

VICTORIA

Auditor-General
of Victoria

Report of the
AUDITOR-GENERAL
on the
STATEMENT OF
FINANCIAL OPERATIONS
1995-96

Ordered by the Legislative Assembly to be printed

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PART 1

Executive Summary



**VICTORIAN
AUDITOR-
GENERAL'S
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*Auditing in the
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Overview

My Report on the Government's Statement of Financial Operations for the year ended 30 June 1996 outlines the results of the annual audit of the Statement, including an analysis of the operating result achieved in the year and the State's liabilities and financial assets at year-end.

As indicated in Part 2 of this Report, a confirming audit opinion has been provided on the Statement of Financial Operations. However, as commented in my previous Reports to the Parliament over a number of years, adequate accountability to the Parliament over government financial operations will not be achieved until such time as audited information is presented on an accrual basis, covering the whole-of-government.

The Report highlights the positive impact of the Government's privatisation program on the level of the State's liabilities and on the operating result achieved for the financial year. In particular, the privatisation program has been the largest contributing factor to an unprecedented \$10 billion reduction in the level of the State's liabilities, which now stand at \$57.2 billion. In addition, the program has contributed to the achievement of a substantial budget sector surplus for the year. Specifically, the Consolidated Fund operating result for the year prior to abnormal items which cover the proceeds from privatisation, was \$1 billion which was consistent with that achieved in the previous financial year.

While the sale of State-owned assets will have a significant positive ongoing impact on the State's financial performance, in relation to a number of sales outlined in Part 4 of this Report, the State has provided various inducements and has accepted certain financial obligations which need to be taken into account when analysing the outcomes achieved from these sales.

A major challenge still faced by the Government is the achievement of its longer-term aim of bringing Victoria's overall revenue raising effort from taxation into closer alignment with the average of the other Australian States. In this regard, the Government recently announced that further consideration of planned tax relief has been deferred due to the adverse impact of the Commonwealth Government's deficit reduction program on the State's finances.

Finally, in my previous Reports to the Parliament, I have expressed concern on the use of confidentiality provisions in contractual arrangements, entered into between the Government and third parties, which adversely impact on the level of accountability to the Parliament and Victorian taxpayers. However, as indicated in Part 8 of this Report, in the case of the Grand Prix events, the Parliament has considered the confidentiality provisions included in the agreements with race promoters and has ratified these provisions through the passing of the *Australian Grands Prix Act 1994*.

Summary of major findings

FINANCIAL RESULT

Page 17

- An analysis of the Consolidated Fund result for the year indicated that the operating surplus prior to abnormal items which cover the proceeds from privatisation, was \$1 billion compared with \$930 million in the previous year.
Paras 3.1 to 3.12
- The achievement of improved financial results for the State has been brought about by the Government's budgetary and financial management reforms, and the improved economic conditions within the State.
Paras 3.10 to 3.12
- There is a need to continue to review and improve Public Account transaction classifications in order to enhance the transparency of the Statement of Financial Operations and its usefulness to the Parliament and the public.
Paras 3.13 to 3.14

ASSET SALES

Page 25

- The State's financial position has been strengthened as a result of the privatisation of government business enterprises, through the application of the sale proceeds towards the reduction of State debt.
Paras 4.1 to 4.4
- The net benefit to the State from the sale of the 5 electricity distribution companies and Yallourn Energy was approximately \$4.8 billion.
Paras 4.5 to 4.26
- The estimated total costs incurred by the State in relation to the sale of electricity undertakings were \$54 million.
Para. 4.21
- The sale of the distribution companies and Yallourn Energy will result in ongoing net savings of around \$425 million a year through reduced interest costs resulting from the repayment of debt, offset by revenue forgone from dividends and State taxes.
Paras 4.27 to 4.28
- The State has taken-on liabilities of \$175 million and various contingent liabilities associated with the sale of the electricity businesses.
Paras 4.29 to 4.42
- The net proceeds from the sale of port of Geelong assets were \$6.4 million less than the book value of the assets sold.
Paras 4.52 to 4.74
- The channel deepening project which is to cost the State in excess of \$20 million which will enable larger shipping vessels to utilise the facilities at the port at Geelong, will generate additional revenues for the new purchasers and, therefore, would have inflated the sale result achieved by the State.
Paras 4.71 to 4.74

ASSET SALES - *continued***Page 25**

- The assets at the port of Portland were sold for \$11 million less than their book value.
Paras 4.80 to 4.92
- While the purchaser of the assets at the port of Portland has assumed responsibility for the maintenance of the associated channel, this arrangement has had a positive impact on the sale result achieved by the State, given that the purchaser is not required to recoup the capital cost associated with the channel and therefore can reduce fees to attract greater levels of trade, or retain existing fees and generate greater profitability.
Paras 4.94 to 4.96
- The offer accepted by the Government for the sale of the World Trade Centre reflected a forced sale situation and the decision on whether to accept the offer or to retain ownership of the complex was dependent on the Government's philosophy of whether the property was regarded as a core asset.
Paras 4.97 to 4.112
- The net proceeds from the sale of the World Trade Centre were \$21 million below the book value of the Centre as at 30 June 1995.
Paras 4.113 to 4.123
- The relocation of Victoria Police and other public sector tenants to the World Trade Centre, which jointly occupy around 75 per cent of the available lettable office accommodation space which is leased for periods up to the year 2010, favourably impacted on the sale result achieved by the State.
Paras 4.107 to 4.111
- The sale of the World Trade Centre did not provide a net benefit to the State, after taking into account debt repayments (\$75 million), the costs of sale (\$1 million) and the cost of lease incentives (\$27 million).
Para. 4.123
- The settlement for the sale of the former Southern Cross site remained outstanding, with the balance of \$9.5 million yet to be paid by the purchaser and site re-development works temporarily suspended.
Paras 4.124 to 4.127
- Based on the latest available information, it is projected that the State will incur an overall negative cashflow of \$9.2 million from the sale of the Grain Elevators Board.
Paras 4.147 to 4.154

EXECUTIVE SUMMARY

ASSET SALES - *continued***Page 25**

- While the development of the Northcote bus depot was completed in June 1990 at a cost of \$12.5 million, the total proceeds from its sale only amounted to \$2.7 million.
Paras 4.180 to 4.187
- An analysis of the sale result in relation to Cathedral Place indicated that the total proceeds were \$6.8 million greater than a Valuer-General valuation of the property.
Paras 4.195 to 4.200

CONSOLIDATED FUND RECEIPTS**Page 73**

- The reliance of the Consolidated Fund on revenues derived from gambling activities has substantially increased, with revenue of \$1.1 billion generated from this source.
Paras 5.13 to 5.19
- The proportion of gambling fees and taxes to total State-sourced receipts (excluding privatisation proceeds) has increased from 7 per cent in 1991-92 to 11 per cent in the 1995-96 financial year.
Para. 5.19
- Consistent with the arrangements relating to the establishment of the additional casino gaming tables, during 1995-96, the Consolidated Fund received \$17 million which represents part of the additional annual licence fee. In addition, the State received from the Casino \$5.3 million compensation for the delay in the construction of the casino and \$1 million for tourism purposes.
Paras 5.21 to 5.30
- During the 1995-96 financial year, the Government entered into a new licensing arrangement with Tattersall's, which will generate minimum annual licence fees of \$35 million to the State.
Paras 5.31 to 5.42
- While the licence fees have been set to attempt to achieve equity between TABCORP and Tattersall's, in the event that gaming machine activity continues to grow, there is scope for both entities to generate significant profits in a market with limited competition.
Para. 5.42

CONSOLIDATED FUND PAYMENTS**Page 95**

- The impact of finance charges on the budget has declined in recent years, reflecting the favourable outcome of Government debt reduction and budget management strategies.
Paras 6.7 to 6.12
- The impact of the taxation rulings on the annuity and gold loan financing arrangements has been to increase the financing costs of both arrangements by up to \$154 million. However, the State may be liable for additional costs of up to \$183 million in terminating the gold loan arrangement, if the investor's claimed termination value for this arrangement is supported by legal proceedings.
Paras 6.13 to 6.17
- Under the terms of a March 1996 agreement between the State and the Melbourne City Council, a principal sum of \$100 million, including a \$50 million contribution in 1995-96 from the Consolidated Fund together with an equivalent contribution provided by the Melbourne City Council, is being held in a specific purpose trust account, for use on the Federation Square project.
Paras 6.23 to 6.26

ASSETS OF THE STATE**Page 107**

- The financial asset holdings of the public sector at 30 June 1996 stood at \$15.4 billion.
Paras 7.1 to 7.3
- Various initiatives have been introduced over recent years which have enhanced the management of the State's asset holdings and the financial performance of the public sector.
Paras 7.4 to 7.20
- While the implementation of accrual accounting in Departments will inevitably contribute to enhanced financial accountability for the budget sector, to fully realise the benefits available from its implementation, it will now be important that accrual based financial reporting becomes an integral financial management tool, for departmental financial monitoring and decision-making.
Paras 7.7 to 7.10

EXECUTIVE SUMMARY

LIABILITIES AND COMMITMENTS**Page 113**

- The liabilities of the State totalled \$57.2 billion at 30 June 1996, compared with \$67.3 billion in the previous year.
Paras 8.1 to 8.8
- The substantial reduction of \$10.1 billion in the level of State liabilities was mainly due to the privatisation of 5 electricity distribution companies and one electricity generation company, and the application of the resultant sale proceeds mainly towards the reduction of State debt.
Paras 8.4 to 8.5
- In June 1996, the Treasurer agreed to terminate a transport sale and lease-back arrangement at the end of the lease term. Costs associated with terminating this arrangement, which will be met by the State in 1996-97, will be around \$291 million.
Paras 8.18 to 8.25
- The arrangement entered into for the lease-back of police helicopters previously owned by the Government, in my opinion, constitutes a finance lease.
Paras 8.26 to 8.36
- The unfunded liabilities of public sector superannuation funds at 30 June 1996 totalled \$15.6 billion, representing an increase of \$506 million since the previous year.
Paras 8.49 to 8.56
- The Government has identified that, despite the superannuation reforms implemented to date, the unfunded liabilities will continue to grow in real terms over the next 5 years, due to the present financing of such liabilities on an *emerging cost basis* and the increasing age and length of service of remaining scheme members.
Paras 8.57 to 8.62
- Based on current expectations of future aluminium prices and inflation levels, the present value of the State's aggregate exposure under the flexible electricity tariff arrangements is estimated by the Department of Treasury and Finance to be \$1.6 billion at 30 June 1996.
Paras 8.72 to 8.76
- In May 1996, the Treasurer approved the commencement of negotiations for the purchase of the World Congress Centre, which would result in the termination of the associated financing arrangements as at February 1997, at an estimated cost of up to \$176 million.
Paras 8.82 to 8.87
- The arrangements associated with the new prison facilities have been structured by the Government with the aim of transferring certain of the risks associated with the construction, ownership and operation of the facilities to the private sector.
Paras 8.88 to 8.106

- Under the arrangements associated with the new prisons, the State is obligated to provide *start-up funding* of up to \$7 million to the private sector companies responsible for the commissioning of 2 of the prisons, for initial working capital purposes.
Paras 8.97 to 8.98
- To ensure the effective recording, reporting and management of the State's contingent liabilities, it is critical that prompt action is taken to complete the implementation of various previously established initiatives.
Paras 8.107 to 8.115
- The operating costs incurred by the State, determined on an accrual basis, from the inception of the Formula One Grand Prix project to 30 June 1996 totalled \$11.7 million, of which \$6.2 million related to the 1995-96 financial year.
Paras 8.121 to 8.123
- While the Formula One event to 30 June 1996 has resulted in a net cost to the State, the event has facilitated the provision of improved public infrastructure, including roadworks, and improvements to parklands and transport facilities.
Para. 8.124
- In relation to future Formula One Grand Prix events, the Corporation's objective is to achieve a self-funding position.
Para. 8.125
- The Corporation's financial statements include the fees paid associated with holding the Formula One Grand Prix. However, consistent with the relevant legislation, these payments have been included but were not separately disclosed in their financial statements.
Paras 8.134 to 8.136
- Expenditure incurred by the Melbourne City Link Authority during the 1994-95 and 1995-96 financial years in relation to the City Link project amounted to \$56 million, with capital expenditure still to be incurred by the State totalling \$218 million.
Paras 8.155 to 8.158
- The maximum total Petroleum Rent Resource Tax (PRRT) exposure in nominal dollar terms has been estimated at around \$3 billion (net present value of \$1.9 billion) under the existing gas supply agreements which are expected to conclude in the year 2008, excluding any interest that may be payable on outstanding amounts.
Paras 8.159 to 8.167
- If ESSO and BHP are successful in passing-on the PRRT cost, the above substantial exposure ultimately will be met by Victorian taxpayers.
Paras 8.165 to 8.167

PART 2

Audit Opinion on Statement



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AUDIT OPINION ON STATEMENT

Financial accountability framework

2.1 The key element of the accountability framework relating to the State's finances is the requirement, under the *Financial Management Act* 1994, for the Government to annually present to the Parliament a Statement of Financial Operations. In broad terms, this Statement is required to provide a summary of the transactions and balances of the Public Account, comprising the Consolidated Fund and the Trust Fund, and the liabilities (including contingent liabilities) and prescribed assets of the State.

2.2 Under the current accountability framework, the Consolidated Fund is the Government's main operating account and records the collection of all departmental revenues such as State taxes, Commonwealth grants and asset sale proceeds. Fundamental to the framework is the principle that only the Parliament can authorise expenditure from the Consolidated Fund. Accordingly, Appropriation Acts, which provide the key means by which parliamentary control is exercised over public finances, are prepared annually by the Government and sanctioned by the Parliament.

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

2.4 In accordance with the *Financial Management Act* 1994, the Statement of Financial Operations must be audited by the Auditor-General and presented to the Parliament each year, together with a Report of the Auditor-General on that Statement. The *Audit Act* 1994 outlines the powers of the Auditor-General in conducting this and other audits in the public sector.

2.5 **This Report presents detailed comment on the information contained in the Statement of Financial Operations to assist the Parliament in its analysis of the Statement. However, as commented in my Reports over a number of years, adequate accountability to the Parliament over government financial operations will not be achieved until audited information is presented on an accrual basis, covering the whole-of-government.**

2.6 As a first step towards the production of annual whole-of-government financial reports, in June 1996 the Government publicly released an unaudited trial consolidated financial report covering the financial operations and financial position of the State for the year ended 30 June 1995. It is the Government's intention to consider publishing audited consolidated financial statements for the State for the 1996-97 financial year if the statements prepared comply with appropriate accounting standards. These are welcomed developments which will undoubtedly contribute towards the enhanced financial management of the State's resources and the accountability of the Executive to the Parliament and the community.

Audit opinion on the Statement of Financial Operations

2.7 The Statement of Financial Operations for the year ended 30 June 1996 has been audited in accordance with the requirements of the *Financial Management Act* 1994. The audit has been undertaken in accordance with Australian Auditing Standards, using methodologies consistent with those applied by the accounting profession. My opinion on the Government's 1995-96 Statement of Financial Operations is as follows:

AUDIT OPINION ON STATEMENT

Audit Scope

The accompanying Statement of Financial Operations for the year ended 30 June 1996, comprising the financial statements and relevant notes contained in Parts A and B of the Statement, has been audited. The Secretary to the Department of Treasury and Finance is responsible for the preparation and presentation of the Statement and the information it contains. An independent audit of the Statement has been carried out in order to express an opinion on it as required by the *Financial Management Act 1994*.

The audit has been conducted in accordance with Australian Auditing Standards to provide reasonable assurance as to whether the financial statements are free of material misstatement. The audit procedures included an examination, on a test basis, of evidence supporting the amounts and other disclosures in the financial statements, and the evaluation of accounting policies and significant accounting estimates. These procedures have been undertaken to form an opinion as to whether, in all material respects, the financial statements are presented fairly in accordance with the *Financial Management Act 1994* and comply with the requirements of that Act.

The audit opinion expressed on the Statement of Financial Operations has been formed on the above basis.

The explanatory notes provided on pages 2 to 22 and the supplementary material contained in Part C of the Statement are included for information purposes only and accordingly, an audit opinion is not expressed thereon.

Audit Opinion

In my opinion, the financial statements present fairly the financial transactions of the Public Account and the liabilities and financial assets of the State for the year ended 30 June 1996, in accordance with the *Financial Management Act 1994*.

Reconciliation of the Public Ledger

2.8 The public ledger is the Government's central record of Public Account transactions and balances which is maintained by the Department of Treasury and Finance, and is the basis used to prepare Part A of the Statement of Financial Operations. To ensure the integrity of the public ledger, it is reconciled on a monthly basis to the ledgers maintained by individual departments. This process involves the reconciliation of approximately 20 000 departmental accounts to around 630 consolidated public ledger accounts, involving receipts and payments of around \$55 billion respectively.

2.9 Substantial difficulties were experienced in the reconciliation of the public ledger to the departmental ledger relating to the Department of Treasury and Finance as at 30 June 1996, with the reconciliation incomplete for more than 6 months.

2.10 The reconciliation process as at 30 June 1996 resulted in a variance of \$975 000 between the public ledger and the departmental ledger. The Department identified a number of reasons contributing to the difficulties encountered in reconciling these ledgers, including:

- a new public ledger system was not fully implemented in October 1995 as previously planned;
- the new and old ledger systems were both maintained during the year, which contributed to an additional workload in tracking transactions within the systems;

AUDIT OPINION ON STATEMENT

- an inadequate audit trail existed between the departmental ledger and the new public ledger system; and
- some transactions were directly posted into the public ledger and not recorded in the departmental ledger.

2.11 Following extensive attempts to reconcile the 2 ledgers, in order to agree these ledgers, the Department of Treasury and Finance updated its departmental ledger by processing a balancing entry to the value of \$975 000, without reconciling the individual differences between the 2 ledger systems. The Department has taken action to ensure that these difficulties are not encountered in future.

Auditor-General's Report on the Statement of Financial Operations

2.12 As mentioned earlier, the Statement of Financial Operations broadly discloses the financial transactions of the Public Account and the liabilities and prescribed assets of the State.

2.13 To assist in the analysis and assessment of the Statement, this Report to the Parliament is presented in a format consistent with that adopted for the Statement. The Report comments on:

- Financial result;
- Asset sales;
- Consolidated Fund receipts;
- Consolidated Fund payments;
- Assets of the State;
- Liabilities and commitments; and
- Other matters.

PART 3

Financial Result



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FINANCIAL RESULT

Financial result for the year

3.1 The Statement of Financial Operations discloses that **the overall Consolidated Fund result for the 1995-96 financial year, not including receipts from borrowings, was a surplus of \$380 million, which was \$913 million better than budget expectations.**

3.2 However, the result for the budget sector when calculated under the *national accounting format* was a surplus of \$5.2 billion. While the Statement of Financial Operations discloses the overall Consolidated Fund result, the *national accounting format* takes into account not only the transactions of the Consolidated Fund, but also the transactions relating to the Trust Fund and those public bodies subject to substantial central budgetary control. Also, under the *national accounting format*, budget sector outlays do not include certain Consolidated Fund financing transactions such as debt repayments.

3.3 The difference of \$4.8 billion between the Consolidated Fund and *national accounting* reporting format results largely relates to borrowing repayments. Table 3A presents a summary of the key differences between these results for the year.

TABLE 3A
RECONCILIATION OF 1995-96 CONSOLIDATED FUND
SURPLUS WITH THE REPORTED RESULT UNDER
THE NATIONAL ACCOUNTING FORMAT
(\$million)

<i>Item</i>	<i>Amount</i>
Budget sector surplus (national accounting format)	5 174
Less -	
Appropriations for repayment of borrowings -	
Treasury Corporation of Victoria managed debt	4 691
Public Transport Corporation leases	18
Computer lease facility	4
	(a)4 713
Borrowing repayments outside the Consolidated Fund	9
National Rail Corporation share purchase	12
Federation Square project deposit	50
Net effect of other items (mainly changes in cash, investments and other items)	(10)
Total reconciling items	4 794
Consolidated Fund surplus	380

(a) Does not include a \$48 million payment to purchase bonds previously issued to finance projects undertaken under the Accelerated Infrastructure Program (refer to Part 8 of this Report for further comment on this matter).

Key factors impacting on result

3.4 As a result of the Government's privatisation program, during the 1995-96 financial year, the Consolidated Fund received proceeds of \$4.8 billion from the sale of a number of State-owned business enterprises, which were subsequently applied in the main towards the reduction of budget sector debt. These sale proceeds were the most significant factor positively impacting on the budget sector's result for the year.

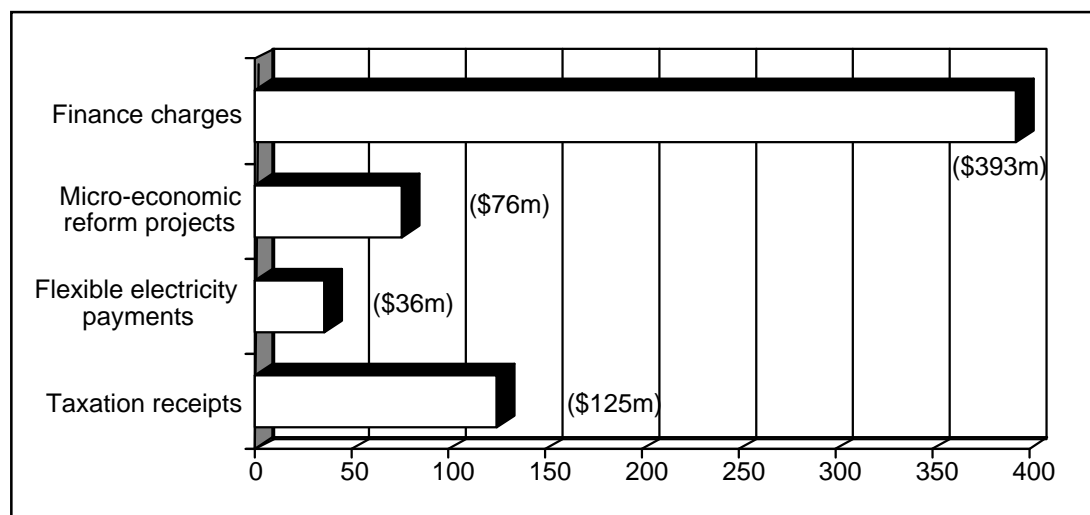
FINANCIAL RESULT

3.5 In addition, the favourable Consolidated Fund result for the year as compared with budget was achieved mainly due to:

- Expenditure savings achieved by departments, particularly within the recurrent sector. The key items contributing to these savings included financing charges, micro-economic reform project costs and payments under the flexible electricity tariff arrangements; and
- Receipts from taxation sources being higher than expected.

