confidence. The code also requires public sector employees to receive and manage information in such a way as to maintain confidentiality. Audit saw evidence that these requirements were met.

Under the code of conduct, contractors and consultants engaged by public sector bodies must comply with the code.

Notwithstanding the general obligations under the code of conduct, consultants employed to undertake the various roles and responsibilities in the negotiation process and the final transaction were required to declare any conflict of interest and to sign conflict of interest declarations and confidentiality deeds.

Legal due diligence

As part of the due diligence for the buy-back DOI instructed its legal advisers to do legal due diligence for the proposed purchase of the below-rail business assets. The aim was to identify and record the material risks and issues to assist the state in buying back the network and in its negotiation of the terms of the final agreement.

The legal advisers reported to the government on 27 February 2007. Audit reviewed the due diligence report and noted that it included review of:

- the lessee's commercial arrangements—major contracts, access agreements and sub-leases
- employment and work safety arrangements
- information technology and intellectual property, including software licences
- litigation issues.

The legal due diligence identified a number of minor issues for the state to address, and made recommendations. Overall, the due diligence did not identify any material legal risks to the state in the network buy-back.

Conclusion on management of negotiations

The departments managed and documented the buy-back negotiations adequately and assigned appropriate resources and expertise to the task.

6 The transition to state control

At a glance

Background

The safe and effective transfer of network control to the state was a key consideration once the government committed to buying back the regional intrastate rail network.

The buy-back will have ongoing financial implications for the state associated with operation and maintenance of the network. There should be a focus on realising the financial and other benefits cited as justification for the buy-back.

Findings

- V/Line managed the transition of the network to state control well, with minimal disruption to the day-to-day running of the network or to V/Line operations.
- The government determined that V/Line be the operator of the network in the interim only, but a new entity to run the network has yet to be established.
- The government has responded to a review of the Victorian rail freight network but V/Line indicates that it has not committed enough funding to reduce the maintenance backlog.
- There is a lack of data to show whether V/Line is maintaining the network and other operations more efficiently than the lessee. This is relevant in that the government expected the buy-back to produce savings from more efficient maintenance, and lower operating costs.

Recommendations

- That the 2006 decision to establish a state body under the *State Owned Enterprises Act 1992*, independent of VicTrack and V/Line, to operate the below-rail business for the intrastate rail network be revisited and actioned or set aside.
- That the actual cost savings achieved compared to the business case be determined and a full accounting of the transaction, based on actual costs, be disclosed.

6.1 Introduction

Once the government committed to buying back the regional intrastate rail network it had to consider the safe and effective transfer of network control.

In addition, the buy-back will have ongoing financial implications for the state associated with its operation and maintenance of the network. There should be a focus on realising the financial and other benefits cited as justification for the buy-back.

6.2 Transfer of network control to the state

When the government committed to buy-back the network it had to set up or nominate an organisation to manage the network once under state control.

The arrangements had to be appropriate to successfully manage the immediate tasks and risks. The government also had to consider longer term network management consistent with its own objectives and industry and community expectations.

6.2.1 Government decisions on management of network transfer to state control

The announcement on 1 November 2006 of the in-principle agreement for the buy-back suggested that a VicTrack subsidiary would manage the network.

However, on further investigation it was not considered feasible for such an entity to be created and to attain safety accreditation in time for the transfer to the state. The departments advising the government agreed that V/Line Passenger Corporation (V/Line) was the best entity to take immediate responsibility for the below-rail network.

This was primarily because V/Line had the capacity and expertise to gain safety accreditation from the state's public transport safety regulator in time to take control of the network early in 2007. Accreditation was a prerequisite for running the network.

Notwithstanding, the government did not consider V/Line the ideal long-term state operator as it perceived a potential for conflict between V/Line's responsibilities as network operator and access provider, and its core business running a passenger rail service.

In December 2006 the government endorsed:

- V/Line as the interim agency responsible for track operations and maintenance
- the establishment of a state body under the *State Owned Enterprises Act 1992*, independent of VicTrack and V/Line, to enable transfer of the below-rail network from V/Line as the interim agency to the state body immediately after its safety accreditation.

6.2.2 Management of network transfer to state control

In line with the government decisions of December 2006, V/Line was responsible for planning and implementing a safe and orderly transfer of network control to the state. The Department of Infrastructure (DOI) provided V/Line with a budget of $5.2 million for the transition. A further $1.3 million was budgeted for V/Line to be accredited under the state's rail safety legislation to run the network.

Implementation plan

In January 2007 V/Line set up a transition management team.