3.6 Chart 3B shows the contribution of the above items to the year's Consolidated Fund result.

CHART 3B
MAJOR ITEMS CONTRIBUTING TO FAVOURABLE BUDGET RESULT, 1995-96
(\$million)



Re-statement of Consolidated Fund result by audit

3.7 As commented in my previous Reports to the Parliament on the Statement of Financial Operations, while the Statement of Financial Operations classifies Consolidated Fund transactions between the recurrent and works and services sectors consistent with parliamentary appropriations, under this classification basis, the recurrent sector includes a number of capital items, such as borrowing repayments, and conversely the works and services sector includes certain operating costs. The absence of a clear differentiation between operating and capital items inhibits the ability of users of the Statement of Financial Operations to ascertain and assess the Consolidated Fund's operating result for the year.

3.8 Some progress has been made in recent years by the Department of Treasury and Finance to enhance the classification of Public Account transactions, resulting in the re-classification of significant items particularly relating to repairs and maintenance costs. However, there still remains a need for continuing action by the Department to satisfactorily address this matter.

FINANCIAL RESULT

3.9 Table 3C presents the Consolidated Fund result for the year, segmented according to operating and capital transactions. The table also highlights major transactions that are not of an ongoing nature, which are known in accounting terms as "abnormal items".

TABLE 3C
AUDIT RE-STATEMENT OF
CONSOLIDATED FUND RESULT FOR YEAR (a)
(\$million)

<i>Item</i>	1995-96	1994-95
<i>Operating transactions -</i>		
Receipts	14 985	14 471
Payments	13 939	13 541
Operating surplus prior to abnormal items	1 046	930
Add - Abnormal items (b)	4 594	235
Operating surplus for the year	5 640	1 165
<i>Capital transactions (excluding borrowing transactions) -</i>		
Receipts	934	1 004
Payments	1 479	1 543
Capital deficit prior to abnormal items	(545)	(539)
Add/(Less) - Abnormal items (c)	46	(206)
Capital deficit for year (excluding borrowing transactions)	(499)	(745)
Consolidated Fund surplus prior to borrowing transactions	5 141	420
Borrowing repayments	(4761)	(1 331)
Overall Consolidated Fund surplus / (deficit funded from borrowings) for year	380	(911)
Less - Reconciling items (refer to Table 3A of this Report)	4 794	1 126
Budget sector surplus (national accounting format)	5 174	215

(a) Table 3E provides a summary of inappropriately classified receipts and payments, as identified by audit.

(b) Abnormal items of an operating nature include the receipt of \$4.8 billion representing part of the profit on the sale of State-owned business enterprises (\$656 million, 1994-95), employee departure program payments of \$89 million (1994-95, \$293 million), the reversal of a prior year expenditure deferral arrangement of \$33 million (1994-95, \$40 million) and a once-off payment of \$64 million to the purchaser of one of the privatised electricity businesses (United Energy) under the sale agreement, which was funded from sale proceeds. (In 1994-95 there was a once-off payment of \$88 million to the State Superannuation Fund under revised funding arrangements established in that year.)

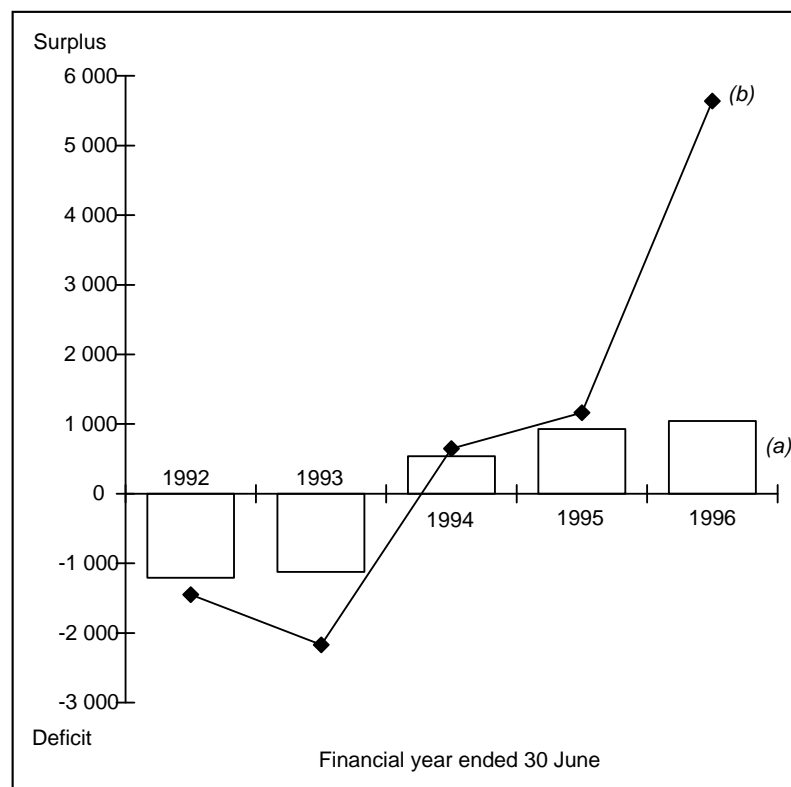
(c) Abnormal items of a capital nature comprise the receipt from Crown Casino of \$46 million (1994-95, \$26 million) for the right to operate the new casino. (In 1994-95 there was a once-off payment of deferred employer superannuation contributions of \$232 million.)

FINANCIAL RESULT

3.10 An analysis of the restated result indicates that the operating surplus for the year prior to abnormal items was \$1 billion, compared with \$930 million in 1994-95. The improved operating result in the year was due to increased recurrent grants from the Commonwealth Government, higher taxation receipts due to improved economic conditions, increased revenues from electronic gaming machines due to their progressive installation and increased turnover, reduced finance charges due to lower interest rates and reduced debt levels, and general expenditure restraint by departments. However, the year's overall operating result was influenced by a number of abnormal items, including receipts of \$4.8 billion from the sale of State-owned business enterprises, expenditure of \$89 million on employee departure programs, a once-off payment of \$64 million to the purchaser of one of the privatised electricity businesses under the sale agreement, and payments of \$33 million relating to the reversal of a prior year expenditure deferral arrangement.

3.11 The strong operating performance achieved by the Government in the period continues the positive trend established over recent years. The achievement of a strengthened financial position for the State has been brought about by the Government's budgetary and financial management reforms, and the improved economic conditions within the State. Chart 3D illustrates the improvement in the Consolidated Fund operating result over the past 5 years.

CHART 3D
CONSOLIDATED FUND OPERATING RESULT,
1991-92 TO 1995-96
 (\$million)



(a) Consolidated Fund operating result prior to abnormal items.

(b) Consolidated Fund result after taking into account abnormal items.

FINANCIAL RESULT

3.12 The capital sector result prior to debt repayment transactions and abnormal items was a deficit of \$545 million, which was consistent with the result achieved in 1994-95. However, the overall result for the capital sector in 1995-96 was also influenced by a number of abnormal transactions relating to the receipt of a \$46 million premium for the right to operate the new casino.

Re-classified transactions

3.13 In Table 3C, audit has presented a re-statement of the Consolidated Fund result, which differentiates between operating and capital transactions. Table 3E below details those transactions which have been re-classified by audit.

TABLE 3E
RE-CLASSIFIED CONSOLIDATED FUND
TRANSACTIONS, 1995-96
((\$million))

<i>Item</i>	<i>Amount</i>
Receipts	
Operating receipts classified as works and services - Portion of privatisation proceeds in excess of book value of assets sold	3 660
Capital receipts classified as recurrent - Casino premium payment	(17)
Re-classified receipts	3 643
Payments	
Operating payments classified as works and services - Employee departure programs	89
Repairs and maintenance	9
Housing programs	134
	232
Less - Capital payments classified as recurrent - Repayment of borrowings (principal)	73
Re-classified payments (net)	159

3.14 Consistent with my comments of prior years, the Department of Treasury and Finance needs to continue to review and improve Public Account transaction classifications to enhance the transparency of the Statement and its usefulness to the Parliament and the public to enable a more informed assessment of the year's financial outcomes.

*FINANCIAL RESULT***Elimination of prior-year expenditure deferrals**

3.15 In 1992-93, the Government commenced action to eliminate certain expenditure deferral arrangements established in prior years, which transferred to future periods the financing of significant obligations. As commented in my previous Reports to the Parliament, expenditure deferrals totalling around \$700 million were reversed by the Government in the period July 1992 to June 1995.

3.16 In the 1995-96 financial year, action was taken to reverse a further expenditure deferral arrangement established in 1990-91 in relation to payments made to private bus operators. Prior to the introduction of the deferral arrangement, payments to private bus operators were made quarterly by the former Department of Transport. However, during 1990-91, the previous Government entered into an arrangement with an overseas lending institution to fund these payments to the individual bus operators through a shelf company known as Warana Valley Pty Ltd, established by the Bus Proprietors Association. Under the established arrangements, the lending institution was later reimbursed by the Department at the end of each quarter for funds paid by the company during the period.

3.17 In May 1996, the Treasurer approved the termination of this deferral arrangement, resulting in a payment of \$33 million in the 1995-96 financial year that was not budgeted. As from the 1996-97 financial year, the Department of Infrastructure is making payments on a monthly basis directly to the private bus operators.

PART 4

Asset Sales



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*Auditing in the
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GOVERNMENT ASSET SALES PROGRAM

4.1 In recent years, a major component of the Government's public sector reform program has been the privatisation of government business enterprises with a key stated objective of improving the efficiency of the major service industries in order to reduce business costs and enhance the productivity of the Victorian economy. The application of privatisation proceeds towards the reduction of State debt has also been an important means of strengthening the State's financial position.

4.2 In addition, to enhance the operational efficiency and effectiveness of the budget sector, the Government since 1987-88 has operated an asset sales program involving the disposal of surplus and underutilised properties.

4.3 This part of the Report outlines the major business and property sales undertaken or completed by the Government during the 1995-96 financial year, and up to the date of preparation of this Report. The sales covered in this Report include:

Business sales

- Electricity businesses;
- Port-related businesses, including the World Trade Centre;
- Utilities Insurance Company Pty Ltd;
- BASS joint venture;
- Grain Elevators Board;
- GFE Resources Ltd; and
- Statewide Mobile Radio Network and Vistel.

Property and equipment sales

- Northcote bus depot;
- Southern Cross Hotel site;
- Bundoora/Mont Park precinct properties;
- Cathedral Place; and
- Educational properties.

4.4 The proceeds paid into the Consolidated Fund during the 1995-96 financial year from both business and property assets are shown in Part 5 of this Report.

ASSET SALES

Electricity businesses

4.5 My May 1996 *Report on Ministerial Portfolios* provided detailed comment on the Government's electricity industry privatisation program, including the results achieved by the State from the sale of 5 electricity distribution businesses during the 1995-96 financial year and the key residual financial obligations of the State resulting from these sales.

4.6 That Report highlighted that, while a financial analysis of the sale results was undertaken by audit, it did not extend to an examination of the extent to which the Government's economic policy objectives were achieved. In particular, the long-term nature of government reforms may prevent audit in the short-term from forming firm conclusions on this issue, given that the success or otherwise of privatisation will not in many cases be fully known for many years.

4.7 Subsequent to preparation of my May 1996 Report to the Parliament, the Government announced the sale of a further electricity business, namely, the generation company Yallourn Energy Ltd. In this Report, I have provided a comprehensive analysis of this sale, together with details of the overall results achieved by the State from the electricity privatisation program during the 1995-96 financial year.

4.8 In August 1996, the Government announced a further sale of an electricity generation business, namely, Hazelwood Power Corporation Ltd and Energy Brix Australia Ltd. The results of these later sales will be analysed by audit and reported in a subsequent Report to Parliament.

Yallourn Energy Ltd

4.9 As part of the current Government's electricity industry reform program, in October 1994, all power stations that were operated by the State Electricity Commission of Victoria (SECV) were transferred to Generation Victoria. This business was further disaggregated in January 1995 through the formation of 4 new companies, namely, Yallourn Energy Ltd, Hazelwood Power Corporation Ltd, Loy Yang Power Ltd and Southern Hydro Ltd. The State's two gas-fired power stations, Newport and Jeeralang, were retained by Generation Victoria.

4.10 Within the above framework, Yallourn Energy's core functions include the operation of the Yallourn W 1 450 megawatt brown coal fired thermal power station and the associated coal mine which supplies brown coal to the power station. The power station and mine are located east of Moe in the Latrobe Valley, approximately 140 kilometres east of Melbourne.

4.11 The power generated by Yallourn Energy represented around 25 per cent of the Victorian wholesale electricity market in the year ended 30 June 1995, with the company bidding with other generators to sell the power station's electricity output into the wholesale electricity market. While this market is currently predominantly State-based, in future it is planned to develop into a national market.

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4.12 The company has entered into hedging contracts with the 5 distribution businesses for the supply of electricity to their franchise customers, which effectively regulate the price of wholesale electricity to these customers until the year 2000. These hedging contracts are estimated to cover 72 per cent of the company's available output in the 1996-97 financial year. While the contracts provide stability in the medium-term for a high proportion of the company's income, it is anticipated that their coverage will be progressively eliminated by the year 2001 when all customers will be contestable and retail electricity pricing deregulated.

4.13 Although the power station has operated for over 20 years, the future profitability of the company is expected to be strong as it has a low variable cost structure which is likely to make it highly competitive in the Victorian wholesale market.



Yallourn power station.

Sale process

4.14 An information memorandum for the sale of Yallourn Energy was distributed in October 1995 to all parties that had previously expressed an interest in the acquisition of the company. Subsequently, the Government in December 1995 received 7 indicative bids for the acquisition of the company and a short-listing process was completed. To assist in enhancing the quality of final bids, a list of parties that lodged expressions of interest to acquire the business was made available to those short-listed bidders that intended to form a consortium.

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4.15 Following the completion of due-diligence inquiries by bidders, in early March 1996, two firm offers were received. These offers were subsequently evaluated by representatives from the Department of Treasury and Finance, and the Department's financial, accounting and legal advisors, against the key evaluation criteria which related to bid price, certainty of completion of sale arrangements and the impact of any proposed special conditions of sale.

4.16 Based on the results of the evaluation process, it was determined that neither bid was suitable for acceptance in its existing form due to certain conditions which were attached to the proposed financing packages. However, following the submission of revised offers by the 2 parties and a re-evaluation process, the Government in March 1996 selected the PowerGen consortium as the successful purchaser of Yallourn Energy. The consortium comprised:

- *PowerGen plc*, a British company which operates 5 coal-fired power stations in England (49.9 per cent interest);
- *ITOCHU Corporation*, a Japanese investment company (10.4 per cent interest);
- *AMP Investments Australia Limited*, an Australian-based investment company (26 per cent interest). This company had also previously acquired a 41 per cent interest in the distribution business, United Energy Ltd;
- *State Authorities Superannuation Board of New South Wales*, a public sector superannuation fund (8 per cent interest). This Fund had also previously acquired a 9 per cent interest in the distribution business, United Energy Ltd; and
- *Hastings Funds Management Pty Ltd*, an Australian-based fund management company (5.7 per cent interest).

4.17 A private sector accounting firm appointed to perform the responsibilities of process auditor for the sale of the company, in its July 1996 Report concluded that all bidders were accorded fair and equitable treatment and that tenders were evaluated and ranked fairly against the agreed selection criteria.

Results of sale of electricity businesses

4.18 Under the arrangements established for the sale of Yallourn Energy, the State received total proceeds of \$2.4 billion, comprising amounts relating to:

- sale of the State's interest in the net assets of the businesses (\$1.6 billion);
- repayment by the purchaser of outstanding business debt owed to the Treasury Corporation of Victoria (\$575 million);
- dividends payable in relation to company profits earned up to 30 June 1995 (\$11 million); and
- stamp duty payable on sale transactions (\$269 million).

4.19 This outcome brings to \$11.4 billion the total proceeds received by the State during 1995-96 from the sale of electricity businesses. Table 4A outlines the key components of these proceeds.

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TABLE 4A
COMPOSITION OF ELECTRICITY BUSINESS
SALE PROCEEDS, 1995-96
(\$million)

<i>Details</i>	<i>Yallourn Energy</i>	<i>Distribution businesses</i>	Total
Proceeds in excess of book value	726	4 659	5 385
Proceeds equal to the SECV's interest in the book value of the businesses	847	1 553	2 400
	1 573	6 212	7 785
Repayment by purchaser of outstanding debt of the businesses	575	2 058	2 633
Dividends owed to the State	11	73	84
Stamp duty on sale transactions	(a) 269	30	299
Franchise fees receivable (net present value)	-	632	632
Total proceeds	2 428	9 005	11 433

(a) As a result of the different structuring of the Yallourn Energy sale as compared with the distribution business sales, a higher level of stamp duty revenue was payable to the State.

4.20 The above table shows that the State received \$7.8 billion for the sale of the net assets of the electricity companies, which at the effective date of sale had a book value of \$2.4 billion. In effect, this resulted in the State obtaining \$5.4 billion more than the book value of the businesses.

4.21 However, of the \$5.4 billion received in excess of the businesses' book value, \$531 million was paid to municipal councils in relation to the electricity undertakings' net assets previously transferred to the distribution businesses. In addition, **the Department of Treasury and Finance estimates that total costs of \$54 million were incurred by the State in relation to the sale of electricity undertakings**, including \$46 million directly attributable to individual business sales and \$8 million of indirect costs relating to electricity privatisation. Accordingly, **the net benefit to the State from the sale of the 5 distribution companies and Yallourn Energy is approximately \$4.8 billion.**

4.22 Under the sale arrangements for all electricity companies except Powercor, the sale proceeds may be adjusted in respect of the final value of net assets sold, which is to be determined following the finalisation of the balance sheet reviews undertaken subsequent to the sales. At the date of preparation of this Report, the completion process in respect of United Energy and Solaris had been finalised, with no net adjustments required to the sale price. However, in relation to Solaris, as part of the adjustment process, the State provided an indemnity to the purchaser which is effective until January 1997, covering costs of up to \$1.1 million that may be incurred in relation to certain disputed transactions with other electricity companies undertaken prior to the date of sale. The completion process in relation to the other privatised companies was still in progress at the date of preparation of this Report.

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Application of sale proceeds

4.23 The audit review identified that the total proceeds of \$10.8 billion received by the State, not including franchise fees receivable in future years, were mainly applied towards State debt reduction (\$9.9 billion) and the financing of payments to municipal councils (\$531 million), with the balance (\$307 million) retained by the SECV. Table 4B illustrates the application of the sale proceeds.

TABLE 4B
APPLICATION OF SALE PROCEEDS
(\$billion)

<i>Details</i>			<i>Amount</i>
Retirement of State debt -			
Budget sector debt	(a) 4.7		
SECV debt	2.6		
Electricity business borrowings	2.6		9.9
Payments to municipal councils			0.5
Costs of sales			(b) 0.1
Retention by SECV			0.3
Total sale proceeds			(c) 10.8

(a) Of this amount, \$3.6 billion was initially received by the SECV, with the balance of \$1.1 billion received by the Consolidated Fund.

(b) Includes a payment of \$64 million to the purchaser of United Energy under an indemnity provided by the State within the sale agreement, representing a refund of State equivalent tax paid by the company to the State subsequent to the effective date of sale.

(c) In addition to the \$10.8 billion received from the sales, the State is entitled to receive franchise fees from the purchasers of the distribution businesses over the next 5 years with an estimated present value at the time of sales of \$632 million.

Adequacy of results

4.24 As outlined in my May 1996 Report on Ministerial Portfolios, the Government obtained external valuations of the businesses based on the float and trade sale options, prior to their sale, to ensure that reasonable returns were achieved by the State from the sale of the companies.

4.25 In relation to the distribution businesses, based on the most recent valuations for the individual companies prior to their sale, the proceeds of \$6.2 billion received by the State from the sale of the business net assets compared favourably with the external valuations obtained by the Government of \$3.9 billion, resulting in \$2.3 billion being received in excess of the valuations. In the case of Yallourn Energy, the proceeds of \$1.6 billion received from the sale of its net assets, together with stamp duty of \$269 million received by the State from the sale transactions, compared favourably with a May 1995 valuation of the business of \$1 billion, based on discounted cash flows and the valuation of comparable companies and acquisitions.

4.26 Table 4C details the sale result achieved by the State in relation to Yallourn Energy, on the basis of earnings multiples, with the result achieved from the sale of the distribution businesses.

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TABLE 4C
SALE PROCEEDS AND EARNINGS MULTIPLES
ACHIEVED FROM THE SALES (a)

Company	Sale proceeds (b)	Price to earnings multiples				
		1994-95	1995-96	1996-97	1997-98	Average
	(\$m)					
Yallourn Energy (c)	2 148	13.8	14.3	13.6	11.3	13.2
Distribution businesses (c)	8 270	15.9	15.0	12.8	14.9	14.6

(a) The earnings multiples are based on projected earnings before interest and tax as per the Information Memorandum for each company (in nominal dollars).

(b) Represents proceeds for the sale of the net assets of the businesses and the repayment of debt.

(c) The earnings ratios achieved from the sale of Yallourn Energy and the distribution businesses are not comparable, given that these businesses operate under different markets.

What will be the ongoing impact of the sales on State finances?

4.27 In my May 1996 Report on Ministerial Portfolios, an audit analysis highlighted the impact of the distribution business privatisations on the State's finances over a 3 year period, in terms of the net interest savings to be achieved from the repayment of State debt resulting from the sales, after taking into account revenue forgone in the form of dividends and State equivalent taxes. This analysis is updated in Table 4D, to take account of the impact of the sale of Yallourn Energy.