A comprehensive plan was developed for country passenger and freight operations to keep running safely without disruption when the primary infrastructure lease (PIL) over the network terminated. The plan was a condition of V/Line's network operation safety accreditation.

It outlined a strategy and detailed the many hundreds of tasks required for a successful transition of network control. The strategy identified the following as essential:

- a competent and appropriate transition team
- adequate funding
- communication and consultation as necessary with affected employees and management
- cooperation from unions and key stakeholders
- support from DOI, Public Transport Safety Victoria (PTSV), Independent Transport Safety and Reliability Regulator (ITS&RR) New South Wales and the V/Line Board
- an effective and well resourced transition implementation plan
- processes to plan and monitor the implementation plan
- processes and resources for follow up activities.

The plan also focussed on risk identification and treatment. Risk workshops involving V/Line, the former lessee, DOI and observed by the PTSV identified issues and actions. V/line integrated initial and ongoing risks from the takeover into its overall risk management.

The team reviewed and revised the plan regularly as the below-rail business was integrated into V/Line.

Safety accreditation

The public transport safety regulators in Victoria and New South Wales (NSW) had to accredit V/Line before it could take control of and operate the network. V/Line needed NSW accreditation because some of the network extends into southern NSW.

As V/Line held safety accreditation in Victoria for passenger rail services it applied to PTSV for variation of accreditation to cover its planned takeover. V/Line used the mutual recognition provisions between PTSV and the NSW ITS&RR and submitted a copy of the application to the PTSV to the ITS&RR. The application included V/Line's implementation plan.

V/Line gained accreditation in late April 2007. It was conditional on V/Line reporting regularly on the transition and other matters. V/Line met these conditions.

Handover of network control

The state signed the buy-back agreement on 13 April 2007. The agreement provided for the vendor to hand the network over to the state on a later date, subject to various conditions.

The agreement went final on 4 May 2007 when V/Line became the operator and access provider for the network. V/Line set up a regional network and access division to integrate the network into its business. In taking control of the network and below-rail business V/Line became responsible for:

- physical assets, including track, bridges, signaling, electrical and power supply, telecommunications, level crossings, maintenance facilities, spares inventory, major yards, and infrastructure maintenance machines and equipment
- key functions transferred from the vendor including information technology systems and hardware such as asset and rail access management systems
- train control functions including the train control centre, CENTROL
- infrastructure management functions including maintenance
- safety, security, environment and access functions associated with the network
- around 346 previous employees of the vendor involved in asset and access management for the network
- changing its safety management system to reflect its control over the network.

Ministerial directions under the *Rail Corporations Act 1996* formalised the transfer of the below-rail network to V/Line control. The directions required V/Line to make a number of agreements and contracts, including:

- *Asset Surrender and Sale Agreement*—providing for V/line to become the access provider of the network.
- *Network Access Agreement*—between V/Line and the vendor with V/Line to provide interim access to the vendor to run freight trains. This agreement is for 10 years at rates estimated to generate $15.3 million revenue in an average grain year.
- *Transitional Services Agreement*—between V/Line and the vendor, requiring both parties to provide mainly information technology services to each other for an agreed period.

- *Regional Infrastructure Lease*—replaced the PIL, with V/Line leasing land and rail infrastructure from the Director of Public Transport for 10 years starting on completion date of the Asset Surrender and Sale Agreement.
- *Major Periodic Maintenance Agreement*—between V/Line and the Director of Public Transport and requiring the Director to fund a maximum of $30 million in MPM projects over two years ending on 30 June 2008.

Conclusion

V/line managed the transfer of the network back to state control effectively. It developed and implemented a comprehensive risk based plan for the transition and there was minimal disruption to the day-to-day running of the network or to V/Line operations. It managed the transition within budget.

V/Line gained the required safety accreditation for managing the network by the deadline.

6.3 Ongoing management of the network

The state bought back the network to facilitate government transport objectives to increase the proportion of freight carried by rail, and to ensure an efficient, well maintained regional passenger network. The buy-back was also justified on the basis of other financial and non-financial benefits.

Achieving these benefits requires sound organisational and management arrangements and strategic investment in the network.

6.3.1 Organisational arrangements

In December 2006, the government endorsed V/Line as the agency responsible for the below-rail business in the interim only, and directed that a new body be set up to transfer the below-rail network from V/Line immediately after its safety accreditation.

The rationale for this approach included:

- V/Line's operation of the below-rail business long term could take its focus away from delivery of passenger rail services
- there was a potential conflict of interest in having a rail services operator also providing access to the network to third parties. Competitors might not perceive V/Line as an impartial and independent party
- The state saw a benefit in having an independent entity whose primary task was to maximise rail access revenue to run the business.