TABLE 4D
PROJECTED NET SAVINGS FROM PRIVATISATION
OF ELECTRICITY BUSINESSES
(\$million)

Details	1995-96	1996-97	1997-98
Revenue forgone -			
Dividends (a)	141	213	278
State equivalent tax (b)	-	11	43
	141	224	321
Less income entitlement payments to municipal councils	(25)	(26)	(28)
	116	198	293
Interest savings (c) -			
Budget sector debt	91	413	412
SECV debt	140	258	258
	231	671	670
Net savings	115	473	377

(a) Based on revenue projections contained in the Information Memorandums issued by the Government in relation to the sales and an estimate relating to United Energy Limited for 1997-98.

(b) Provided by the Department of Treasury and Finance based on a "no privatisation" assumption.

(c) Based on estimates of interest savings provided by the Department of Treasury and Finance, and the Treasury Corporation of Victoria. These estimates do not include interest savings relating to distribution businesses' debt owed to the Treasury Corporation of Victoria as the impact is already taken into account in arriving at the businesses' profits upon which dividends are based.

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4.28 Based on established projections, the sale of the distribution companies and Yallourn Energy will result in a positive cashflow to the State over future years, given that the projected interest savings from the repayment of public sector debt will more than offset the revenue forgone from dividends and State equivalent taxes. **This ongoing net saving is estimated to be around \$425 million a year. In addition, the substantial reduction in State debt may positively impact on the State's credit rating which may result in a further reduction in interest rates payable on State debt.**

Remaining obligations of the State

4.29 While substantial financial benefits have accrued to the State from the electricity industry privatisation program, under the sale arrangements, the State has provided certain indemnities and warranties to the purchasers, and has retained certain financial obligations.

General indemnities and warranties

4.30 The State has provided a number of general warranties and indemnities to purchasers of the various businesses which, in relation to Yallourn Energy, United Energy, Eastern Energy and Powercor, gave rise to an aggregate maximum exposure to the State of \$200 million in the event that purchasers lodge claims within 12 months from the date of the relevant sale. In relation to Solaris, the State's maximum financial exposure under indemnities and warranties provided has not been specified or limited as no substantial undertakings were provided by the State in this sale agreement and, in relation to United Energy, the 12 month period has expired with no claims lodged against the \$40 million indemnity provided by the State.

4.31 In addition, the State has indemnified certain purchasers against a requirement to pay State equivalent taxation which was not fully provided for in the financial statements in respect of the period up to the effective date of sale.

Obligations specifically relating to Yallourn Energy

4.32 Under the sale arrangements for Yallourn Energy, the State has retained the following specific obligations:

- General warranties and indemnities to the purchaser, giving rise to a maximum exposure to the State of \$80 million in the event that the purchaser lodges claims before 1 October 1997;
- Within 2 years of sale completion, the State must compulsorily acquire certain private land holdings in Maryvale, adjacent to the existing power plant and mine. The Government is then required to resell each acquired parcel to the company. Under the agreement, Yallourn Energy is required to reimburse acquisition costs incurred by the State up to a specified sum, with the State bearing responsibility for any costs in excess of this amount;

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- At the date of sale, Yallourn Energy was committed to the supply of briquetting coal to Energy Brix Australia. However, as part of the sale arrangements, the State agreed to use all reasonable endeavours to procure an alternative supply of coal to Energy Brix Australia at a comparable price, to allow the termination of the supply contract between these companies. If the State failed to find an alternative supply of coal at a comparable price, it undertook to terminate the supply contract on or before October 1998 and that Energy Brix Australia would not seek to exercise any option for renewal of the supply contract. In August 1996, in preparation for the privatisation of Energy Brix Australia, the respective parties agreed to allow the coal supply contract to expire on or before October 1998 and that the option for renewal will not be exercised;
- As a transitional arrangement to the establishment of the national electricity market, the State has undertaken to regulate the operation of the Hazelwood power station so that the station's generating capacity cannot exceed a specified output. This cap, which could impact on the production levels of other generating companies, is to continue until the earlier of the commencement of the national electricity market or 30 June 1997. If during this limitation period, the average pool price of electricity falls below a certain specified level, Hazelwood's capacity is to be limited to the abovestated maximum capacity until the average pool price exceeds this specified level;
- The State agreed to terminate, prior to sale completion, the company's contractual obligations to provide power under the energy export contract entered into between the State Electricity Corporation of Victoria and the Electricity Trust of South Australia. The purchaser has been indemnified by the State against any future claims that may arise as a result of the termination of this contract; and
- The State has agreed to compensate the purchaser against certain losses of income until the year 2000, resulting from reduced electricity production caused by major industrial relations disputes which effect one third or more of the company's generating capacity.

Franchise fee indemnity

4.33 Under the sale agreement relating to United Energy, the Government provided an indemnity to the purchaser concerning the deductibility of franchise fees for taxation purposes. The State may be required under this indemnity to make a payment of \$85 million to the purchaser in the event that an unfavourable tax ruling is received from the Australian Taxation Office (ATO), and the ruling is not overturned within the next 3 years.

4.34 In August 1995, the ATO issued a private tax ruling to United Energy which concluded that franchise fees payable by the company to the State were not tax deductible. However, taxation advice received by the Government and one of the purchasers of the distribution businesses has indicated that franchise fees are deductible for income tax purposes. Consequently, in October 1995, the Government lodged an objection to the ATO's ruling and has held discussions on the issue with the ATO.

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4.35 A private tax ruling was issued by the ATO in August 1996 which confirmed that the franchise fees are not deductible for taxation purposes. **While the State is only obligated to make the \$85 million indemnity payment to the purchaser of United Energy if this ruling is not overturned within 3 years from the date of sale, the State has recognised this amount as a liability, with the State Electricity Commission of Victoria including it in its financial statements as at 30 June 1996.** Audit was advised that the State plans to lodge an objection to the August 1996 tax ruling and, if the objection is disallowed, to appeal the ruling in the courts.

Sales tax obligations

4.36 As explained in my previous Report to the Parliament, given that the distribution companies were publicly-owned prior to their sale, they were exempt from the sales tax regime of the Commonwealth Government, which permitted the companies to acquire goods free of sales tax. However, following their sale, the companies became liable for such taxes. The Commonwealth (including the ATO) and the State Government have had protracted negotiations over the sales tax obligations of the privatised electricity distributors.

4.37 As part of the sale arrangements, the SECV on behalf of the State has entered into agreements with all the purchasers of the distribution companies so that the State ultimately bears the financial costs of the sales tax obligations met by the companies. This financial assistance was provided to ensure that electricity consumers are not disadvantaged by those costs being reflected in charges levied by the distribution companies.

4.38 Since October 1995, the SECV has made payments totalling \$7.6 million to the distribution businesses for reimbursements of sales tax. **The estimated annual impost of sales tax on the distribution companies is \$20 million and is potentially an ongoing liability of the State.**

4.39 While the State is able to terminate these agreements on the provision of 21 days notice to the respective businesses, any such action will ultimately impact on electricity prices payable by customers. Nevertheless, **the State has recognised a liability of \$90 million, representing the estimated sales tax expense to be incurred by the Commission over the next 5 years, with the State Electricity Commission of Victoria including this amount in its financial statements as at 30 June 1996.** Audit was advised that action has commenced by the State to have the matter relating to the sales tax obligations for the privatised distribution companies resolved by the courts.

Community service obligations

4.40 The State has entered into agreements with the purchasers of the distribution companies for the provision and funding of certain community services to eligible customers. Such community services include non-commercial programs and activities designed to meet community and social objectives determined by the Government.

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4.41 All agreements relating to community service obligations will expire on 31 December 2000. However, the parties have agreed to meet and discuss in good faith the possible extension of the agreements before 30 June 2000. Under the arrangements, the Government is obliged to reimburse the companies for costs incurred, including associated administrative costs, for the various community services provided to customers eligible for concessional benefits.

4.42 The annual estimated cost to the State of funding community services delivered by the distribution companies on behalf of the Government is in the order of \$37 million. The funding of these community service obligations by the State is consistent with the arrangements operating prior to the sale of the companies.

Tax compensation for the sale of State-owned enterprises

4.43 In my October 1995 Report on the Statement of Financial Operations, I commented on the status of action taken by the Government to obtain compensation from the Commonwealth Government for revenues forgone on privatisation of business enterprises.

4.44 In accordance with a *Statement of Policy Intent* agreed at the March 1994 Premiers Conference, the Treasurer forwarded a submission to the Commonwealth Government in April 1995 seeking tax compensation in relation to the privatisation of the former Totalizator Agency Board. The submission, which was to be used as a test case, concluded that the overall gain to the Commonwealth via additional taxation revenues from the privatisation of government business enterprises will be *more than sufficient* to meet proposed compensation relating to the privatisation of these entities.

4.45 In December 1995, a Joint Commonwealth/State working group issued its *Final Report to Heads of Treasuries*, outlining the continuing disagreement by the Governments on the issue and stating that, in the opinion of the Commonwealth Treasury, further work was unlikely to resolve the conflicting positions.

4.46 In May 1996, the Commonwealth Government announced that it would end the previous policy of case-by-case consideration of claims for tax compensation. This decision was based on the view that the States and Territories are *fully compensated for the income they forgo on the sale of their assets in the sale price they receive upon privatisation*.

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Sale of port-related assets

4.47 My May 1996 Report on Ministerial Portfolios commented on the status of the Government's extensive reform program of the commercial ports in Victoria at Melbourne, Portland, Geelong and Hastings.

4.48 Under the established arrangements, for many years, individual port authorities managed and operated each port (except for Hastings which was managed by the Port of Melbourne Authority), providing a range of port services to exporters and importers, including channel dredging, harbour control, leasing of berths and land for stevedoring, and pilot services. In addition, the port authorities were allocated responsibility for 14 associated ports, which were mainly used for recreational and commercial fishing activities. Port services in Victoria were characterised by a combination of high cost structures, poor commercial practices and the attainment of inadequate productivity gains, compared with international ports.

4.49 The specific objectives of the port reform process was to improve the efficiency and effectiveness of port services, reduce port costs to importers and exporters and achieve a reasonable return to the Victorian taxpayer.

4.50 The *Port Services Act* 1995 established the framework for the implementation of the reform process by providing for, inter alia, the restructure of existing services and a port asset divestment program under the oversight of the port reform unit within the Department of Treasury and Finance. The reform program includes:

- an asset sale program, relating to onshore assets at Geelong, Portland and Hastings and the sale of the World Trade Centre, which was previously managed by the Port of Melbourne Authority; and
- a program to transfer certain associated port assets, mainly to municipal councils

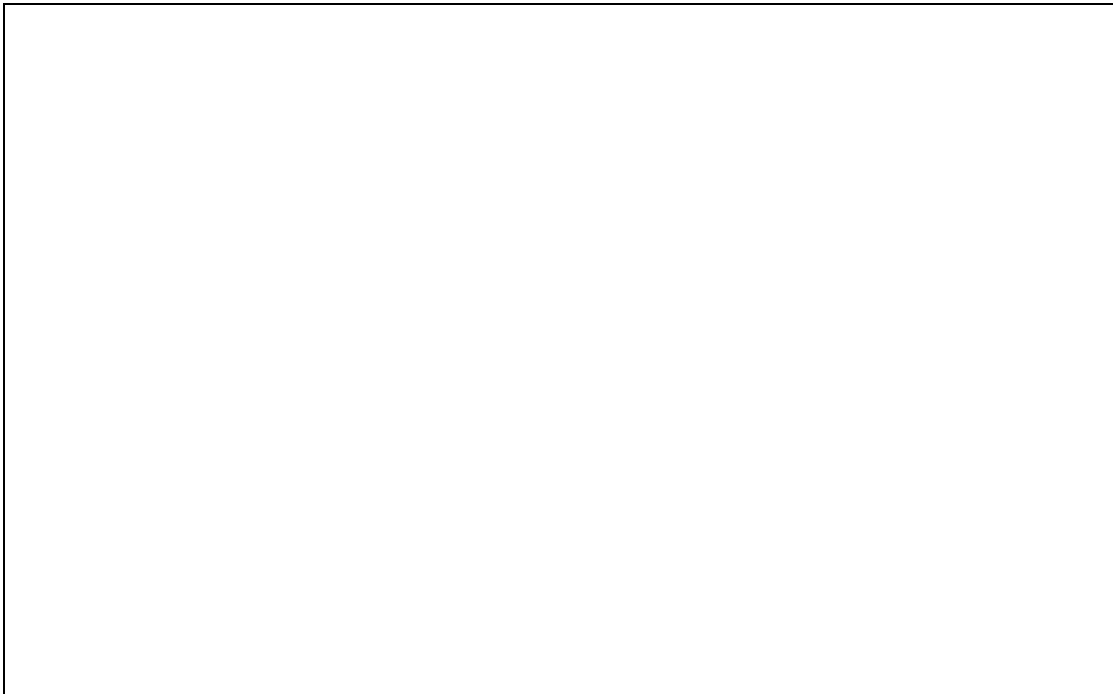
4.51 Since the establishment of the reform program, the Government has completed the sale of commercial port-related assets under the management of the Port of Portland Authority and the Port of Geelong Authority. In addition, in September 1996, the Department of Treasury and Finance completed the sale of the World Trade Centre. At the date of the preparation of this Report, action had also commenced to facilitate the sale of the port-related assets at the Port of Hastings.

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Port of Geelong

4.52 The Port of Geelong Authority, established in 1905 as the Geelong Harbour Trust, was responsible for the management and regulation of activities at the port at Geelong, and within Corio Bay and the outer harbour of Geelong. In addition, the Authority was responsible for the associated ports at Queenscliff, Barwon Heads, Lorne and Apollo Bay, which are principally used for the berthing of fishing and pleasure crafts.

4.53 The infrastructure of the port at Geelong mainly comprises 14 commercial berths located at 5 wharves, and a ship repair and slipway facility. Cargo shipped through the port mainly consists of bulk grain, oil, alumina, fertiliser and other general cargo. An extensive road and rail network connects the port to the Melbourne metropolitan area, regional centres and interstate locations.



Port of Geelong.

4.54 As part of the Government's reform program, the Authority was required to divest its non-strategic assets and facilities. This divestment program included the transfer of the Authority's community service obligations relating to the associated ports to the Department of Natural Resources and Environment and, in particular, the sale of its on-shore port assets. The residual assets, consisting of channels and navigational aids, were placed under the control of the newly created Channels Authority, which is also responsible for the management and maintenance of the channels relating to the Ports of Geelong and Melbourne.

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Sale process

4.55 In September 1995, consistent with the Government's Port Reform Policy Statement, the predominant users of the berths were offered the first right to purchase the berth facilities that they utilised. Prior to the commencement of negotiations with these parties, in October 1995, the Port of Geelong Authority obtained valuations of each respective berth facility from the Valuer-General (\$29.5 million) and a private valuer (\$22.7 million).

4.56 In November 1995, following the evaluation of 2 formal bids which were received, the Treasurer advised the respective parties that the bids were below the reserve price determined by the Valuer-General and the private valuer, and indicated that the respective berths would be included as part of the assets planned to be sold by the Authority on a whole-of-port basis. In addition, the Treasurer invited the bidders to finalise the lease arrangements for their respective berths with the Authority prior to the impending sale, or to negotiate the leases with the new owner.

4.57 The Authority invited expressions of interest in December 1995 for the sale of its onshore assets, on a whole-of-port basis, and following the issue of an Information Memorandum to interested investors, in February 1995, the Authority received 8 indicative non-binding bids from potential purchasers.

4.58 The bids were evaluated by a selection panel, consisting of representatives of the Department of Treasury and Finance, and legal and financial advisers, against a number of predetermined criteria, including:

- the price offered, including proposed terms and conditions and any warranties sought by the bidder;
- the financial capacity of the bidder to complete the purchase; and
- the bidder's port management experience and expertise.

4.59 All interested parties were subsequently short-listed by the selection committee and were invited to undertake due diligence inquiries, prior to the submission of their final bids. In May 1996, the Authority received 2 final bids and in the same month, the Government announced the sale of the port at Geelong undertakings and assets to a private consortium, consisting of TNT Australia Pty Ltd and Infrastructure Investment Corporation Ltd.

4.60 An independent accounting firm, appointed in October 1995 by the Department of Treasury and Finance as the process auditor in relation to the sale concluded that all tenders were afforded fair and equitable treatment and all tenderers were ranked fairly against the established selection criteria.

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Business valuations

4.61 In November 1993, independent financial consultants assessed the value of the Port of Geelong Authority at \$77 million, excluding cash and assets surplus to requirements, based on the assumption that the marine services activities relating to the operation of the channels would not be sold and remain with the Authority. Subsequently, in September 1995, the Department of Treasury and Finance received a further indicative valuation from a firm of merchant bankers of \$55 million as at May 1995 on a whole-of-port basis, which included the marine services.

4.62 However, in March 1996, the Department received a private valuation from the same merchant bankers of between \$33 million and \$61 million for the port's operating assets, on the basis of the following alternative business strategies:

- \$33 million, if the port was to continue in its present form;
- \$55.2 million, if there was a 30 per cent or \$2.8 million reduction in the port's operating expenses within 2 years; and
- \$61 million, if there was a significant increase in port traffic due to additional customers.

4.63 The book value of the port's net assets subject to the sale arrangements as at the date of sale was \$54 million.

Key terms of the sale

4.64 Consistent with the terms of the sale agreement, the Port of Geelong Authority received net sale proceeds of \$49.6 million for the business operations and assets of the port. This included a sale price of \$50.5 million received on 1 July 1996 for the acquisition of the operational business of the port at Geelong, excluding any operations relating to the maintenance and dredging of channels, the provision and maintenance of navigation aids and shipping movements. However, a payment of \$860 000 by the Authority to the purchaser was offset against the sale price, representing an adjustment of net liabilities acquired and movements in interest rates between the date of the sale and the sale completion.

4.65 Under the sale arrangements, the Authority retained investments valued at \$55 million as at the date of sale, and the rights to any amounts received by the purchaser from outstanding trade debtors totalling some \$1.6 million. At the date of preparation of this Report, the Authority had received \$1.3 million of this amount.

4.66 Prior to the date of sale, a pricing order which placed price restrictions on all non-competitive port services, such as berth hire and the provision of short-term storage facilities, was approved by the Governor-in-Council, under the provisions of the *Port Services Act 1995*. The effect of this order was to protect the port users from increases in charges above the Consumer Price Index until June 2000 and to restructure port user charges.

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Remaining obligations of the State

4.67 Under the terms of the sale agreement, the Port of Geelong Authority has provided certain indemnities and warranties to the purchaser, which may expose the State to future liabilities.

4.68 Specifically, various general warranties and indemnities have been provided by the Authority to the purchaser which give rise to an maximum potential exposure to the State of \$10 million, in the event that the purchaser lodges a claim within 12 months from the date of completion of the sale. In addition, the State has changed the relevant legislation which effectively protects the purchaser against any land tax assessed on the value of buildings, breakwaters, berths, wharfs, aprons, canals or associated works relating to the port.

4.69 The State has also agreed to the following conditions:

- to grant a seabed lease to the purchaser at a nominal rental;
- to warrant the provision of adequate rights of access to the purchaser to the Rippleside Pier, which has been sold to another private sector operator;
- to be responsible for the funding of the Authority's unfunded superannuation liability which as at July 1996 was valued at \$1 million;
- the assignment of intellectual property rights such as trade marks to the purchaser, with the State providing an indemnity to the purchaser against any loss arising from any act or omission caused by the State in connection with these rights up to the date of sale; and
- the Authority agreeing to lease a building at Brougham Street, Geelong, to the purchaser for a period of 3 years, with the option of 2 further terms of 3 years.

4.70 Consistent with the sale agreement, the State has accepted responsibility for costs associated with contamination of the property acquired by the purchaser and the adjacent seabed which is subject to ongoing environmental examination. In particular, the following potential environmental liabilities exist:

- compliance with any clean up notices issued before or after the sale by the Environment Protection Authority for environmental contamination as at July 1996; and
- the payment of any clean up costs incurred by July 1997, resulting from an environmental audit undertaken by the purchaser.

ASSET SALES

Application of sale proceeds

4.71 The sale proceeds of \$49.6 million, together with the funds realised from the Authority's investments and trade debtors which total \$56.8 million, are to be applied as follows:

- funding of a channel dredging project involving the deepening of the channels to allow large cargo vessels to use the port, at an estimated cost in excess of \$20 million;
- repayment of the Authority's borrowings of \$450 000;
- repayment of the Authority's unfunded superannuation liability, estimated at \$1 million;
- costs associated with the sale, estimated at \$2 million; and
- costs incurred by the Authority for the disposal of its residual assets and liabilities.

4.72 In accordance with the Treasurer's approval, the estimated residual amount of between \$60 million and \$65 million is to be paid into the Consolidated Fund, with an initial instalment of \$50 million expected to be paid in September 1996.

Assessment of sale result

4.73 An analysis of the sale result, from the State's perspective, indicates that:

- The net sale proceeds were \$6.4 million less than the book value of the assets sold; and
- The sale proceeds of \$49.6 million for the whole-of-port operations were in excess of a valuation received in March 1996 of \$33 million, which was predicated on the port continuing in its present form. However, the proceeds were \$5.6 million below a valuation based on the scenario of the port achieving a 30 per cent reduction in its operating expenses.

4.74 However, the channel deepening project which is to cost the State in excess of \$20 million will enable larger shipping vessels to utilise the port facilities and will therefore generate additional revenues for the new purchasers, which would have inflated the sale result achieved by the State.

Rippleside ship repair and slipway facility

4.75 The ship repair yard and associated slipway at Rippleside Pier, although forming part of the Port of Geelong's core port assets, were not included in the whole-of-port sale process, given that the terms of the existing lease agreement with its operator provided for a right of refusal to be available to the operator, in the event of a sale.

4.76 In October 1995, the Valuer-General estimated the value of the Rippleside facilities at \$1.5 million, compared with a valuation of \$500 000 provided by a private valuer. However, the Valuer-General subsequently revised his estimate to \$950 000, as the existing lease agreement, which included an option to extend the term for a further 5 years, was not taken into consideration in the first valuation. A separate private valuation undertaken at the request of the Department of Treasury and Finance estimated the market valuation of the facilities at \$890 000.