V/Line management said it considered V/Line was the appropriate entity to run the below-rail business and did not believe that other rail operators were concerned about V/Line's impartiality in its roles as access provider and access taker.

Nevertheless, the government directed that a new body be established under the *State Owned Enterprises Act 1992* to take over network management from V/Line after it gained safety accreditation. At the time there was seen to be benefit in setting up the new body quickly as delay would increase the risk that network management and operation would become strongly embedded within V/Line and more difficult and costly to transfer out.

The Department of Treasury and Finance (DTF) recommended establishing the new entity as a state body under the *State Owned Enterprises Act 1992*. The advantage of this was that an appropriate governance structure could scrutinise operations. The Treasurer and relevant minister would have joint responsibilities with the Treasurer as the ‘shareholding’ minister.

DTF further recommended that VicTrack, V/Line and the new entity should all be declared as state business corporations under the *State Owned Enterprises Act 1992*. They would then have to submit corporate plans for the Treasurer’s and relevant minister‘s approval. The Treasurer would oversee board appointments and the general direction of the entities.

In January 2007, VicTrack was declared as a state body under the *State Owned Enterprises Act 1992* which gave the Treasurer and the Minister for Public Transport shared governance roles. This was considered necessary to enable the eventual reallocation of VicTrack assets and activities of the below-rail business to the new state body. The main assets returning to the state, including the PIL, are VicTrack assets.

In September 2007 the Treasurer approved the postponement of the establishment of the new state body to operate and maintain the below-rail network and the declaration of V/Line as a state body under the *State Owned Enterprises Act 1992*.

To date the new state body has not been set up. In October 2008, V/Line was declared as a state body under the *State Owned Enterprises Act 1992,* which gave the Treasurer a shared governance role with the Minister for Public Transport. V/Line management advised it is unaware of any plans to divest V/Line of the below-rail business in the immediate future.

The government is currently reviewing the state entities in the rail industry.

Recommendation

6.1 That the 2006 decision to establish a state body under the *State Owned Enterprises Act 1992*, independent of VicTrack and V/Line, to operate the below-rail business for the intrastate rail network be revisited and actioned or set aside.

6.3.2 Rail freight network review

A possible review of the condition, maintenance and future demand for the freight network was raised during negotiations in 2006.

In October 2006 the government agreed to an independent review of the future of the freight network, saying that a review panel could make non-binding recommendations on future network expenditure.

The vendor agreed to the review on the basis that the state wanted to establish a long term sustainable freight network. The April 2007 final agreement included a clause requiring the government to conduct the review by 31 March 2008.

In June 2007, the government set up a committee to review the rail freight network. The committee brief was to:

- analyse the issues and identify opportunities for future development and improvement
- recommend options for future development

A DOI secretariat and a group comprising representatives from DOI, VicRoads, and VicTrack supported the committee. A stakeholder reference group was also set up comprising representatives from V/Line, the vendor, grain handlers, Victorian Farmers Federation, local government and the Victorian Freight and Logistics Council.

Review findings and conclusions

The committee reported to the government in December 2007 with *Switchpoint: The template for rail freight to revive and thrive*[1].

The main findings and conclusions were:

- The freight only network had been allowed to deteriorate over the last 15 years and was in extremely poor condition.
- Declining rail volumes, extended severe drought, increased efficiencies in the road sector, increases in track access charges and an accumulated backlog of track maintenance meant the freight rail system ran at low speeds with customers experiencing unacceptably low service levels on most of the network.
- The lack of investment in the freight only network was accelerating a switch to road with major environmental, social and economic consequences. Closure of the freight only network would result in at least 100 000 extra truck trips on regional roads each year with dramatic implications for road safety, the environment and economic efficiency.
- There was a pressing need to rehabilitate the track on nominated sections of the network to restore sustainable operating speeds. On some sections of the track speeds were restricted to only 20 kilometres per hour.

[1] The committee's full report is available from the Department of Transport website http://www.transport.vic.gov.au or in hard copy on request.