ASSET SALES

4.77 An offer to purchase the facilities was made in January 1995 by the existing lessor of the facilities. Following negotiations between the parties, a contract for the sale of the facilities was signed in February 1996, incorporating a sale price of \$950 000. Settlement of the sale was initially anticipated to occur in August 1996, however, the date of settlement was subsequently changed to September 1996.

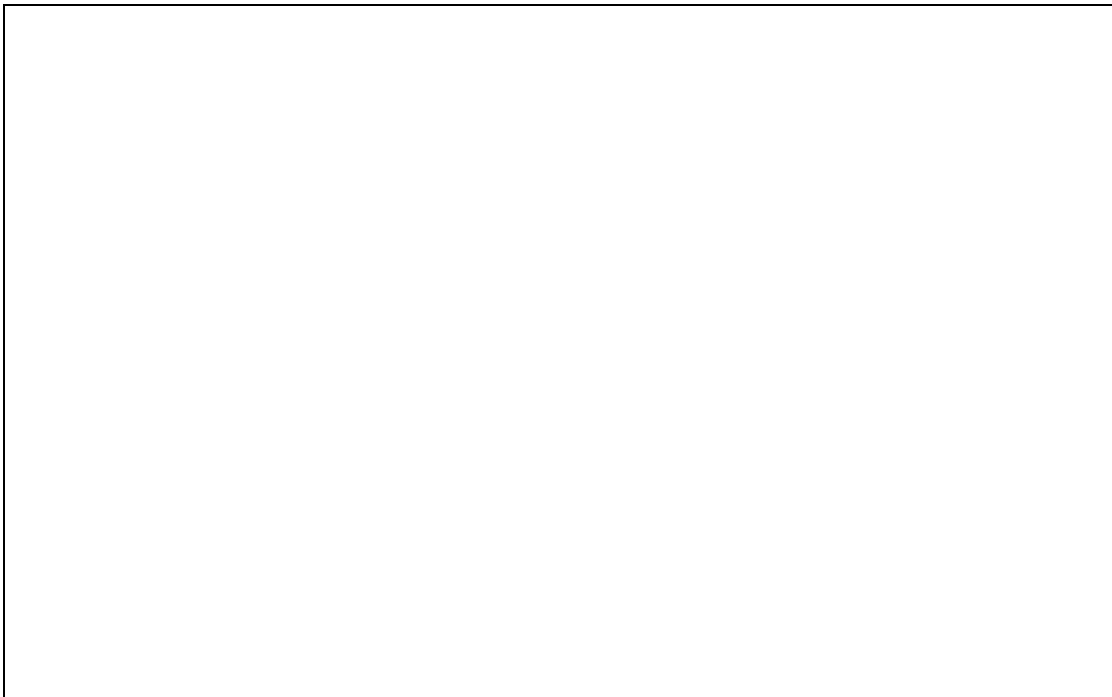
4.78 In August 1996, an environmental clean up notice was issued in relation to this facility. Consistent with the sale agreement, the estimated clean up cost of \$80 000 will be borne by the State.

4.79 **The result achieved by the State from this sale was consistent with the valuation of the facility, but was \$450 000 below its book value of \$1.4 million.**

Port of Portland

4.80 My May 1996 *Report on Ministerial Portfolios* outlined the process established by the Government for the sale of port-related assets under the control of the Port of Portland Authority, including the results achieved from the sale of these assets in February 1996 to a consortium comprising Infratil Australia Ltd (a subsidiary of a New Zealand-based company, holding a 50 per cent interest) and Ascot Investments Pty Ltd (an Australian-based company, holding a 50 per cent interest).

4.81 The port at Portland is a deep water port servicing western Victoria and south-eastern Australia and is connected to key regional areas through an extensive network of road and rail services. The onshore assets of the port mainly include 5 common user berths, one dedicated smelter berth, and channel assets and navigational aids.



Port of Portland.

ASSET SALES

4.82 Under the terms of separate sale agreements, the consortium acquired the port-related assets and the operations of the Authority for \$30 million, excluding the operations relating to navigational aids and shipping movements, and the investments, borrowings, deferred debtors and cash held by the Authority.

4.83 As a part of the arrangements, in March 1996, a pricing order was approved by the Treasurer and the Governor-in-Council under the authority of the *Port Services Act* 1995, which imposes price restrictions on the port's channel operations and other non-competitive port services, including berth hire and the provision of short-term storage facilities, over a 4 year period.

Application of sale proceeds

4.84 The proceeds of \$30 million achieved from the sale of the port at Portland have been applied by the Authority as follows:

- repayment of the Authority's borrowings of \$26 million with the Treasury Corporation Victoria;
- a payment of \$500 000 to the purchaser in March 1996, representing an adjustment to the sale price on account of the final value of net assets acquired; and
- a payment of \$200 000 to various public sector superannuation funds in respect of the Authority's estimated unfunded superannuation liabilities as at 6 March 1996.

4.85 The residual proceeds of \$3.3 million are to be held by the Authority to meet costs associated with the sale, and the disposal of the residual assets and liabilities of the Authority.

Assessment of sale result

4.86 Prior to analysing the sale result, reference needs to be made to the valuations obtained prior to the sale of the business.

4.87 In particular, in May 1995, the financial advisors to the Government provided the following business valuations in relation to the port at Portland, on a discounted cashflow basis, and assuming that the proposed private acquisition of the port would be predominantly funded from debt financing and that the current operating practices would remain unchanged:

- \$26 million, if there is low growth in trade volumes;
- \$36 million, if there is constant growth in trade volumes; or
- \$59 million, if there is high growth in trade volumes.

4.88 Further valuations were provided in December 1995 by the same financial advisors of the Government on the same basis to that used for the earlier valuations, but taking into account the proposed pricing restrictions on port services. The advisors estimated that, if the port achieved constant growth in trade volumes and was operated at its most cost-efficient level, the value of the business would be:

- \$27 million, if the port was acquired by a domestic purchaser; and
- \$36 million, if the port was acquired by a foreign purchaser.

ASSET SALES

4.89 In addition, the financial advisor estimated that, if there was no improvement in the port's cost-efficiency, the value to a foreign purchaser would only be \$23 million. However, under this scenario, the value to a domestic purchaser would be:

- \$22 million, if there is low growth in trade volume;
- \$31 million, if there is constant growth in trade volume; and
- \$51 million, if there is high growth in trade volume.

4.90 In comparison, the book value of the net assets sold was recorded at \$41 million as at the date of sale.

4.91 **An analysis of the sale result, from the State's perspective after taking into account the above valuations, indicates that:**

- **the sale proceeds were \$11 million less than the book value of the assets sold; and**
- **the proceeds were consistent with the port valuation range previously provided by the Government's advisors in December 1995, which assumed a constant rate of growth in trade volumes.**

4.92 The costs incurred by the Authority and the Department of Treasury and Finance in relation to the sale totalled \$1.4 million.

Remaining obligations of the State

4.93 The future obligations of the State under the sale arrangements mainly relate to various general warranties provided to the purchaser, under which the State's maximum exposure is \$30 million in the event that the purchaser lodges any claims within 12 months from the completion of the sale. However, the State's exposure to any one claim is limited to \$500 000. Included in the general warranties are:

- A requirement of the State to comply with any environmental and decontamination notices issued by the Environmental Protection Authority, arising from the environmental survey conducted prior to the sale;
- Any liabilities arising from legal action against the Port of Portland Authority for WorkCover claims related to asbestos, and claims arising from the construction of the main port breakwater;
- An undertaking to change the relevant legislation to effectively protect the purchaser against land tax assessed on the value of buildings, breakwaters, berths, wharfs, aprons, canals or associated works relating to the port; and
- An indemnity provided to the purchaser for certain land reclamation costs that may be incurred in relation to existing and future erosion downstream of the harbour.

ASSET SALES

Channel operations

4.94 Prior to completion of the sale in March 1996, the Port of Portland Authority was responsible for the management, dredging and maintenance of channels associated with the port, the provision and maintenance of navigational aids, and control over the movement of vessels within port waters.

4.95 On 1 March 1996, as part of the port reform process, responsibility for these functions was transferred to the Victorian Channels Authority. However, on 6 March 1996, the Victorian Channels Authority delegated responsibility for these functions to the purchaser of the port under a Channel Operating Agreement which is to operate for a term of 99 years. The key provisions of this agreement include:

- the purchaser to perform all responsibilities under the agreement, at their own expense, and to comply with all laws and requirements of relevant government authorities;
- the purchaser to be entitled to levy usage charges in respect of vessels entering the port on account of the above responsibilities;
- the purchaser to be responsible for maintaining adequate insurances against port blockage, pollution, property damage, public liability and marine hull insurance;
- the purchaser to provide an indemnity to the State for all claims or liabilities arising from an third party in relation to the delegated functions ; and
- if certain events of default are not addressed within agreed timeframes, the State may terminate the agreement.

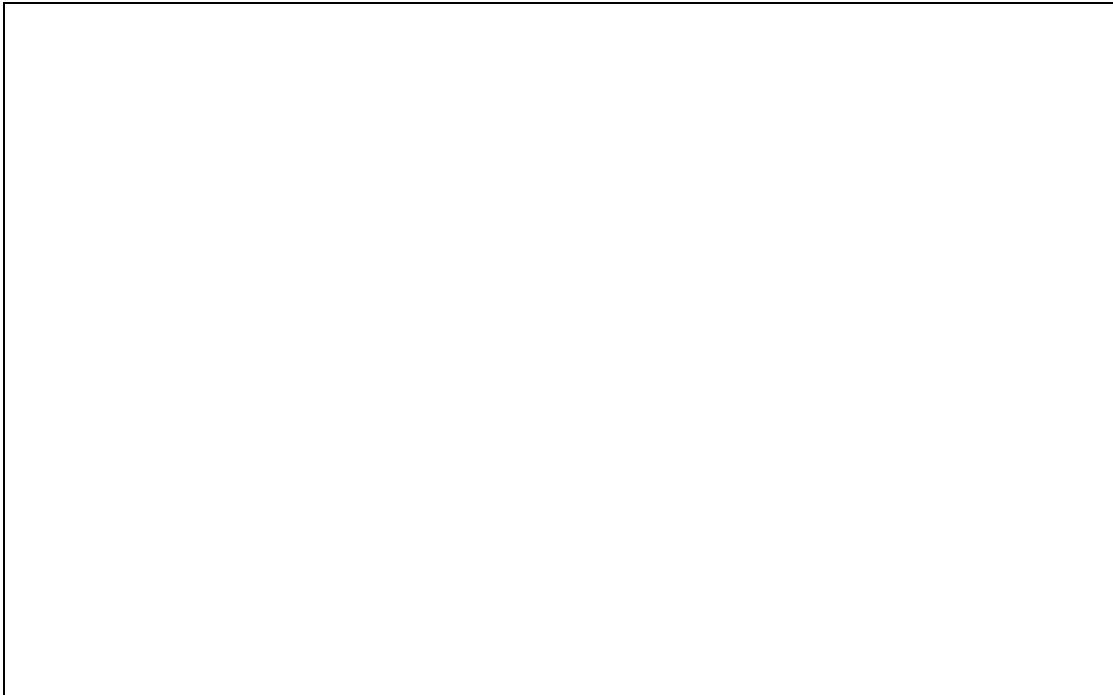
4.96 While the purchaser has assumed responsibility for the maintenance of the channel, the associated revenues for the use of this asset are also to be retained by the purchaser. This arrangement has had a positive impact on the sale result achieved by the State, given that the purchaser is not required to recoup the capital cost associated with the channel and therefore can reduce fees to attract greater levels of trade, or retain existing fees and generate greater profitability.

World Trade Centre

4.97 My previous reports to the Parliament have commented on the on-going losses incurred by the Port of Melbourne Authority from the operations of the World Trade Centre, mainly resulting from the substantial financing costs associated with borrowings raised to finance its construction and difficulties associated with attracting tenancies.

4.98 The World Trade Centre was constructed by the Authority in the early 1980's at a cost of around \$92 million and comprises 5 inter-linked buildings located at the western end of the central business district, near the corner of Flinders and Spencer Streets.

ASSET SALES

*World Trade Centre.*

4.99 In 1987, the Authority initiated a major marketing campaign to attract prospective purchasers for the Centre. While this action resulted in the signing of a contract of sale in May 1988, involving a price of \$158 million, the sale did not proceed and the Authority retained the deposit lodged by the prospective purchaser of \$280 000. The continued marketing of the Centre resulted in the signing of another contract of sale in October 1988, which involved a sale price of \$162.5 million, with settlement due to occur on 30 June 1989. However, due to the prospective purchaser's failure to proceed with the acquisition, the Authority retained the deposit of \$5 million provided by the purchaser and continued to hold ownership of the Centre.

4.100 As the World Trade Centre was not within the Melbourne central business district due to the physical barrier of the railway viaduct across Spencer Street, its management proved to be difficult in terms of attracting new lease tenancies. However, the use of the complex as the temporary location for the Crown casino resulted in renewed enthusiasm for the Centre. Furthermore, the entire precinct near the complex has undergone considerable change, including the development of Southbank, the construction of the permanent casino on Clarendon Street, South Melbourne and the completion of the Exhibition Centre on the opposite bank of the Yarra River. The proposed construction of a pedestrian bridge over the Yarra River, linking the World Congress Centre precinct with the Exhibition Centre, will further improve the viability of the Centre.

ASSET SALES

Sale process

4.101 Consistent with the Government's policy to divest non-core port assets, in June 1994 the Board of the Port of Melbourne Authority resolved to once again attempt the sale of the World Trade Centre complex. This resulted in a prospective purchaser approaching the Board of the Authority in July 1994 with a proposal to purchase the Centre for a price of \$115.3 million. However, this offer was subsequently withdrawn by that party, inter alia, due to the non-finalisation at that time of various Government actions to improve the marketability of the Centre.

4.102 In December 1994, at the request of the then Minister for Roads and Ports, responsibility for the sale was transferred to the Property Group of the Department of Treasury and Finance.

4.103 In order to optimise the marketability of the complex and therefore its sale value, the Department during 1995 focused on addressing a number of strategic issues, including the enhancement of the Centre's lease profile, and determining the future of the temporary casino site and the impact of the Docklands strategy on the area surrounding the Centre. The resolution of the outstanding tenancy matters and the establishment of a secure long term income stream from the leasing property were regarded as essential to a successful sale of the Centre.

4.104 Following improvements in the occupancy of the property and the resolution of certain planning and site boundary issues, the complex was placed on the market in October 1995. Private real estate agents were engaged to offer the property for sale by public tender, with tenders closing by November 1995.

4.105 The property was actively marketed nationally and internationally, culminating in the receipt of 9 non-conforming tenders, with indicative prices ranging from \$80 million to \$150 million. Following an initial tender evaluation process, it was determined that the highest bidder would be given exclusive rights to undertake a due diligence examination and to re-submit a firm proposal by mid January 1996. However, a firm offer was not subsequently submitted by this bidder and, as a result, the Department invited the 3 tenderers with the next highest bids to undertake due diligence enquiries with the view of submitting firm proposals for the complex. **This process resulted in the receipt of one proposal for the sale of the Centre by a Malaysian-based syndicate for a price of \$115 million.**

4.106 However, as a result of the due diligence examination, the prospective purchaser identified a number of issues in relation to the existing leases which would impact on the purchase price, particularly the requirement within the leases for the building owner to upgrade certain services if they fell below Australian Standards. In effect, this lease clause could require the building owner to upgrade the air-conditioning, lift and fire services once every 5 years.

ASSET SALES

4.107 In addition, while the Centre was placed on the market on the basis that government agencies would continue to lease all areas occupied at that time, which in relation to Victoria Police was until 2010, and the Port of Melbourne Authority would lease the space it then occupied until December 1999, the successor body, the Melbourne Ports Corporation later advised that it would not honour that undertaking beyond 30 June 1996 due to the prospective downsizing and restructuring of its operations. However, the selling agents for the centre advised that the withdrawal of the proposed leases by the Corporation would have a detrimental effect on the current sale negotiations, or any future negotiations, as the investment market would perceive such action as a negative signal, that the current owners are not willing to occupy the Centre, even in the medium term. Furthermore, it was considered by the agents that prospective purchasers had submitted their offers on the basis that the Corporation would take up the proposed lease and it was critical that this undertaking was fulfilled, as non compliance could result in the reduction or withdrawal of offers.

4.108 As a result of the advice from the agents, it was proposed by the Department of Treasury and Finance that the government leases would remain and, as a result, other tenancies would need to be identified to minimise the dead-rent, estimated at \$250 000 per annum, which would need to be underwritten by the Department.

4.109 Following a decision by Victoria Police to become a major tenant of the complex, consistent with its *Police CBD Consolidation Strategy*, and subsequent negotiations with the prospective purchaser of the complex, an in-principle agreement was reached on the modifications that would need to be made to the existing lease agreements, which were considered to be commercially justified. In this regard, the Department sought legal advice to ensure that the revised arrangements protected the tenant's rights and that the owner's risks in relation to building services were not transferred to tenants.

4.110 In attracting lease tenancies for the World Trade Centre complex, in previous years the Port of Melbourne Authority, as lessor, had provided incentive monies to lessees to cover fitout and refurbishment costs. **During the 1994-95 financial year, the Authority funded tenancy fitout works consistent with certain leasing agreements, relating to Victoria Police, to the value of \$26 million. In addition, in July 1995, the Treasurer approved the allocation of capital funding of approximately \$3 million to cover certain additional refurbishment costs for the Victoria Police tenancies.**

4.111 In March 1996, following the finalisation by the prospective purchaser of due diligence inquiries and subsequent negotiations between the parties, the prospective purchaser submitted a revised purchase offer of \$103 million. At this time, Victorian public sector bodies occupied around 75 per cent of the available lettable office accommodation space at the World Trade Centre.

4.112 In March 1996, a firm of chartered accountants was employed to assess the economic merits of 2 alternatives available to the Government, namely, selling the property for the price that was offered, or retaining the property in Government ownership and attempting to facilitate a sale of the complex at a later date. **The results of this review indicated that the offer reflected a forced sale situation and that the decision on whether to accept the offer or to retain ownership of the complex was dependent on the Government's philosophy of whether the property was regarded as a core asset.**

ASSET SALES

Property valuations

4.113 In November 1994, the Port of Melbourne Authority obtained a private valuation of the complex which indicated that the value of the Centre was \$109 million. In view of this valuation, the Department of Treasury and Finance recommended to the Authority that it should consider adjusting the property's book value, which stood at \$123 million as at 30 June 1995.

4.114 Correspondence between the Minister for Finance and the Treasurer in June 1995 indicated that the action taken by the Department to improve the lease profile of the complex and the resolution of certain other issues would increase the value of the property to in excess of \$120 million.

4.115 However, a firm of chartered accountants engaged by the Department in November 1995 to independently assess the sale and marketing processes employed by the Department for the sale of the property, provided an estimated valuation for the property in the range of \$95 million to \$105 million.

4.116 Also in November 1995, the Valuer-General estimated the value of the complex at \$125 million, which compared with a private valuer's assessment of \$100 million.

4.117 On the recommendation of the Department, in light of the variation in property valuations and to provide some flexibility in sale negotiations, in November 1995 the Minister for Finance set a reserve price for the sale of the World Trade Centre of \$100 million. However, in March 1996, the Valuer-General re-assessed the previously provided valuation of \$125 million to take account of the issues that were raised in the purchaser's due diligence examination and advised that the estimated valuation of the complex was \$102.5 million, representing the current market value of the State's freehold interest of the property. It was further advised that the decline in the valuation was mainly related to:

- changes in interest rates and the inability of Centre's revenues to offset these changes; and
- concerns raised during the due diligence process regarding building works that need to be undertaken.

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Key terms of the sale

4.118 In May 1996, the Treasurer approved the sale of the Centre for a price of \$103 million, resulting in a contract of sale being finalised between the Malaysian-based investment syndicate and the Authority. The Treasurer also agreed to underwrite any dead rent incurred as a result of the Port of Melbourne Authority's inability to occupy the entire area previously designated for the Authority.

4.119 The satisfactory completion of the contract of sale was conditional upon the finalisation a number of issues relating to:

- the surrender, re-zoning and transfer of certain land associated with the complex;
- the proclamation of Siddeley Street as a public roadway; and
- the confirmation by an environmental specialist that the condition of the land relating to the complex is not detrimental to the current use of the land and that the presence of any contaminants does not pose an unacceptable risk to any beneficial use of adjoining land and the Yarra River.

4.120 In relation to the environmental issue, the Department of Treasury and Finance commissioned an environmental auditor in mid June 1996, resulting in the submission of an Environmental Audit Report, incorporating a Statement of Environmental Audit, to the Department in August 1996. The auditor was of the opinion that the land was suitable for its current commercial use, subject to certain conditions.

4.121 The contract of sale provides that if the environment auditor, the Environmental Protection Agency or any other relevant authority requires any remediation works to be carried out as a result of any matters disclosed by the Report, the Port of Melbourne Authority, shall at its own cost carry out all such works as soon as reasonably practicable after the report is issued.

4.122 Consistent with the approval of the Treasurer, the proceeds of \$103 million from the sale of the World Trade Centre were earmarked for application towards the repayment of the borrowings of the Port of Melbourne Authority, which as at 30 June 1996 stood at around \$75.5 million, with the balance of proceeds retained by the Authority.