- The below-rail network was unviable and required on-going significant support. The condition of the below-rail network and associated infrastructure were basic to the viability of above rail operations, which had to be profitable to provide adequate rolling stock. Substantial rehabilitation of the track had to be accompanied by adequate rolling stock.
- Rail access charges were not competitive with the charges on the interstate network and were much higher than the southern NSW branch lines. In these circumstances, rail could not compete with road, which was partly subsidised. The high access charges were discouraging grain industry investment and had an adverse effect on rail operator viability. Reducing access charges would enable a sustainable and viable rail freight system if there were also a major track upgrade program and a collaborative and supportive institutional framework.
- The solution to Victoria's rail freight challenge required a total supply chain approach—the system was such that a weakness or inefficiency in any links of the chain would affect the viability of rail operations. The main components were track condition, access, rolling stock, regional and port rail terminal characteristics and the rail freight rate required to commercially sustain above rail operations and its competitiveness with road freight.
- The Victorian rail freight system had systemic inefficiency and as a result was uncompetitive—all issues had to be addressed in a holistic pro-active way to sustain the network.

Review recommendations

The committee recommended that the government provide a fit for purpose regional rail freight system at reasonable cost, capable of efficiently transporting known freight volumes at competitive prices, and allowing growth that was economically, socially and environmentally responsible.

Specific recommendations included:

- that network lines be prioritised and categorised to guide investment:
  - *Platinum (the base network)*—track that will be maintained as part of the V/Line passenger network, the interstate network or the declared Auslink network
  - *Gold*—first priority after the Platinum base network for upgrading and restoring to original track classification
  - *Silver*—high priority lines to be upgraded to original track classification, conditional on grain industry collaboration and commitment to improve supply chain efficiency to support rail
  - *Bronze*—minimum maintenance line sections not flagged for priority rehabilitation.
- a capital cost of $83.5 million and three years ongoing maintenance cost of $57.2 million for a total of $140.7 million. After the initial upgrade, the freight only network needs annual routine maintenance and major periodic maintenance worth $25 million annually after 2011

- the government immediately sets access fees competitive with the interstate network and Southern NSW for at least five years
- establish a Grain Logistics Taskforce to coordinate the grain supply chain and collaboration on grain handling and marketing
- a government entity to champion and develop rail freight business including collaboration between stakeholders and aggregation of smaller freight tasks to create viable freight tasks
- establish a Rail Freight Development fund to facilitate rail freight opportunities via (seed) capital contributions to rail freight facilities
- establish ongoing asset management to maintain the network at designated speeds after the capital upgrade, including routine and major periodic maintenance on tracks and bridges
- give higher priority to capacity for freight trains on the Melbourne metropolitan rail network by improving integration with metropolitan rail system planning.

Government's response to the review

The Minister for Transport said in December 2007 that the government would examine the report's issues and recommendations.

The government later announced funding and other initiatives:

- *Rail freight support package (February 2008)*—$20 million for the rail freight industry to keep container and export grain on the network. The package consists of a two year rebate for container freight on rail services from Warrnambool, Horsham, Mildura and Shepparton/Tocumwal.
- *Gold Line upgrades (April 2008)*—$43 million to upgrade six lines on the 'core grain' freight network. The review recommended these lines be upgraded to gold standard as a priority. The package consists of $23.7 million for the first stage of the six line upgrades and $19 million for general maintenance across the network.
- *Silver Line upgrades (October 2008)*—$38.7 million to upgrade four silver lines. The review recommended silver lines be upgraded pending a commitment from the grain industry to transport grain along these lines in the long term.
- *Portland to Maroona line (July 2008)*—this was identified as a gold line. The review recommended it for upgrade in 2010–2011. The government announced it would be upgraded as part of a new long term lease with the operator of the interstate network. As part of the agreement that lessee will upgrade the line with train speeds increased to 80 kilometres per hour.

Other government initiatives include:

- *Mildura line upgrade (May 2006)*—this will upgrade the 525 kilometre line between Mildura and Gheringhap (north of Geelong) allowing freight trains to run at a speed of 80 kilometres per hour. The project was announced as the first major step towards the re-introduction of passenger services on the line and is expected to cost $73 million. The Victorian and Commonwealth governments are jointly funding the project with $53 million and $20 million respectively.

- *North-East Rail Revitalisation project (May 2008)*—this project upgrades the passenger and rail freight link between Melbourne and Sydney and includes the construction of a five kilometre bypass around Wodonga, upgrade of 200 kilometres of broad gauge track to standard gauge between Seymour and Albury and rail upgrades between Melbourne and Seymour. It is a joint state and Commonwealth initiative with Victoria contributing $171.3 million and the Commonwealth $330 million. It is expected to be completed in 2010 with the operator of the interstate network to be responsible for the new north-east standard gauge rail line under a 45-year lease with Victoria.
- *Access charge subsidy*—the cost of maintaining Victoria's rail freight network would be subsidised by around 60 per cent with the subsidy to operate under new access charges approved by the Essential Services Commission in June 2008.