Assessment of the sale

4.123 An analysis of the sale result, from the State's perspective, indicated that:

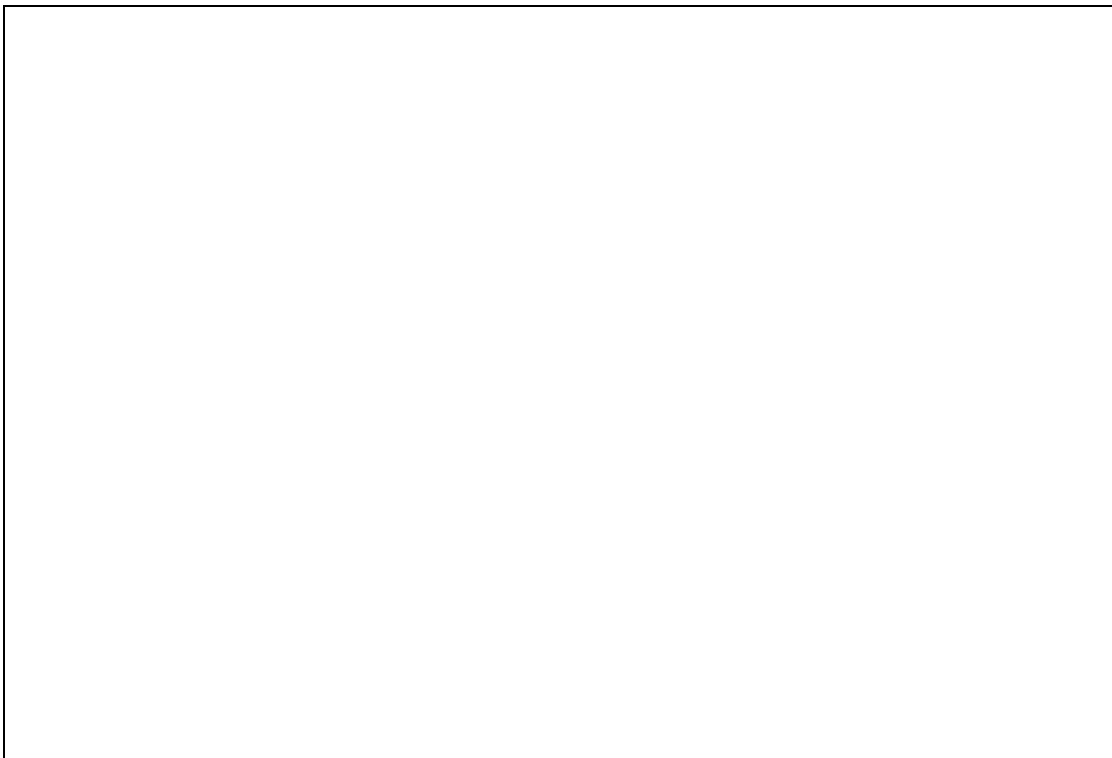
- after taking into account the unamortised costs incurred by the Port of Melbourne Authority and the State up to 30 June 1996 in relation to the provision of lease incentives of \$27 million and the estimated costs of sale of \$1 million, the net proceeds from the sale of the World Trade Centre only amounted to \$75 million;
- the net sale proceeds were \$21 million below the book value of the Centre as at 30 June 1995;
- the relocation of Victoria Police and other public sector tenants to the World Trade Centre, which jointly occupy around 75 per cent of the available lettable office accommodation space, together with the take-up by the Government of leases in relation to these tenancies for periods up to the year 2010, favourably impacted on the sale result achieved by the State; and
- the sale did not provide a net benefit to the State, after taking into account debt repayments (\$75 million), the costs of sale (\$1 million) and the cost of lease incentives (\$27 million).

ASSET SALES

Southern Cross Hotel site

4.124 My previous report on the Statement of Financial Operations commented on the sale of the former Southern Cross Hotel site located at the corner of Exhibition and Bourke Streets, Melbourne.

4.125 In September 1994, the Government sold the site to parties affiliated with the Republic of Nauru, the then lessees, for \$10 million. Under the terms of the sale agreement, a deposit of \$500 000 was paid by the purchaser at the date of sale, with the balance of \$9.5 million payable into the Consolidated Fund in March 1996.



Former Southern Cross Hotel site.

4.126 At the date of preparation of this Report, settlement of the sale remained outstanding, with the balance of \$9.5 million yet to be paid by the purchaser and site re-development works temporarily suspended. The Department of Treasury and Finance has been advised that the default by the purchaser to effect settlement resulted from a re-evaluation by the new Nauru Government of its off-shore investments, including the Southern Cross development.

4.127 While negotiations were continuing between the parties to achieve settlement, the purchaser has been advised by the Department of Treasury and Finance that it is liable to pay penalty interest from March 1996 until the completion of settlement, and that the Government, by notice published in the *Government Gazette*, has the option under the sale agreement to declare the agreement void.

ASSET SALES

Utilities Insurance Company Pty Ltd

4.128 Utilities Insurance Company Pty Ltd was established in August 1990 as a wholly-owned subsidiary of the State Electricity Commission of Victoria (SECV) to enable the Commission to gain direct access to the wholesale insurance market. The company's key activities included the provision of insurance and risk management services to the Victorian electricity industry.

4.129 In January 1994, in line with the Government's electricity industry reform program, the generation, transmission and distribution functions of the SECV were respectively transferred to Generation Victoria, National Electricity and Electricity Services Victoria. At the same time, the company's shares were equally distributed to the new electricity entities. However, in October 1994 when these bodies were further disaggregated to form 12 independent electricity businesses, the company's shares were transferred to the SECV which became responsible for the management and, where appropriate, disposal of the residual assets and liabilities of the electricity industry not allocated to the new businesses.

4.130 Given that the SECV did not intend continuing the provision of insurance cover to the disaggregated electricity industry and the new electricity businesses did not wish to take up an ownership interest in the company, the Administrator of the SECV decided to proceed with the sale of the company.

Sale process

4.131 During 1995, as a first step towards the sale, the company's Board of Directors sought advice from a number of insurance and finance market participants on the available sale options for the company. The subsequent advice supported the establishment of a negotiated sales process, mainly due to the company's specialised functions and the view that a sale by public tender was not appropriate, given that the company was not significant enough for any major insurer to entertain a tender process and that the disclosure of the company's affairs to more than one bidder was likely to reduce the company's value.

4.132 In early 1996, a private sector insurance group which had been closely affiliated with the SECV expressed an interest in the purchase of the company. However, the group advised that it was not prepared to enter into either a public or limited tender process for the acquisition.

4.133 Subsequently, in March 1996, the SECV Administrator sought independent advice from 4 financial advisors and insurance brokers to assist in assessing whether entering into formal negotiations with a single bidder would produce the best commercial outcome for the State. The advice received from these experts included the following:

- There was likely to be more than one buyer interested in the purchase of the company;
- Normal insurance industry practice did not involve an open tender process;

ASSET SALES

- A potential buyer who was willing to offer a suitable price and accept all residual liabilities was a preferable option which should be pursued in a timely fashion;
- The objectives of the SECV and the Government would be best met by a limited tender process. In this case, the expert provided details of potential purchasers whose intent could be gauged prior to commencing any formal discussions; and
- A formal tender process was appropriate for a traditional insurer as the risk of revealing confidential information could be minimised. However, in this case, the company had a small number of clients, and policies which were specifically designed and re-insured, and therefore proposed bidders may discount their price in the knowledge that other bidders, who may become direct competitors in the future, have gained intimate details about the company.

4.134 In late March 1996, following consideration of the previously mentioned independent advice and preliminary discussions with potential purchasers, the Board of Directors of Utilities Insurance Company resolved to recommend to the Administrator of the SECV that negotiations progress with the insurance group which had previously expressed an interest in the purchase of the company with a view to negotiating sale terms acceptable to all parties. In making this decision, the Board was cognisant of the advice provided by the experts that insurance industry practice supported this form of sale and that a sale by tender would lead to the diminished value of the company and therefore not achieve the best result for either the SECV or the State. In April 1996, the Treasurer concurred with the Board's proposal to proceed with the sale of the company to the sole bidder.

Business valuations

4.135 As at 31 December 1995, the company was valued at between \$2.1 million and \$2.6 million by an independent advisor appointed by the SECV Administrator. However, the Administrator was also advised that the inherent value of the company exceeded the mid-point value of \$2.3 million.

4.136 In May 1995, the same advisor revised the company valuation to between \$1.8 million and \$2.4 million, mainly due to the recognition of liabilities which had not been taken into account in the earlier valuation. The advisor also indicated that the lower end of the valuation range would be more appropriate if no warranties were offered to the purchaser. However, if warranties were offered, the valuation would be towards the higher end of the range in order to cover the additional risk.

ASSET SALES

Key terms of sale

4.137 In April 1996, following the conduct of a due diligence review of the company's records by the bidder, the SECV received a formal offer of \$1.8 million for the purchase of the company, with no requirement for any SECV warranties. The estimated book value of the net assets to be acquired by the purchaser was \$1.6 million.

4.138 Under the terms of the sale agreement, the SECV was to be absolved from any liabilities arising from insurance policies issued by the company prior to the completion of the sale. However, in early June 1996, the SECV provided a warranty to the purchaser that there were no unsatisfied judgements, awards or orders against the company. This warranty has now lapsed, without any claim being made by the purchaser.

4.139 The sale proceeds of \$1.8 million were received by the SECV in June 1996 and were retained by the Commission for working capital purposes. The estimated costs of the sale to 30 June 1996 were \$82 000, mainly relating to the engagement of insurance industry experts to provide professional advice regarding the sale process.

Assessment of sale result

4.140 An accounting firm engaged in March 1996 by the Administrator of the SECV to act as the process auditor for the sale, concluded that the bidder was accorded fair and equitable treatment and that the sale process was conducted with probity. In April 1996, another accounting firm appointed by the SECV Administrator to evaluate the purchaser's offer, advised that the bid was reasonable and should be accepted, given that the purchaser did not seek any warranties for possible future claims relating to the company's existing insurance program.

4.141 The audit analysis of the sale result indicated that:

- the net proceeds to the SECV from the sale, after the costs of sale, were \$1.7 million;
- the sale price compared favourably with the book value of the company's net assets, which was estimated at \$1.6 million as at 31 March 1996;
- the sale proceeds were consistent with the May 1996 valuation of the company; and
- the sale enabled the State to transfer to the private sector the insurance exposures relating to the company's operations.

ASSET SALES

BASS joint venture

4.142 My October 1995 Report on the Statement of Financial Operations commented on the establishment of a joint venture arrangement between the Victorian Arts Centre Trust and Ticketmaster Corporation involving the sale of 50 per cent of BASS Victoria to Ticketmaster for an estimated price of \$4 million.

4.143 In July 1993, BASS was independently valued between \$5.1 million and \$6.1 million based on the maintainable earnings of the business. This valuation was subsequently confirmed by the valuer as current in 1995. Under the terms of the sale arrangements, a completion audit was undertaken in November 1995, which determined the book value of the net assets of BASS to be approximately \$1.3 million.

4.144 While the previously estimated sale price for 50 per cent of BASS was \$4 million, the actual proceeds from the sale were \$3.3 million. Management of the joint venture advised audit that the reduction in the sale price was a direct result of unsuccessful negotiations with certain theatrical venues to finalise ticketing arrangements prior to the completion of the sale. The non-finalisation of these ticketing arrangements impacted on the future revenues of the joint venture and, therefore, the purchase price.

4.145 Consistent with the terms of the sale, a deposit of \$100 000 was paid into the Consolidated Fund in May 1995, with a further amount of \$3.2 million paid by March 1996. The estimated cost incurred by the State in relation to the sale was \$735 000, mainly relating to the reimbursement of costs incurred by the Victorian Arts Centre Trust and BASS in negotiating the sale, which have been incurred over a number of years.

4.146 An analysis of the sale result indicated that the net sale proceeds of \$2.6 million were \$1.3 million greater than the book value of the net assets of BASS sold, but the sale price was consistent with a business valuation undertaken in July 1993 and confirmed in 1995.

Grain Elevators Board

4.147 My October 1995 Report on the Statement of Financial Operations commented on the sale of the former Grain Elevators Board (GEB) business which had operated since 1935 and provided storage, handling and distribution services for bulk agricultural commodities within Victoria and southern New South Wales.

4.148 The sale of the business was announced by the Government in May 1995 following the completion of a *Sale of Business and Shares Agreement* with a consortium headed by the Victorian Farmers Federation. The agreement outlined the terms of the sale and was ratified in June 1995 by the Parliament through the enactment of the *Grain Handling and Storage Act 1995*.

ASSET SALES

4.149 Under the sale agreement, the State was entitled to receive total estimated proceeds of \$52.4 million, as follows:

- \$46.6 million at 30 June 1995, subject to final adjustment for variations in the value of assets and liabilities sold; and
- \$5.8 million receivable over the next 3 years, \$5 million of which was receivable only if the purchaser obtained a favourable tax ruling in relation to fixed asset depreciation deductions, and the remaining \$800 000 subject to the receipt from marketers of amounts in respect of grain received but not distributed by the GEB at the time of sale.

4.150 Consistent with the terms of the sale agreement, at 30 June 1995 the State received \$46.6 million sale proceeds from the consortium and assumed the GEB's loan liabilities which had a net market value of \$54.2 million. The sale proceeds, together with an additional government appropriation of \$7.6 million, were applied to the retirement of the loan liabilities of the GEB.

4.151 However, following the determination of the final value of business assets and liabilities sold, in November 1995 the State made a payment of \$1.1 million to the purchaser, representing an adjustment of the purchase price in accordance with the sale agreement. This final sale settlement was formalised through the issue by the Treasurer to the purchaser of a *letter of waiver and acknowledgment*, which also provided an indemnity to the purchaser against future costs incurred in excess of \$10 000 in relation to any claims made under a workers compensation policy with the State Insurance Office, and against future costs incurred in excess of \$300 000 in respect of WorkCover premiums payable for the period up to the date of sale.

4.152 In relation to the amount of \$5 million receivable by the State under the sale agreement associated with the deductibility for taxation purposes of depreciation on fixed assets, at the date of preparation of this Report, the purchaser had commenced action to obtain a preliminary tax ruling on this issue from the Australian Taxation Office.

4.153 In terms of the amounts receivable by the State relating to receipts from marketers of amounts in respect of grain received but not distributed by the GEB at the time of sale, at the date of preparation of this Report, negotiations were in progress between the parties to determine the amount to be received.

Final sale result

4.154 Based on the latest available information, the net proceeds to be received by the State from the sale are estimated to total \$46.3 million. As the State has assumed and repaid outstanding loans from the GEB totalling \$54.2 million and has incurred costs associated with the sale of \$1.2 million, it is projected that the State will incur an overall negative cashflow from this sale of \$9.2 million.

ASSET SALES

GFE Resources Ltd

4.155 My October 1995 Report on the Statement of Financial Operations commented on results achieved by the State from the sale of GFE Resources Ltd (GFE). This company, which was a subsidiary of the Gas and Fuel Corporation of Victoria (the Corporation), was established in 1978 to assist in the stimulation of gas exploration activity in the State, to enhance the Corporation's knowledge of the Victorian gas industry and the available gas reserves, and to develop profitable oil and gas production. GFE's objectives were later extended to include involvement in areas outside Victoria.

4.156 In March 1994, the Government announced its intention to publicly float 27 per cent of its interest in the company. However, in April 1994 the proposed float was abandoned due to adverse market conditions. Subsequently, the Government proceeded to prepare the company for a trade sale by transferring, in May 1995, an outstanding loan due from GFE to the State of \$49.9 million in return for equity in the company, through the issue of shares to the State with an equivalent aggregate value. This arrangement substantially improved the financial position of the company, from an estimated net liabilities position of \$9.6 million to a net asset position of \$40.3 million as at 30 June 1995.

4.157 Following a tender process, in August 1995 the Government announced the successful purchaser of GFE, a Sydney-based oil and gas company. **The sale was completed in September 1995 with the receipt by the Consolidated Fund of the full purchase price of \$56.2 million.**

4.158 **The sale proceeds were \$15.9 million greater than GFE's net assets. However, the net cashflow to the State was \$3.6 million,** based on the Government's intention to repay debt with an equivalent value to the debt assumed of \$49.9 million and after taking into account the final costs associated with the abandoned float and the sale, as advised to audit, of around \$2.7 million.

Statewide Mobile Radio Network and Vistel

4.159 In mid-1992, the Government commenced the establishment of a Statewide mobile radio (SMR) network predominantly for use by the Victorian emergency service organisations and other government agencies. The infrastructure of the SMR network, which is valued in the order of \$43 million, mainly consists of network equipment, computers, radios, software and communications towers located at around 130 sites throughout the State. Under the established arrangements, the network was constructed and operated on the Government's behalf by Telstra Corporation Limited under a 10 year contractual arrangement, with the equipment leased by the State from the private sector over a 6-7 year period. The administrative responsibility for the SMR network rested with the Department of Treasury and Finance.

ASSET SALES

4.160 In August 1994, the Government decided to commence action to divest the SMR business, to position the State to:

- take advantage of the increasing competition within the telecommunications market;
- avoid the risk of further capital injections to complete the development of the SMR network infrastructure, estimated at approximately \$7 million; and
- eliminate the risk of future operating losses.

4.161 In addition, the Government in 1993 determined to initiate action to sell Vistel Limited, which was established in 1987 as a State-owned company to provide telephone and PABX (switchboard) facilities to government departments.

Sale process

4.162 In 1994, the Budget and Economic Review Committee of the Cabinet approved the establishment of a competitive process for the proposed sale of Vistel. However, the former Department of Business and Employment favoured the sale of the business to Telstra, which was consistent with a previously established *Strategic Alliance Agreement* between the company and the Government which was aimed at developing closer working relationships between the respective parties and strengthening telecommunications activity within the State. Subsequently, it was agreed by the Department of Treasury and Finance that unless Telstra presented an exceptional offer, a tender process would be more appropriate for the sale of Vistel.

4.163 In December 1994, Telstra submitted an initial indicative offer for the purchase of Vistel and the SMR network which included the following key elements:

- a price of \$4.2 million for the sale of Vistel's assets and business;
- 5 year customer service agreements to be established between Telstra and the existing Victorian public sector agencies contracted to Vistel;
- a financial evaluation to be undertaken by Telstra by the end of January 1995 to assist in determining an appropriate price for the acquisition of SMR's assets and liabilities; and
- the Bureau of Emergency Services and Telecommunications to be required to use the SMR network to service its radio communications needs.

ASSET SALES

4.164 In February 1995, the former Department of Finance received the following valuations from its financial advisors for the SMR network and the Vistel business:

- Based on the projected future revenues of the SMR network, the business was valued of between \$9 million and \$11 million to Telstra and between \$5 million and \$7 million to a third party. The higher valuation of the business to Telstra reflected that company's lower cost structure and its extensive infrastructure and personnel already in place. However, the advisors also considered that, based on the SMR network's financial performance, the business had a nil value to Telstra and possibly a negative value of between \$5 million to \$7 million to a third party; and
- Based on the price-earnings multiples for Vistel, the preliminary valuation of that business was in the order of \$4 million to \$5 million. However, its value on the basis of discounted cash flows was between \$12 million to \$14 million.

4.165 The Department's advisors recommended that exclusive negotiations commence with Telstra with a view to securing an up-front sale price for the SMR network of between \$9 million and \$11 million and that a detailed valuation of Vistel be conducted. Subsequently, Telstra was advised that the State did not intend to seek expressions of interest for the sale of the SMR business from other purchasers prior to May 1995, and then only if an in-principle agreement had not been reached with Telstra.

4.166 In May 1995, Telstra submitted an indicative proposal for the joint purchase of the SMR network and Vistel, indicating that significant benefits would accrue to the State from the direct negotiation of a commercial sale agreement with the company. In June 1995, the Department's advisors notified Telstra that, while its offer was considered inadequate, the State was prepared to proceed with the sale on the basis of the initial bid price.

4.167 Following the completion of due diligence inquiries by Telstra in July 1995, the company submitted a revised proposal for the acquisition of the SMR network and Vistel. The key elements of the revised proposal included:

- An \$11.75 million cash purchase price for SMR network's business assets and working capital, and Vistel's assets and creditors, excluding all other liabilities and surplus cash. However, the offer was to be adjusted to take account of any movement in the value of Vistel's business assets from June 1994 to the proposed sale completion date. The proposed purchase price was broadly allocated between the SMR network and Vistel at \$3.5 million and \$8.25 million, respectively;
- Establishment of service contracts for a period of at least 7 years between the SMR network and the Victoria Police, the former Department of Conservation and Natural Resources, and the disaggregated electricity entities;
- Telstra to assume responsibility for the SMR network's existing finance leases;
- Telstra to invest funds in the order of \$20 million over a 10 year period to upgrade the SMR network;

ASSET SALES

- The State to enter into a 5 year contract with Vistel for the provision of communications services at a level comparable with the existing service level;
- A revenue sharing arrangement between Telstra and the State; and
- A royalty arrangement between Telstra and the State, to enable the State to participate in any earnings which are in excess of Telstra's expectations, for a period of 5 years.

4.168 Following an assessment of this proposal, in July 1995, the Department's financial advisors recommended that a directly negotiated trade sales with Telstra should be pursued in relation to the 2 businesses. Table 4E shows the indicative valuations for the businesses determined by the financial advisors in August 1995, based on discounted future cash flows, under 3 scenarios, including the continued ownership of the businesses by the State, the sale of the businesses to a third party and the sale of the businesses to Telstra on the basis of the July 1995 proposal.

TABLE 4E
VALUATION RANGES OF THE SMR NETWORK AND VISTEL
(\$million)

<i>Business</i>	<i>Valuation based on continued State ownership</i>	<i>Valuation based on private sector purchaser</i>	<i>Valuation of Telstra proposal</i>
SMR Network	10.6 to 13.2	1.7 to 3.6	12.5 to 13.6
Vistel	6.6 to 7.1	4.2 to 4.5	8.2

4.169 Based on the above valuation, the advisors concluded that Telstra's offer for the purchase of both the SMR network and Vistel was higher than the value of the businesses to the Government if it retained ownership. In addition, it was considered unlikely that any other third party would be prepared to match Telstra's offer in the event that the businesses were offered for sale by competitive tender, either individually or jointly. Accordingly, it was recommended to the Department that negotiations continue with Telstra for the sale of the businesses by private treaty. Consequently, in September 1995, Cabinet approved the sale of the SMR network and Vistel to Telstra, subject to the satisfactory completion of negotiations.

4.170 In January 1996, the State and Telstra entered into a Memorandum of Understanding, under which Telstra agreed in-principle to the acquisition of the businesses.

ASSET SALES

Sale arrangements

4.171 In June 1996, the State agreed to sell the SMR network and Vistel to Telstra for \$1.55 million and \$8.45 million respectively. The sale price was subject to adjustment, based on the final value of the net assets sold. In relation to the sale of the SMR network, the State is entitled to receive a further maximum payment of \$3.5 million under a revenue sharing arrangement.