6.3.3 Funding decisions after the buy-back

Prior to the buy-back, both the lessee and the state acknowledged a maintenance backlog of over $200 million on the regional intrastate rail network. The government had funded the lessee directly from 2005–06 for major periodic maintenance.

After the buyback V/Line took responsibility for the network and sought subsidies from the government for both normal network operations and the maintenance backlog. V/Line's budget for 2008–09, as set out in its corporate business plan 2008–09 to 2010–11, shows that it will receive $98.2 million from the state for network operations and the below-rail business. This comprises a general subsidy of $19 million for the freight only network, $49.5 million for major periodic maintenance on the passenger network and $29.7 million for major periodic maintenance on the freight network.

Government decisions arising from the regional freight network review are reflected in V/Line funding for 2008–09.

The V/Line business plan indicates that the government funding commitment is not enough to sustain the network, with no funding provision for the maintenance backlog. On that basis, the maintenance deficit will keep increasing with implications for V/Line's ability to maintain line speeds and ride quality.

In its business plan, V/Line states that it asked for $180 million for major periodic maintenance (MPM) on the passenger and freight network in 2008–09, including $76.1 million for catch up works as part of a proposed program to eliminate the network maintenance backlog over four years. The business plan shows that the government approved:

- $49.5 million MPM for the passenger network—short of the $57.8 million needed to maintain the existing network condition

- $29.7 million MPM for the freight only network, which falls short of the $47 million identified to maintain the current network condition, even after allowing for the transfer of certain rail corridors to the operator of the interstate rail network
- no MPM freight funding for the freight network beyond 2008–09, creating uncertainty about the future parts of this network.

The business plan also notes that the industry is concerned at the lack of clarity in the government's long term commitment to the freight network.

There is a lack of data to show whether the new operator, V/Line, is maintaining the network and other operations more efficiently than the vendor and former lessee. This is relevant because the government expected the buy-back to produce savings from more efficient maintenance, outsourcing and lower operating costs.

V/Line has not outsourced network maintenance as it is uncertain about the future management of the network. However, it believes it has made savings in a number of network operations.

Recommendation

6.2 That the actual cost savings achieved compared to the business case be determined and a full accounting of the transaction, based on actual costs, be disclosed.

Auditor-General's reports

Reports tabled during 2008–09

Report title	Date tabled
Managing Complaints Against Ticket Inspectors (2008–09:1)	July 2008
Records Management Checklist: A Tool to Improve Records Management (2008–09:2)	July 2008
Investing Smarter in Public Sector ICT: Turning Principles into Practice (2008–09:3)	July 2008
Private Practice Arrangements in Health Services (2008–09:4)	October 2008
Working with Children Check (2008–09:5)	October 2008
CASES21 (2008–09:6)	October 2008
School Buildings: Planning, Maintenance and Renewal (2008–09:7)	November 2008
Managing Acute Patient Flows (2008–09:8)	November 2008
Biosecurity Incidents: Planning and Risk Management for Livestock Diseases (2008–09:9)	November 2008
Enforcement of Planning Permits (2008-09:10)	November 2008
Auditor-General's Report on the Annual Financial Report of the State of Victoria, 2007–08 (2008–09:11)	November 2008
Local Government: Results of the 2007–08 Audits (2008–09:12)	November 2008
Management of the Multi-Purpose Taxi Program (2008–09:13)	December 2008
Results of Audits for Entities with 30 June 2008 Balance Dates (2008–09:14)	December 2008
Preparedness to Respond to Terrorism Incidents: Essential services and critical infrastructure (2008–09:15)	January 2009
Literacy and Numeracy Achievement (2008–09:16)	February 2009
Administration of the *Flora and Fauna Guarantee Act 1988* (2008–09:17)	April 2009
Access to Public Hospitals: Measuring Performance (2008–09:18)	April 2009
Management of School Funds (2008–09:19)	May 2009
The New Royal Children's Hospital—a public private partnership (2008–09:20)	May 2009
The Channel Deepening Project (2008–09:21)	May 2009
Results of Audits for Entities with other than 30 June 2008 Balance Dates (2008–09:22)	May 2009
Governance and Fraud Control in Selected Adult Educational Agencies (2008–09:23)	June 2009
Withdrawal of Infringement Notices (2008–09:24)	June 2009
Claims Management by the Victorian WorkCover Authority (2008–09:25)	June 2009

Auditor-General’s reports

Reports tabled during 2008–09

Report title	Date tabled
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Implementing Victoria Police’s Code of Practice for the Investigation of Family Violence (2008–09:27)	June 2009
Effectiveness of Drought Assistance Measures (2008–09:28)	June 2009

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