4.172 The key provisions of the sale agreement and the customer agreements between Telstra and Victorian public sector agencies included:

- proceeds of \$1.55 million for the sale of the SMR network, paid to the State in July 1996;
- a revenue sharing arrangement relating to the SMR business, under which the State is entitled to an aggregate maximum payment of \$3.5 million, in present value terms;
- an agreement by Telstra to invest \$20 million for the continued enhancement of the SMR network over the next 10 years;
- a 7 year service agreements between Telstra and Victoria Police and the Department of Natural Resources and Environment for use of the SMR network;
- novation of lease agreements for the equipment used in the SMR network to Telstra;
- proceeds of \$5.45 million paid to Vistel in July 1996 for the acquisition of its business, with the final sale price subject to any variations in the final value of certain assets and liabilities sold;
- the State to be entitled to additional Vistel *contingency* payments of \$1.5 million in July 2000 and \$1.5 million in July 2001, if the existing public sector customers of Vistel do not terminate their service agreements prior to the due date for these payments; and
- a 5 year agreement between Telstra and the Minister for Finance, for the provision of communication services to the Victorian public service at sites previously serviced by Vistel.

4.173 Under the sale agreement, the State is entitled to *buy back* the SMR network at its fair market value, in the event that Telstra fails to rectify any major service default in the future.

4.174 However, certain indemnities and warranties have been provided to Telstra which may expose the State to future liabilities. The maximum aggregate amount that Telstra may recover from the State for a breach of any warranties provided for the sale of the SMR network is \$5 million plus the value of any other fees paid by Telstra to the State for the use of a SMR site for another purpose. The maximum aggregate amount that Telstra may recover from the State for a breach of any warranties provided in relation to the sale of Vistel is \$8.45 million. Any claims in relation to these warranties and indemnities must be lodged within 2 years from the date of sale completion or, in relation to the non-performance by the State of a continuing obligation, within 2 years from the date of the breach or expiration of the obligation.

ASSET SALES

Application of sale proceeds

4.175 In July 1996, the Consolidated Fund received \$8 million from TelVic (formerly Vistel Limited), representing the return of capital, accumulated profits and proceeds from the sale of the Vistel business. The company has retained approximately \$600 000 to cater for its ongoing requirements prior to it being wound up, with any surplus funds required to be paid to the Consolidated Fund. In addition, **in August 1996, Telstra paid \$1.3 million to the State on account of an adjustment to the Vistel sale price for the final value of net assets acquired.**

4.176 The SMR working account within the Trust Fund, as at the date of preparation of this Report, held a balance of \$3 million, comprising the proceeds from the sale of the SMR network and a refund of a prepayment by the State of \$1.5 million relating to the lease of SMR network equipment. It was anticipated by the Department of Treasury and Finance that the balance of the account, after considering any expenses incurred, will be paid into the Consolidated Fund by October 1996.

Assessment of sale

4.177 Analysis of the sale result indicated that:

- The aggregate cash proceeds of \$12.3 million to be received by the State for the sale of Vistel were comparable with a February 1995 valuation of the business which set its value between \$12 million and \$14 million. The cash proceeds receivable by the State include:
 - \$8 million paid into the Consolidated Fund in July 1996, funded by the sale proceeds of \$5.45 million and surplus cash accumulated by Vistel;
 - the State's entitlement to a Vistel *contingency* payment of \$1.5 million in July 2000 and \$1.5 million in July 2001; and
 - a payment in favour of the State of \$1.3 million on account of the final value of Vistel net assets acquired by Telstra.
- **The cash proceeds to the State for the sale of the SMR network of \$1.5 million were considerably less than the February 1995 valuation of the business of between \$9 million and \$11 million. In addition, the cash proceeds were \$2 million less than Telstra's July 1995 offer of \$3.5 million for the purchase of the network.**

4.178 Audit was advised that the reduced cash proceeds for the SMR network was also due to the Government's non-acceptance of the following components of Telstra's earlier offers:

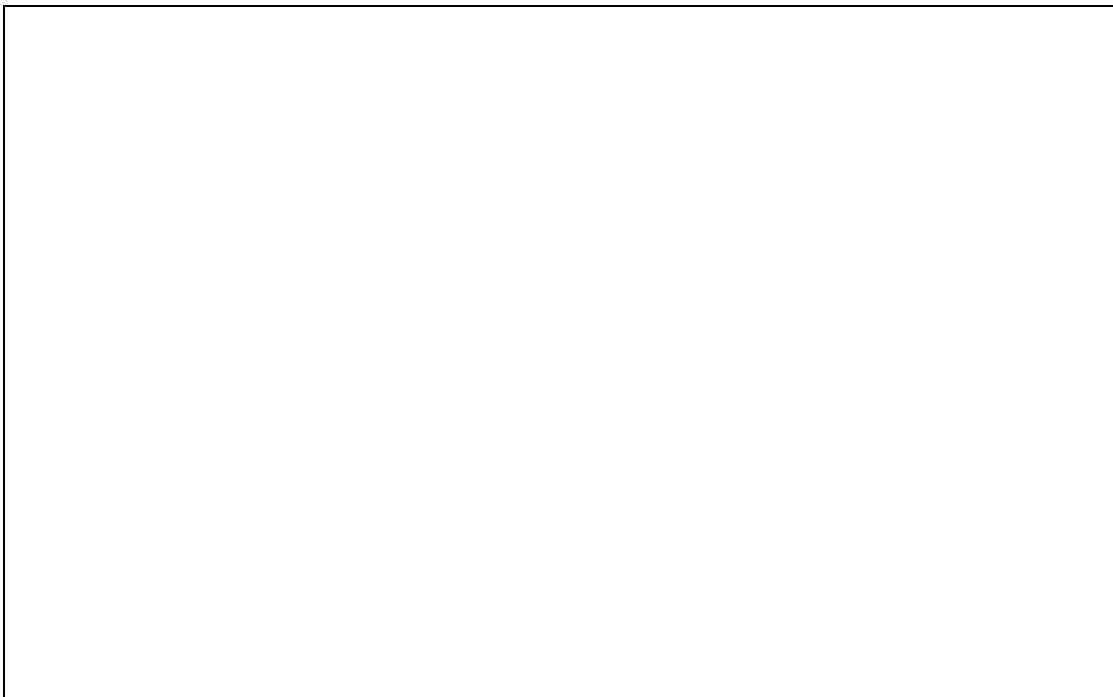
- a requirement for the electricity businesses to enter into service agreements for the use of the SMR network; and
- provision of a right to Telstra to build, upgrade or consolidate the State's emergency services joint telecommunications radio network in the event that it requires access to a high capacity mobile voice and data service.

4.179 However, the lower sales result for the SMR network is offset by Telstra's commitment to fund capital works of \$20 million on the network and the State's entitlement to share in SMR network revenues of up to \$3.5 million, in present value terms.

ASSET SALES

Northcote bus depot

4.180 In 1983, the then Metropolitan Transit Authority initiated a program involving the acquisition of properties bordering its North Fitzroy bus depot to enable the expansion of the existing bus maintenance workshop facilities and staff amenities. However, the Authority subsequently discovered that the proposed depot site was not zoned for such a development and the then Council of the City of Fitzroy was not prepared to amend the planning regulations. As a consequence, **in June 1983, the Authority acquired another site, being a semi-industrial site at Beavers Road, Northcote for \$310 000** and commissioned the construction of a new bus depot, with an anticipated completion date of mid-1985. **The development of the new depot was finally completed in June 1990 at a total cost of \$12.5 million.**



Former Northcote bus depot.

4.181 In early 1994, as part of the current Government's transport reforms, the Northcote bus depot, which had a book value of \$13.7 million as at July 1994, was declared surplus to operational requirements by the Minister for Transport. In July 1994, a private valuation commissioned by the Public Transport Corporation (the successor body to the Metropolitan Transit Authority) valued the property, including building improvements, at \$1.7 million.

4.182 To prepare the site for disposal, certain plant and equipment valued at approximately \$243 000 was relocated to other depot sites. The remaining plant and equipment was sold by the Corporation at a public auction for \$207 000. Responsibility for the vacant depot was then transferred to the Department of Treasury and Finance for disposal.

ASSET SALES

4.183 The land site and building improvements were valued at \$3.25 million by the Valuer-General in October 1994. This valuation reflected the fact that, while the bus depot was designed and constructed to a high quality standard, the complex was nevertheless purpose built as a bus depot and located in a secondary industrial area. Therefore, the Valuer-General considered that the site was over-capitalised. A subsequent valuation by a private valuer in November 1994 assessed the value of the site at \$2.5 million and concurred with the opinion provided by the Valuer-General that the site was over-capitalised, given the restricted access to the site through residential streets and its previous use as a bus depot.

4.184 In December 1994, the property was offered for sale by public auction. However, it was passed in at \$3 million, which was below the reserve price of \$3.25 million set by the Valuer-General.

4.185 In April 1995, following the receipt of a formal offer to purchase the property for a price of \$2.3 million, the Valuer-General was requested by the Department of Treasury and Finance to re-assess the previous property valuation. Subsequently, the Valuer-General advised that the offer should not be accepted, however, the valuation should be reviewed if the Department received any subsequent offers of \$2.5 million or above. Following the receipt of a subsequent offer of \$2.5 million from a different party in August 1995, the Valuer-General revised the property's valuation to this amount. While the Valuer-General did not identify the reasons why the property valuation had declined since the previous valuation of \$3.25 million in October 1994, the Department advised that the movement reflected the changed property market conditions prevalent at that time.

4.186 The above offer was accepted and the site was sold in September 1995 for \$2.5 million, with the sale proceeds paid into the Consolidated Fund. Costs incurred by the Department of Treasury and Finance in relation to the sale of the property totalled \$37 000.

4.187 An analysis of the sale result indicated that:

- the total proceeds of \$2.7 million from the sale of the property and plant and equipment were \$10.8 million less than the estimated book value of these assets as at July 1994; and
- while the sale price for the property was consistent with the final valuation provided by the Valuer-General, it was \$500 000 less than the amount that the property was passed-in at auction in December 1994.

ASSET SALES

Bundoora/Mont Park precinct properties

4.188 During 1995-96, the Urban Land Authority acquired from the Department of Treasury and Finance certain surplus properties located at the Bundoora/Mont Park precinct, for residential development under the Commonwealth Government's *Building Better Cities Program*. These properties were formerly utilised by the Commonwealth-owned Bundoora Repatriation Hospital and the State-owned Janefield Training Centre.

Bundoora Repatriation Hospital site

4.189 In July 1995, the State exercised an option to purchase the site of the former Bundoora Repatriation Hospital located at Plenty Road, Bundoora, for \$31 000. Collectively, these land parcels comprised an area totalling approximately 45 hectares. The option for the State to purchase was contained in an agreement established in 1930 between the State and the Commonwealth Government's former Repatriation Commission.

4.190 As part of the sale agreement, the Department of Treasury and Finance agreed to the following special conditions in relation to the future development of the site:

- 7 500 square metres of land to be granted to Vasey Housing Ltd, an organisation providing housing facilities to veterans and their families, which occurred in August 1995. The company was also to be provided with an option to purchase a further area of approximately 8 000 square metres of land;
- The Urban Land Authority to be given first option to become the responsible authority for the management, development and release of the land;
- The development of the land to be undertaken in accordance with the Better Cities Agreement between the Commonwealth and the State; and
- The State to acknowledge the heritage significance of the J.V. Smith homestead located on the site.

4.191 In November 1995, the Minister for Finance authorised the transfer of the above site to the Urban Land Authority in exchange for consideration of \$7 million, which was consistent with an August 1995 Valuer-General's valuation of the property. Under the terms of the agreement, a deposit of \$700 000 was paid into the Consolidated Fund in November 1995, with the balance of the purchase price of \$6.3 million paid in January 1996. Under the terms of the agreement, the Authority agreed to comply with the special conditions of sale which were originally stipulated under the initial sale agreement between the Commonwealth and the State.

ASSET SALES

Janefield Training Centre site

4.192 In July 1991, the former Department of Health and Community Services identified approximately 110 hectares of land and associated buildings relating to the Janefield Training Centre at Plenty Road, Bundoora, as surplus to operational requirements. In December 1991, in preparation for the development of the site, the reservation of the property for the Centre's operations was revoked. A portion of the property was also permanently reserved for the conservation of natural interests.

4.193 Following the finalisation of planning requirements and community consultation, in November 1995, the Minister for Finance transferred the above site to the Urban Land Authority in exchange for consideration of \$10.5 million, which was consistent with a July 1995 Valuer-General's valuation of the property. Under the terms of the agreement, a deposit of \$1 million was paid into the Consolidated Fund in November 1995, with the balance of the purchase price payable as follows:

- \$9 million payable to the Consolidated Fund in January 1996;
- \$250 000, together with interest on the balance of the purchase price of \$500 000, payable to the Consolidated Fund in April 1996; and
- \$250 000 to be paid in January 1997 or earlier, together with an interest component calculated on this amount as from January 1996.

4.194 The total contribution to the Consolidated Fund from the transfer of these properties to the Urban Land Authority in 1995-96 was \$17.3 million. In addition to these proceeds, in 1995-96, the Consolidated Fund received a \$30 million contribution from the Urban Land Authority in relation to the Federation Square project, which is discussed in Part 6 of this Report.

ASSET SALES

Sale and development of Cathedral Place

4.195 My October 1995 Report on the Statement of Financial Operations commented on the sale and associated development of Cathedral Place, comprising a number of properties located at 33-61 Cathedral Place, 68-100 St Andrew's Place and 14-20 Parliament Place, East Melbourne.

4.196 The development, which is expected to be completed in December 1997 at an estimated total cost of \$100 million, will comprise a 240 suite hotel complex, an 845 space underground car parking facility (with 400 spaces reserved for leasing to the Government for a period of 10 years at market rates) and the construction of a palliative care facility for the Inner and Eastern Health Care Network, at the former Peter MacCallum Cancer Institute.

4.197 At the time of preparation of my previous Report to the Parliament, the sale arrangements between the Urban Land Authority and the developer had not been finalised and therefore details of settlement amounts and property valuations were not disclosed.

Sale result

4.198 Under the sale arrangements, total proceeds of \$6.8 million were received by the Authority, as follows:

- a deposit of \$50 000 paid in March 1995; and
- the balance of \$6.8 million paid in August 1996, including a penalty interest payment of \$216 000 for the delay of the settlement from May 1996 to August 1996.

4.199 Of the total sale proceeds, \$2.8 million was paid into the Consolidated Fund, with the balance of \$4 million retained by the Authority to recoup the costs of property acquisition, management and sale.

4.200 An analysis of the sale result indicated that the total proceeds of \$6.8 million for the site, together with the provision by the developer to the Inner and Eastern Health Care Network of palliative care hospital accommodation and training facilities valued at \$10 million, compare favourably with a Valuer-General valuation of the property of \$10 million at June 1995.

ASSET SALES

Educational properties

4.201 In recent years, the disposal of surplus educational properties by the Directorate of School Education and the Department of Treasury and Finance has been a major component of the Government's asset sales program. During the 1995-96 financial year, \$73.1 million was paid into the Consolidated Fund from the disposal of 380 surplus properties and settlements relating to the prior year property sales.

4.202 Audit examination of a number of property sales completed during the year revealed that the proceeds realised from the sales were generally in excess of valuations and reserve prices assigned to the respective properties. **At 30 June 1996, 85 properties valued at approximately \$17 million had been identified as surplus to present requirements and were awaiting sale.**

Identification of surplus property assets

4.203 For many years, a key element of the Government's asset management program has been the disposal of surplus and underutilised property assets. Since the commencement of the program in 1986-87, the Government has raised proceeds of about \$1.2 billion from the sale of such properties.

4.204 According to departmental records, at 30 June 1996 approximately 2 670 properties with an aggregate value of \$136 million (30 June 1995, \$205 million) had been identified as surplus to government requirements and were awaiting sale. Table 4F shows the periods in which these assets were identified as surplus to requirements and approved for sale.

TABLE 4F
ASSETS AWAITING SALE,
AT 30 JUNE 1996
(\$million)

<i>Year approved for sale</i>	<i>Estimated value</i>
Prior to 1990-91	11.9
1990-91	17.5
1991-92	16.4
1992-93	16.6
1993-94	21.1
1994-95	28.4
1995-96	24.2
Total	136.1

ASSET SALES

4.205 According to the Department of Treasury and Finance, the key reasons for the delay in the sale of these assets were:

- poor quality of assets within the portfolio;
- low demand for development properties;
- the ongoing depressed state of the property market; and
- unavoidable delays in the preparation of certain property titles and the finalisation of related legal matters.

4.206 The Government estimates that the disposal of certain of these surplus property assets in 1996-97 will generate revenue of \$97 million to the Consolidated Fund.

PART 5

Consolidated Fund Receipts



**VICTORIAN
AUDITOR-
GENERAL'S
OFFICE**

*Auditing in the
Public Interest*

CONSOLIDATED FUND RECEIPTS

Summary of financial transactions

5.1 The Consolidated Fund gross receipts for the year totalled \$20.7 billion, which was \$4.9 billion above budget expectations. The major factor contributing to this positive outcome was the receipt of \$4.8 billion from the sale of a number of substantial State-owned enterprises, including 5 electricity distribution companies, an electricity generation company and a gas exploration company, which were not included in the budget estimates. These proceeds were mainly applied towards the retirement of budget sector debt.

5.2 When the privatisation proceeds are excluded, the Consolidated Fund receipts were \$134 million better than budget estimates. The key factors contributing to this favourable budgetary outcome were higher than expected taxation receipts (\$123 million) and increased proceeds from property and equipment sales (\$30 million). However, these increased collections were to an extent offset by lower than anticipated receipts from the Commonwealth Government (\$13 million) and receipts from public bodies relating to the repayment of loans and advances (\$21 million).

5.3 The year's gross receipts, excluding the proceeds from privatisation, were \$466 million higher than the level achieved in the previous year. This result mainly reflects the impact of increased receipts from the Commonwealth Government (\$360 million) and higher taxation revenues (\$340 million), offset by reduced receipts relating to the recoup of superannuation levies (\$280 million) and from the sale of property and equipment assets (\$31 million).

5.4 Table 5A provides a summary of the receipts (excluding borrowings) of the Consolidated Fund for the year.

TABLE 5A
BUDGETED AND ACTUAL CONSOLIDATED FUND RECEIPTS
(\$million)

<i>Item</i>	<i>1994-95 Actual (a)</i>	<i>1995-96 Actual</i>	<i>1995-96 Budget (b)</i>	<i>Variance from Budget</i>	<i>Variance from 1994-95 Actual</i>
Recurrent -					
Taxation	7 547	8 188	7 764	424	641
Commonwealth	4 867	5 239	5 236	3	372
Public authorities	775	1 632	809	823	857
Other	1 282	1 063	1 058	5	(219)
Total recurrent	14 471	16 122	14 867	1 255	1 651
Works and services -					
Commonwealth	507	495	511	(16)	(12)
Sale of assets	214	183	153	30	(31)
Other	965	3 945	303	3 642	2 980
Total works and services	1 686	4 623	967	3 656	2 937
Total receipts (excluding borrowings)	16 157	20 745	15 834	4 911	4 588

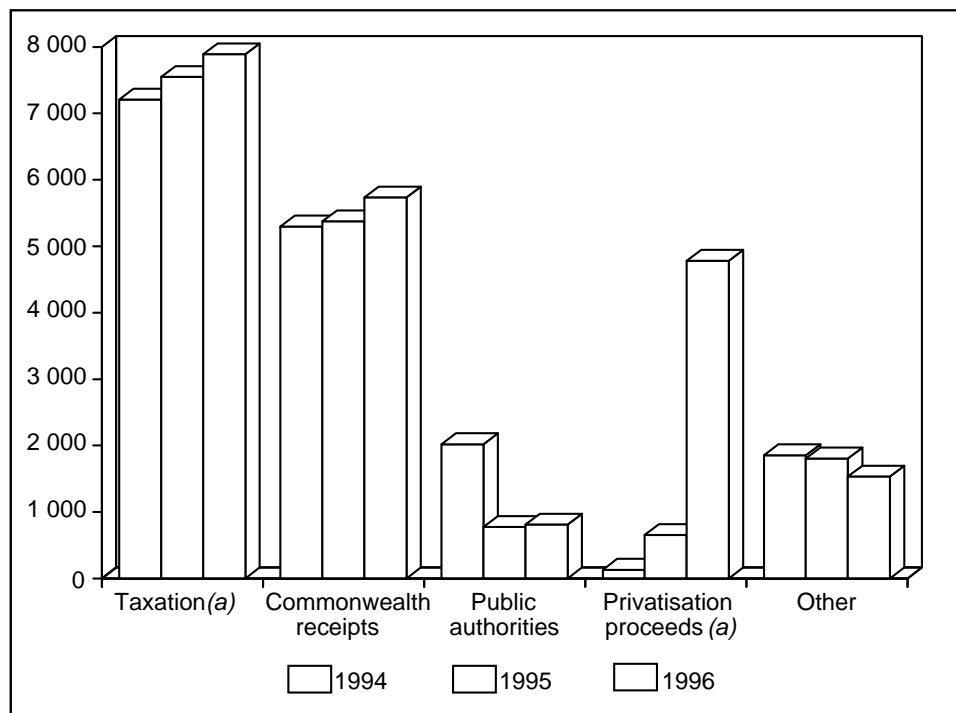
(a) 1994-95 comparatives have been adjusted to reflect the reclassification of certain items in 1995-96.

(b) Budget Estimates, 1995-96 Budget Paper No. 3.

CONSOLIDATED FUND RECEIPTS

5.5 The major revenue sources of the Consolidated Fund for the year comprised taxation receipts, grants and contributions from the Commonwealth Government, dividends and tax equivalent payments from public authorities, and proceeds from privatisation. Chart 5B shows the contribution of the above revenue sources to Consolidated Fund revenue over the past 3 years.

CHART 5B
MAJOR SOURCES OF CONSOLIDATED FUND
RECEIPTS, 1993-94 TO 1995-96
 (\$million)



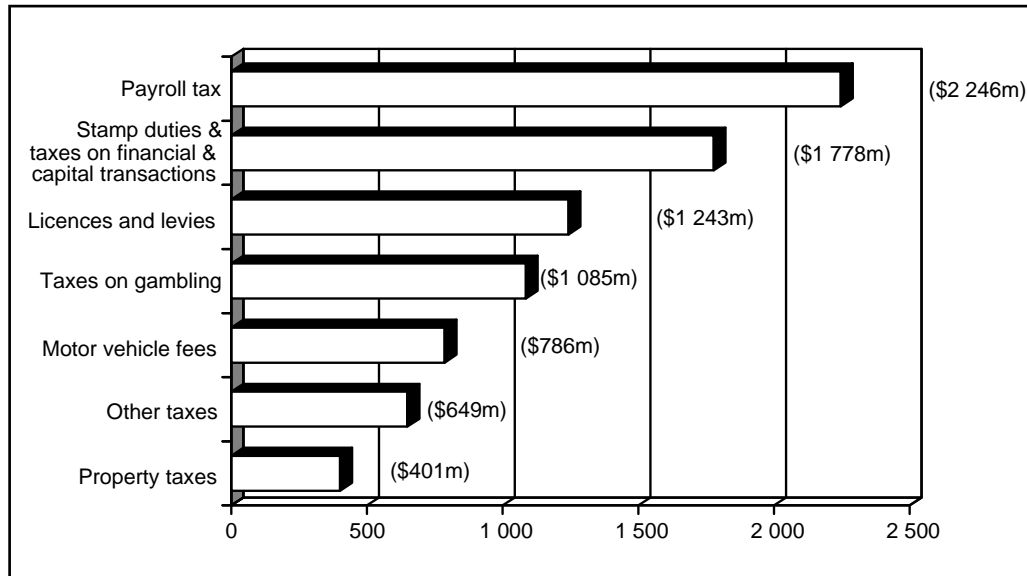
(a) Privatisation proceeds for 1995-96 include \$816 million of related public authority contributions and \$301 million of related taxation receipts.

Taxation revenue

5.6 Taxation receipts are the largest source of government revenue and principally comprise payroll tax, various stamp duties and taxes on financial and capital transactions, taxes on land holdings and gambling activities, motor vehicle fees, and other licences and levies. **In 1995-96, taxation receipts including those related to privatisation totalled \$8.2 billion (1994-95, \$7.5 billion), representing 39 per cent of total Consolidated Fund revenues.** Chart 5C illustrates the key taxation categories.

CONSOLIDATED FUND RECEIPTS

CHART 5C
KEY TAXATION CATEGORIES
 (\$million)



5.7 As highlighted in my previous Report on the Statement of Financial Operations and in the Government's 1995-96 *Budget Papers*, Victoria's revenue raising effort from taxation was above that of the other 3 largest States, namely, New South Wales, Queensland and Western Australia, which has impacted adversely on the State's competitiveness.

5.8 To address this unfavourable situation, the Government has established as one of its 4 longer-term budget aims "... to bring Victoria's overall tax effort into closer alignment with the average of the Australian States", with the first step towards the achievement of this objective being to reduce Victoria's business taxes to the levels of New South Wales at a cost of around \$400 million to the budget. During 1995-96, a number of tax reduction measures were introduced, including the abolition of the State Deficit Levy as from 1 July 1995 at an estimated cost of some \$172 million.

5.9 In the May 1996 *Autumn Economic Statement*, the Government outlined various measures currently under investigation to achieve sufficient expenditure savings to absorb reduced taxation levels. These included the re-engineering of service delivery functions, increased contestability between alternative service providers and cost reduction, particularly in the areas of accommodation, vehicle operations, superannuation, insurance and workers compensation.

CONSOLIDATED FUND RECEIPTS

5.10 However, in the 1996-97 *Budget Papers*, the Government announced that due to the impact of the Commonwealth Government's deficit reduction program on the State's finances, further consideration of planned tax relief has been deferred. In particular, the Victorian Government announced that it has decided to fund its *fiscal contribution* to the Commonwealth, estimated at \$153 million in 1996-97, through the use of expenditure savings that were previously earmarked for tax relief. In the Budget Papers it was also identified that, with some other States funding their contribution through increased taxes, the gap in the level between Victorian and other States' taxes has narrowed. In particular, the Department of Treasury and Finance estimates that Victorian taxes are now only 4.3 per cent above those of New South Wales.

Major variances

5.11 As indicated in Table 5A, **taxation receipts in 1995-96 were \$424 million above the budget estimate and \$641 million higher than the previous year.** Table 5D details the major items contributing to this favourable outcome.

TABLE 5D
TAXATION VARIATIONS
(\$million)

<i>Revenue sources</i>	<i>1994-95 Actual</i>	1995-96 Actual	<i>1995-96 Budget</i>	Variance from Budget	Variance from 1994-95 Actual
Land transfers stamp duties	635	896	675	221	261
Electronic gaming machines	384	509	440	69	125
Marketable securities stamp duties	195	149	115	34	(46)
Payroll tax	2 080	2 246	2 215	31	166
Other taxes on financial and capital transactions	130	164	135	29	34
Casino taxes	68	110	83	27	42
Public authority contribution (Gas and Fuel)	309	328	309	19	19
Tobacco licences	417	569	558	11	152
State Deficit Levy	179	7	5	2	(172)

5.12 The key factors contributing to the major taxation variations, as advised by the Department of Treasury and Finance, were as follows:

- *Land transfers stamp duties* - higher collections mainly relate to the privatisation of State-owned electricity businesses;
- *Electronic gaming machines* - higher than expected turnover per machine combined with a substantial increase in the number of machines and the first year gaming licence fee payments from Tattersall;
- *Marketable securities stamp duties* - higher than expected financial market activity, partly offset by a 50 per cent reduction in the rate of duty applicable to marketable securities listed on the Australian Stock Exchange;

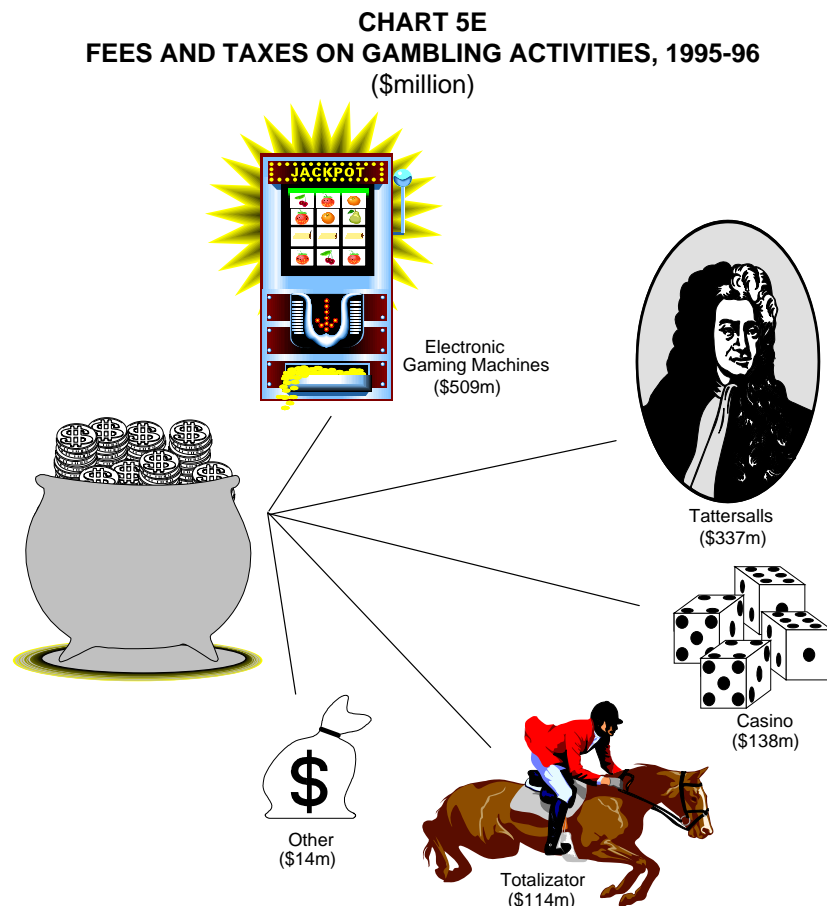
CONSOLIDATED FUND RECEIPTS

- *Payroll tax* - stronger than forecast growth in employment levels;
- *Other taxes on financial and capital transactions* - mainly due to the collection of mortgage stamp duties relating to the privatisation of State-owned business enterprises;
- *Casino taxes* - receipt of full year of taxes in 1995-96 compared with 11 months in the previous year, higher than expected gambling activity and the receipt of an additional licence fee stream arising from Crown Casino expansion;
- *Public authority contribution (Gas and Fuel)* - higher than forecast domestic gas consumption;
- *Tobacco licences* - increase in the franchise fee rate from 75 per cent to 100 per cent of the wholesale value of tobacco sold, as from 1 July 1995; and
- *State Deficit Levy* - abolition of the levy as from 1 July 1995.

Gambling fees and taxes

5.13 Fees and taxes collected in relation to gambling activities conducted within the State represent a significant component of Consolidated Fund revenue. The major sources of such revenue include fees and taxes levied on electronic gaming machine operations, private lotteries, racing and casino operations. **During 1995-96, the total receipts of the Consolidated Fund from gambling activities totalled \$1.1 billion.**

5.14 Chart 5E illustrates the contribution of the major gambling activities to Consolidated Fund revenues during the year.



CONSOLIDATED FUND RECEIPTS

5.15 Tattersall Sweep Consultation, a private sector organisation, was granted a licence to conduct lotteries within Victoria for the period up to 30 June 2002. The duty payable by Tattersall on private lottery operations ranges from 35 per cent to 36 per cent, depending on the value of lottery subscriptions sold. Also, under a profit sharing arrangement between the State and Tattersall, a payment of 25 per cent of the net profit earned by Tattersall is paid to the Consolidated Fund and an additional levy of 10 per cent of its net profit is paid to the Lotteries Development Fund, within the Trust Fund. The remaining profit share to Tattersall is limited to 1.5 per cent of lottery turnover, with any excess profit divided equally between the Consolidated Fund and the Lotteries Development Fund. **During 1995-96, an amount of \$337 million was paid into the Consolidated Fund from taxes on private lotteries.** Moneys paid into the Lotteries Development Fund are used to finance the marketing and promotion of lotteries.

5.16 Electronic gaming machine activity, outside of the Crown Casino, is conducted by 2 gaming operators, namely, Tattersall Sweep Consultation and TABCORP Holdings Ltd. The difference between the total amounts wagered and the prizes paid, representing the *net cash balance*, is split equally between the venue operator, the gaming operator and the State in relation to clubs. In the case of hotel venues, the operator receives 25 per cent of the net cash balance and 8.3 per cent is directed to the Community Support Fund. The Act provides that not less than 87 per cent of machine turnover must be returned to the players as prize money. **During 1995-96, the Consolidated Fund received \$509 million from electronic gaming machine operations, which includes a payment of \$31.7 million for the Tattersall gaming licence,** which is discussed in greater detail later in this Part of the Report.

5.17 TABCORP Holdings Ltd has been granted an exclusive licence to run off-course totalizators and is authorised to run on-course totalizators at racecourses. The licence has been granted for an 18 year period to 2012 under the *Gaming and Betting Act* 1994. Under the provisions of the Act, TABCORP is able to determine the commission (up to a limit of 20 per cent) that it may deduct out of the amount invested by punters for each totalizator. However, not less than 84 per cent of the amounts wagered must be returned to punters in prize money from all totalizators. **During 1995-96, the Consolidated Fund received \$114 million from totalizators and approved betting competitions.**

5.18 The *Casino (Management Agreement) Act* 1993 sets out the manner in which payments are made by Crown Casino to the State. Currently, a 20 per cent taxation rate on gross gaming revenue applies for regular players and 9 per cent for commission players. However, the rate for regular players will rise to 21.25 per cent as from 1 July 1997, to coincide with the elimination of the casino supervision and control charge of \$5 million, which is payable until 30 June 1997. Furthermore, the casino operator is required to pay a one per cent community benefit levy, based on gross gaming revenue from all players. In addition to the above payments, a fixed payment of \$200 million was made in 1993-94 when the casino licence was granted, with subsequent monthly payments of \$2.4 million payable by Crown to the State up until July 1996. **During 1995-96, an amount of \$139 million was collected by the Consolidated Fund from casino operations.**

CONSOLIDATED FUND RECEIPTS

5.19 Audit analysis identified that the significance to the Consolidated Fund of revenues derived from gambling activities has substantially increased in recent years, mainly due to the introduction of electronic gaming machines within the State in 1992-93 and the opening of the casino in June 1994. In particular, the proportion of gambling fees and taxes to total State-sourced receipts (excluding privatisation proceeds) has increased from 7 per cent in 1991-92 to 11 per cent in the 1995-96 financial year.

5.20 During 1995-96, the Government approved the revision of the casino licence and issued a new licence to Tattersall for the conduct of gaming activities in the State, which contributed additional revenue to the State in the year.

Crown Casino licence

5.21 My May 1996 *Report on Ministerial Portfolios* commented on the Government's decision to allow a casino to operate in Victoria and the approval, in November 1993, to grant a licence to Crown Limited to operate the casino in Melbourne for a fee of \$200 million, with additional taxation of \$57.6 million payable over a 3 year period.

5.22 As also commented in that Report, in July 1995, under the provisions of the *Casino Control Act 1991*, Crown Limited sought approval to:

- increase the number of gaming tables in the new casino from 200 to 350, and the gaming machines from 2 500 to 3 500; and
- amend the taxation arrangements in respect of commission-based players.

5.23 The Victorian Casino and Gaming Authority engaged a consultant to review the revenue projections relating to the operation of the additional gaming tables and gaming machines, and the likely impact on the profitability of the casino operator and the taxation revenues to be raised by the State from the casino. The consultant's report concluded that, if the request was approved, it would provide Crown with increased monopoly rights and that an additional licence payment should be made for those rights.

5.24 Consistent with the consultant's recommendation, the Authority agreed to increase the maximum number of gaming tables from 200 to 350, on the condition that an agreement was to be reached between the Government and Crown as to the appropriate licence fee. However, the request by Crown to increase the number of gaming machines was not approved.

5.25 The consultant recommended that an additional 150 gaming tables should result in a licence payment within the range from \$51 million to \$69 million, which would have resulted in the State receiving around 31 per cent of the after tax earnings generated from the additional tables. However, in order to determine an appropriate licence fee for the additional gaming tables, the Treasurer sought advice from the Department of Treasury and Finance.

CONSOLIDATED FUND RECEIPTS

5.26 In its review of this matter, the Department estimated that the stream of projected earnings to be generated from the additional 150 tables was between \$194 million and \$259 million (in present value terms), after taking into account a rate of return to the owners, consistent with that generated by Crown under the original licence fee. However, following the examination of various options, the Department recommended to the Treasurer that the additional licence fee should be calculated on half of the lower-end of the earnings range of \$190 million and discounted by \$10 million, arriving at a recommended licence fee of \$85 million.

5.27 The Department's recommendation was accepted by the Treasurer and, in October 1995, the Government's management agreement with Crown was amended to incorporate the following changes:

- additional payments of \$101 million to be made by Crown for the extra gaming tables by way of monthly payments of \$2.8 million for 3 years, commencing in January 1996 (\$85 million in present value terms);
- a tax rate ranging from 10 per cent to 22.5 per cent in respect of commission-based players to be introduced to provide a rate competitive with overseas and interstate casinos, so that Crown may attract high net worth patrons to Melbourne;
- a contribution of \$1 million a year to be made by Crown to Tourism Victoria for a period of 5 years, from November 1995, to enable the latter to expand its marketing program for the State; and
- the completion date for the construction of the Casino to be extended to November 1996 and a payment of \$5.3 million to be made to the State during the 1995-96 financial year, representing compensation for loss of revenue to the State caused by the delays in construction.

5.28 In respect of the Department's calculation of the additional licence fee, my May 1996 Report to the Parliament included the following observations:

- The consultant recommended taking the higher end of the licence fee ranges provided, as these amounts were based on more accurate estimates of the revenues and expenses likely to be generated from the additional tables. If this recommendation had been accepted by the Government, the licence fee would have been based on the projected earnings from the additional tables of \$259 million rather than \$190 million;
- Given that the estimated profits were calculated after providing for a return to the owner, they represent monopoly profits. However, there was inadequate support provided to audit for the Department's decision for Crown to retain any of the monopoly profits generated from the licence; and
- The Department discounted its estimated licence fee value by \$10 million, to take account of uncertainties associated with the licence fee calculations and its recognition that the Government wanted to make a one-off non-negotiable offer to Crown. However, inadequate support was provided to audit for the discount and why a strategy was adopted involving a one-off negotiable offer.

CONSOLIDATED FUND RECEIPTS

5.29 In response to the comments made in my May 1996 Report, which have been summarised in this Report, the Secretary to the Department of Treasury and Finance commented as follows:

- *The Department did not believe that there was a uniquely correct method of determining the value of additional tables in the casino. For that reason, it was decided to subject the consultant's report to internal departmental scrutiny;*
- *The approach used by the consultant was based on the ratio of the original licence fee payment to the present value of the original projected earnings. The Department's view was that the consultant, an independent valuation expert and one of the big six accounting firms, had adopted a defensible basis for the calculation of the additional licence fee, as the ratio was determined during a market bidding process. The consultants argued that this provided the best objective benchmark available for replicating a competitive bid situation;*
- *Four alternative methodologies, 2 of which were based on projected earnings figures quoted in paragraph 5.26 of this Report, were also considered by the Department. However, it was recognised that these calculations were sensitive to the chosen rate of return, and were likely to be overstated because they did not allow for the opportunity cost of the building space allocated to the extra tables, or the additional capital costs involved in constructing that part of the building; and*
- *The Department also took into account the fact that the expansion in the number of tables would, on Crown's projections, have generated \$30 million per annum of ongoing taxation revenue, although the actual amount might be less after allowing for the substitution of gambling within the casino with other forms of gambling. It was further considered that seeking an excessive licence fee could have placed the ongoing large revenue stream at risk.*

5.30 Consistent with the arrangements relating to the establishment of the additional casino gaming tables, during 1995-96 the Consolidated Fund received an additional licence fee of \$17 million. In addition, the State received \$5.3 million compensation for the delay in the construction of the casino and \$1 million for tourism purposes.

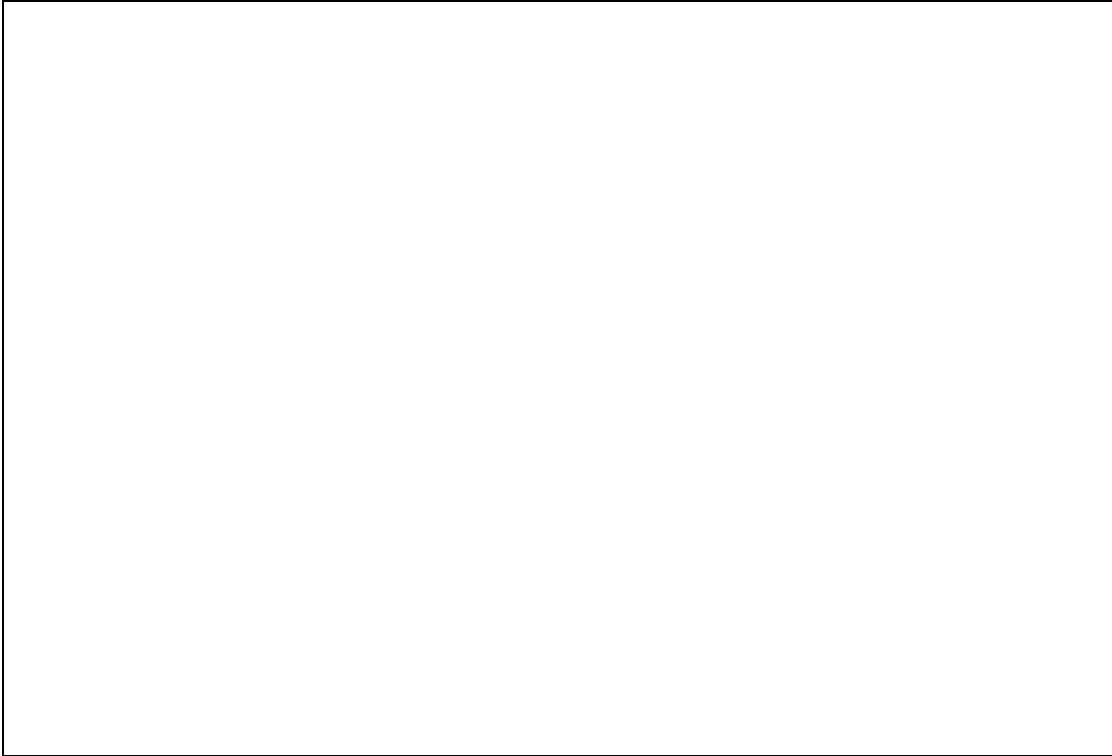
Tattersall licence

5.31 Electronic gaming activity in Victoria is regulated within the framework established under the *Gaming Machine Control Act 1991* and the *Gaming and Betting Act 1994*. Within this framework, Tattersall's and TABCORP have been issued with exclusive licences as gaming machine operators.

5.32 Specifically, in 1991, the Government granted a licence to Tattersall's to operate gaming machines in licensed clubs and hotels in Victoria for a period of 20 years, from April 1992. At the same time, a licence was issued to the TAB (TABCORP's predecessor) for a period of 18 years. These licences were issued at no cost to either operator. However, as part of the privatisation of the TAB in 1994, the proceeds received from the sale implicitly incorporated a share of the future profits to be made from its gaming activities, upon which the licence issued to the TAB could be valued.

CONSOLIDATED FUND RECEIPTS

5.33 As a result of the sale of the TAB, this action placed the 2 industry gaming operators in different competitive positions for their exclusive access to the same market. Consequently, the Treasurer of Victoria directed that negotiations should be undertaken with Tattersall's, with a view to obtaining a licence payment with similar conditions to TABCORP.



Tattersall's head office.

Determination of gaming licence fee

5.34 In April 1994, an independent financial consultant was commissioned by the State to undertake an indicative economic valuation of Tattersalls' gaming machine operations in order to facilitate the commencement of discussions between the Government and Tattersall's regarding the value of the licence issued under the *Gaming Machine Control Act 1991*.

5.35 In May 1994, the consultant estimated that the net present value of Tattersalls' cash flows from operating electronic gaming machines for a period of 18 years from 1994 to 2012 was between \$900 million and \$950 million. In July 1994, the Department advised the Treasurer that by using more optimistic assumptions, the net present value of the cash flows could be as high as \$1.5 billion. In August 1994, TABCORP was sold for \$675 million, of which the Department of Treasury and Finance estimated that \$422 million related to TABCORP's gaming machine activities. Faced with an option of determining Tattersall's licence fee on the basis of the consultant's estimates or on the basis of the market valuation of the TAB licence, which related to around 50 per cent of the gaming machine market, the Government determined that the value of both Tattersalls' and TABCORP's licence fees should be consistent and, as indicated in Table 5F, the market valuation was used as the basis for calculating the Tattersall licence fee.

CONSOLIDATED FUND RECEIPTS

TABLE 5F
DEPARTMENT OF TREASURY AND FINANCE
CALCULATION OF THE GAMING LICENCE FEE
(\$million)

<i>Item</i>	<i>Amount</i>
TABCORP sale proceeds	675
Less - Amount paid for acquiring the net operating assets	(78)
Estimated amount paid by TABCORP to the State for the wagering and gaming licences	597
Add - Adjustment for the racing industry's entitlement to a 25 per cent interest in the net income in the gambling activities of TABCORP	199
Estimated full value of the TABCORP licence	796
Less - Estimated proportion of net income relating to wagering activities, based on TABCORP prospectus	(276)
Nominal value of gaming licence	520
Less - Discount of licence fee to present value	(98)
Estimated net present value of gaming licence paid by TABCORP	422

5.36 Based on the estimated net present value of TABCORP's gaming licence, **the Department estimated that Tattersall's should make licence fee payments equivalent to the amount as disclosed in the Table.**

Agreement to pay licence fee

5.37 Following negotiations involving a series of offers and counter-offers, a licensing agreement was completed in November 1995 between the Minister for Gaming and the Trustees of the Estate of the late George Adams. The key provisions of the agreement were as follows:

- **A licence fee equivalent to 30 per cent of the net profit from the operator's gaming machine division or a minimum payment of \$35 million each year, whichever is the greater.** However, the minimum amount payable of \$35 million is to be indexed in accordance with CPI movements from June 1996, with payments to be made on a quarterly basis;
- When the current licence expires in April 2012 and if Tattersall's is not issued a new gaming machine licence, Tattersall's will be entitled to be paid compensation equal to the original value of the licence or the amount payable by the new licensee, whichever is the lesser;
- The Government to enact legislation that ensures that Tattersall's is subject to the same conditions as its competitors; and
- Tattersall's cannot transfer the licence without the consent of the Treasurer.

5.38 As part of the agreed arrangements, in October 1995, the Treasurer issued a letter of comfort to Tattersall's stating that the Government does not currently intend to grant additional gaming licences. In addition, the Treasurer indicated that it was the intention of the current Government that the commission on gaming machine revenue which is to be retained by Tattersall's would be maintained at 33.33 per cent for the period of the licence, consistent with that applicable for TABCORP.

CONSOLIDATED FUND RECEIPTS

5.39 Under the established arrangements, TABCORP is required to pay an annual supervision charge to cover the operating costs of the Victorian Casino and Gaming Authority in carrying out its functions and powers under the *Gaming Machine Control Act 1991*. However, at this stage, Tattersall's is not required by the Treasurer to pay the annual supervision charge. Audit was advised that the Department of Treasury and Finance was reluctant to address this issue during the negotiation process so as not to risk any further delay in the signing of the licensing agreement. At the date of the preparation of this Report, no agreement has been reached regarding the payment of a supervision charge by Tattersall's.

5.40 During the 1995-96 financial year, Tattersall's paid \$31.7 million into the Consolidated Fund relating to these licensing arrangements, with an expectation to pay the residual of the \$35 million annual licence fee by December 1996.

Assessment of licence fee

5.41 Under the established licensing arrangements, based on the Department's estimate of Tattersalls' future profits, the State will receive a licence fee with a value equivalent to that realised in relation to TABCORP. However, given that a minimum annual licence fee of \$35 million is payable, the State is guaranteed to collect a minimum licence fee in the order of \$330 million, in present value terms, over the term of the licence. In addition, the State will share in the benefit of any profits achieved in excess of expectations by way of increased licence fees equivalent to 30 per cent of such profits.

5.42 While the licence fees have been set to try and achieve equity between TABCORP and Tattersall's, in the event that gaming machine activity continues to grow there is scope for both entities to generate significant profits in a market with limited competition. Based on advice provided by the Department of Treasury and Finance, State gambling revenues are expected to grow over the next 4 years at a rate consistent with the growth of the Victorian economy.

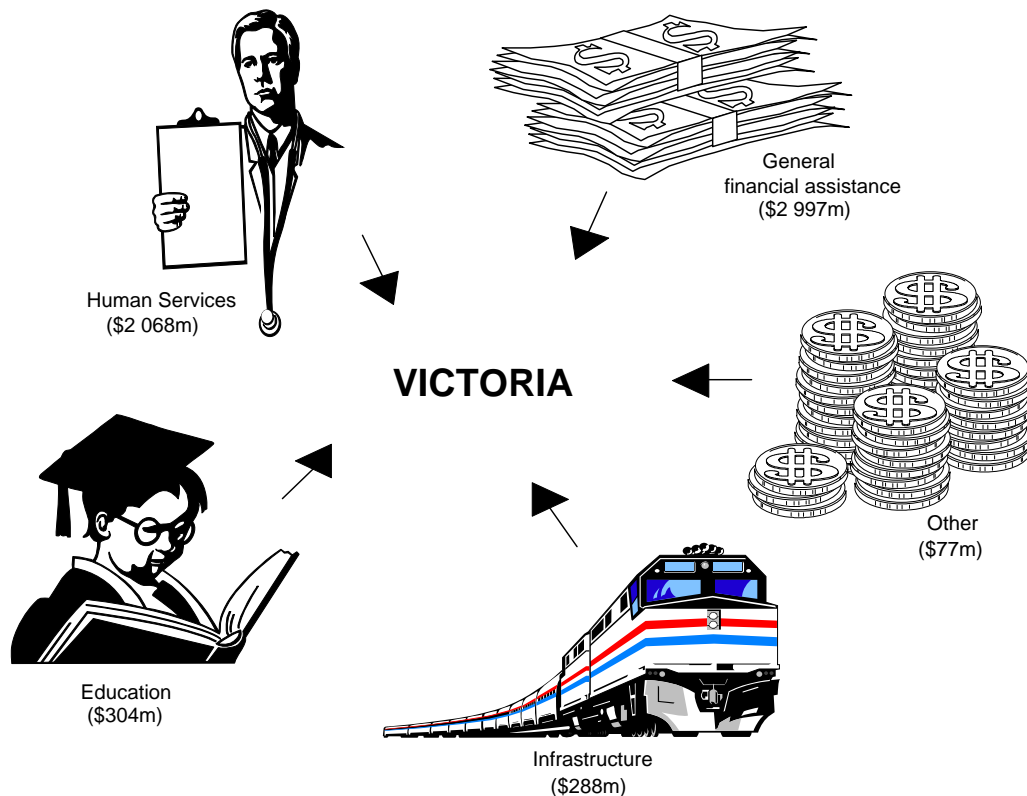
Commonwealth receipts

5.43 Commonwealth receipts mainly consist of annual financial assistance grants to the State and funding relating to human services, education and infrastructure programs. These receipts represent the State's second largest recurring source of revenue and in 1995-96 totalled \$5.7 billion (1994-95, \$5.4 billion), representing approximately 28 per cent of total Consolidated Fund revenues.

5.44 The increased Commonwealth receipts in the year was mainly attributed to higher contributions received to compensate for the integration of the Heidelberg Repatriation Hospital into the Victorian hospital system as from January 1995, and increased financial assistance grants on account of higher than expected movements in the Consumer Price Index and population growth. Chart 5G outlines the major components of Commonwealth receipts.

CHART 5G
COMMONWEALTH RECEIPTS, 1995-96
(\$million)

CONSOLIDATED FUND RECEIPTS



5.45 The 1995-96, general financial assistance grant to the State accounted for 52 per cent of total Consolidated Fund receipts from the Commonwealth, with grants for funding human services programs the next largest, being 36 per cent of revenue from Commonwealth sources.

Public authority contributions

5.46 Public authority contributions mainly represent dividends, tax equivalent payments and franchise fees from various government business enterprises, which are collected under the authority of the *Public Authorities (Dividends) Act 1983*, the *State Owned Enterprises Act 1992* and other specific legislation, and by virtue of the State's interest in certain publicly-owned companies. **During 1995-96, the Consolidated Fund received \$1.6 billion from this source, which was \$823 million greater than that budgeted for the year.** Table 5H provides a summary of public authority payments received by the Consolidated Fund in the past 2 years.

TABLE 5H
RECEIPTS FROM PUBLIC AUTHORITIES,
1994-95 AND 1995-96
((\$million))

	<i>Actual</i> 1994-95	<i>Actual</i> 1995-96	<i>Budget</i> 1995-96	<i>Variance</i> <i>from</i> <i>Budget</i>	<i>Variance</i> <i>from</i> 1994-95 <i>actual</i>
<i>Business enterprises</i>					
Electricity sector	286	1 125	346	779	839
Transport Accident Commission	178	104	69	35	(74)
Water sector	134	139	126	13	5
Gas sector	120	153	150	3	33

CONSOLIDATED FUND RECEIPTS

Treasury Corporation of Victoria	-	38	38	-	38
Aluminium Smelters of Vic.	24	8	24	(16)	(16)
Other	33	65	56	9	32
Total (a)	775	1 632	809	823	857

(a) Excludes statutory contributions relating to a share of natural gas revenues from Gas and Fuel, which are disclosed as taxation revenue in the Statement of Financial Operations.

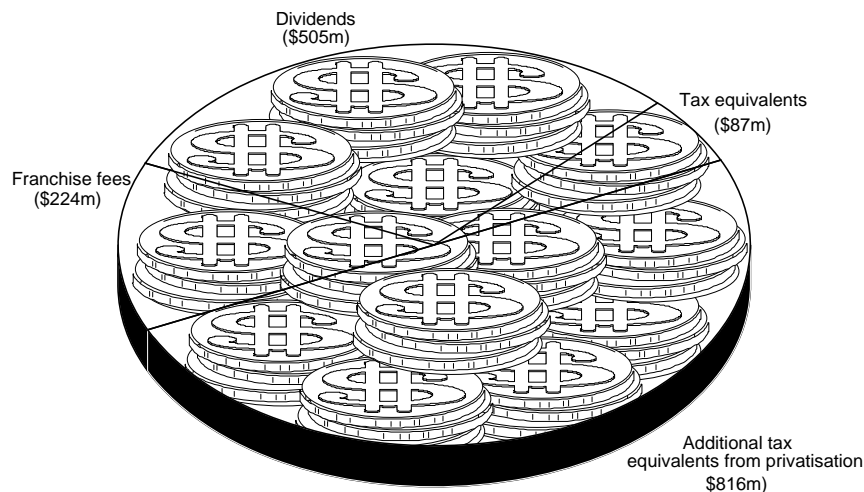
5.47 The substantial increase in public authority income in the year was mainly due to the receipt of additional tax equivalent payments of \$816 million arising from the sale of the State-owned electricity distribution and generation businesses during 1995-96. In addition, higher than budgeted contributions were received from the Transport Accident Commission due to the achievement of profits in excess of expectations, and from the water sector due to a requirement for bodies within the sector to make additional payments to the Consolidated Fund on account of the new wholesale tax equivalent regime and financial accommodation levies which were introduced by the Government in the year. However, these increased receipts were to an extent offset by lower than expected receipts from Aluminium Smelters of Victoria Pty Ltd on account of the restructure of the business during the year, resulting in a reduced dividend.

5.48 Other factors contributing to the improved outcome for the year, compared with 1994-95, included the receipt of an inaugural distribution of \$38 million from the Treasury Corporation of Victoria, increased contributions from the gas sector due to increased gas consumption in the year and reduced contributions from the Transport Accident Commission.

5.49 Chart 5I shows the composition of public authority receipts during 1995-96.

CONSOLIDATED FUND RECEIPTS

CHART 5I
COMPOSITION OF PUBLIC AUTHORITY
RECEIPTS, 1995-96
 (\$million)



Tax equivalent payments

5.50 The above chart shows that, in 1995-96, the major component of public authority receipts was tax equivalent payments, which accounted for 55 per cent of this revenue source. However, when receipts relating to the privatisation of the State-owned electricity businesses are excluded, tax equivalent receipts accounted for \$87 million or 11 per cent of total public authority payments.

5.51 The tax equivalent system was established by the Government in the 1993-94 financial year to ensure competitive neutrality between publicly and privately-owned businesses and to strengthen the financial discipline on government business enterprises (GBEs) by factoring tax payments into their business decisions. There are currently 21 entities subject to this taxation system. However, it is the Government's intention to progressively extend the coverage of the system to all GBEs.

5.52 In April 1995, consistent with an Inter-State Agreement, the Government also introduced a wholesale tax equivalent regime under which GBEs are required to remit to the Consolidated Fund amounts equivalent to sales tax exemptions provided by the Commonwealth Government. The purpose of the tax equivalent regime is to bring public bodies into line with the private sector by capturing the exemption such bodies enjoy as a result of their status as government-owned enterprises. Consolidated Fund collections of wholesale tax, included as part of tax equivalent receipts, in 1995-96 amounted to \$13 million.

5.53 To further strengthen the financial discipline exercised by GBEs and compensate the State for the risks it assumes by providing guarantees over GBE debt, in July 1995, the Government also introduced a financial accommodation levy to be payable by State-owned enterprises with borrowings in excess of \$5 million, to offset the competitive advantage provided to these entities from the government guarantee associated with their borrowings. In 1995-96, the levy contributed \$13 million to tax equivalent receipts collected by the Consolidated Fund.

Dividends

CONSOLIDATED FUND RECEIPTS

5.54 Total dividends received by the Consolidated Fund from public authorities in 1995-96 amounted to \$505 million (1994-95, \$484 million). Current government policy provides that commercial practice is to guide dividend determinations, with dividends being declared around the benchmark of 50 per cent of post-tax profits for bodies subject to the tax equivalent regime, or around the benchmark of 65 per cent of net profit for GBEs not subject to this regime. However, the Treasurer consults with the relevant entities prior to making a dividend determination.

Franchise fees

5.55 Franchise fee collections from electricity distribution business in 1995-96 contributed \$224 million (1994-95, \$103 million) to Consolidated Fund revenues. These fees are payable until December 2000 and are designed to capture excess profits that would have otherwise accrued to these privatised businesses. The fees are to be progressively eliminated by the year 2001 to reflect the introduction of full competition within the electricity industry by that time.

Property and equipment sales

5.56 In the 1995-96 financial year, the Consolidated Fund received proceeds of \$154 million from the sale of surplus or underutilised properties and equipment. The proceeds received were \$30 million above the budget estimate. Table 5J details the asset sales achieved by each agency.

TABLE 5J
ASSET SALES BY AGENCIES
((\$million))

<i>Agencies</i>	<i>Actual 1994-95</i>	<i>Actual 1995-96</i>	<i>Budget 1995-96</i>	<i>Budget variance</i>
Treasury and Finance	59	60	38	22
Directorate of School Education	53	67	53	14
Conservation and Natural Resources	18	20	21	(1)
Transport Authorities	50	4	6	(2)
Office of Major Projects	5	1	6	(5)
Other	3	2	-	2
Total	<i>(a)</i> 188	<i>(a)</i> 154	124	30

(a) Does not include a \$29 million (1994-95, \$26 million) receipt relating to the licensing arrangements for the casino.

CONSOLIDATED FUND RECEIPTS

5.57 The key factors contributing to increased asset sales in the year compared with budget expectations, as advised by the Department of Treasury and Finance, were:

- the sale of a number of properties in the year that were not included in the budget estimates, including the Bundoora/Mont Park precinct properties which were commented upon earlier in this Report;
- higher than expected number of educational property sales, in part due to the availability of an incentive to the Directorate of School Education to apply sales proceeds in the year towards its capital works program; and
- the earlier than expected resolution of certain issues relating to properties awaiting sale.

5.58 In addition to the above sales, a further \$4.8 billion was collected by the Consolidated Fund from the following key business sales:

- Electricity businesses (\$4.7 billion);
- GFE Resources (\$56 million); and
- BASS joint venture (\$3 million).

5.59 Details of the major government asset sales are outlined in Part 4 of this Report.

Dedicated revenue sources

5.60 While the majority of State-sourced revenues are available to the Government for general application in the funding of programs and capital works, certain collections are required under legislative provisions to be applied only towards specified purposes. In addition, certain revenues have been dedicated by the Government for application towards specific capital projects. In 1995-96, State-sourced revenues of \$1.2 billion were dedicated for specific application.

Public health and community services

5.61 A specified proportion of revenues from gaming and gambling activities, including Tattersall, gaming machines, horse racing, bingo and Club Keno, are required under various legislative provisions to be paid into the *Hospitals and Charities Fund*, *Community Support Fund* and the *Mental Hospitals Fund* of the Trust Fund, for application towards the funding of public health services and various projects and programs which will benefit the community.

5.62 The *Hospitals and Charities Fund* was established under the *Health Services Act* 1958 to finance the provision of public health services in the State, including acute, psychiatric and aged care services. In 1995-96, contributions from gambling sources to the *Hospitals and Charities Fund* totalled \$821 million (1994-95, \$743 million), which were supplemented with an annual appropriation from the Consolidated Fund of \$1.8 billion. Payments made during the year from the *Hospitals and Charities Fund* totalled \$2.6 billion (1994-95, \$2.3 billion).

CONSOLIDATED FUND RECEIPTS

5.63 The *Community Support Fund* was established under the *Gaming Machine Control Act 1991* to facilitate the allocation of a portion of electronic gaming machine revenue to the funding of programs and projects that will benefit the Victorian community. The Act provides that 87 per cent of electronic gaming machine turnover must be returned to players in prizes, with the remaining balance allocated between venue operators, the gaming operators and the State. The amounts received by the State must be applied in accordance with the purposes set out in the Act, which include sport and recreation programs, various community services, and the promotion of arts and tourism.

5.64 During 1995-96, contributions from gambling sources of \$66 million were paid to the Community Support Fund (1994-95, \$53 million), while payments of only \$21 million (1994-95, \$13 million) were made from the Fund in the year. **As at 30 June 1996, a balance of \$105 million remained in the Fund, mainly due to the time lag between the approval of projects and the commencement of works.**

5.65 The *Mental Hospitals Fund* was established under the *Tattersalls Consultations Act 1958* to receive a proportion of duty payable on Tattersall operations and the application of these funds towards institutions for the intellectually handicapped. During 1995-96, contributions from gambling sources of \$51 million were paid into the Fund (1994-95, \$49 million), with payments in the year from the Fund amounting to \$49 million (1994-95, \$52 million). As at 30 June 1996, a balance of \$2 million remained in the Fund.

Road construction and maintenance

5.66 In August 1993, the Better Roads Fuel Levy was introduced to finance road construction and maintenance projects of strategic importance in urban and country areas. Under the *Business Franchise (Petroleum Products) Amendment Act 1993*, the moneys raised by the Consolidated Fund from the imposition of the levy are required to be transferred to the Better Roads Victoria Trust Account of the Trust Fund on a monthly basis, for application towards specified road construction and maintenance projects.

5.67 During 1995-96, the Better Roads Fuel Levy raised \$170 million (1994-95, \$165 million) which was paid into the Consolidated Fund and was subsequently transferred to the Better Roads Victoria Trust Account. Payments from the Account for the funding of works in 1995-96 totalled \$226 million (1994-95, \$195 million). At 30 June 1996, a balance of \$20 million remained in the Trust Fund, mainly due to the time lag between the approval of projects and the commencement of works.

5.68 Major works commenced prior to the 1995-96 financial year included the extension of the Eastern Freeway to Springvale Road, Nunawading at an estimated cost of \$250 million and South Eastern Arterial separation works to be completed by mid-1997 at a cost of \$77 million. In 1995-96, further projects with an estimated total cost of \$33 million were approved for funding from the Better Roads Fuel Levy, including various works on the Princes Highway, Omeo Highway, the South Eastern Arterial and the Midland Highway.

Agenda 21

CONSOLIDATED FUND RECEIPTS

5.69 The net addition to budget revenues from taxes imposed on the Crown Casino has been dedicated by the Government towards the funding of major civic projects of strategic significance under the Government's *Agenda 21* Program. In 1995-96, revenue received from the Casino totalled \$139 million, of which \$17 million related to a fixed payment under the licence arrangements for the expansion of the number of tables in the permanent casino currently under construction (1994-95, \$55 million, of which \$26 million related to a fixed payment under the licence arrangements).

5.70 The estimated cost of projects to be funded under the *Agenda 21* Program as at 30 June 1996 totalled \$434 million. Significant works which were currently under construction included the Museum of Victoria (\$250 million), the redevelopment of the State Library - Phase 1 (\$39 million), and the costs associated with the development of the Exhibition Centre (\$145 million).

5.71 As from July 1996, additional works with a total cost of \$131 million are to be funded under the *Agenda 21* program, including works at the National Gallery (\$80 million), Phase 2 of the State Library redevelopment (\$40 million) and construction of a bridge across the Yarra River at the vicinity of the Exhibition Centre (\$11 million).

Tricontinental loan recoveries

5.72 As commented in my previous Reports on the Statement of Financial Operations, under the arrangements established subsequent to the sale of the State Bank of Victoria, in December 1990 the State acquired Tricontinental Corporation Limited and became obligated to meet its net deficiency of \$1.7 billion. In January 1995, a management agreement was entered into between Tricontinental and the Rural Finance Corporation, under which the Corporation provides administrative and accounting services to Tricontinental, in return for a management fee, to facilitate the realisation of the balance of the loan portfolio.

5.73 During 1995-96, the Consolidated Fund received a payment of \$97 million, representing Tricontinental contributions sourced from loan recoveries, compared with a budget estimate of \$138 million. Tricontinental advised that the variance between the budgeted and actual loan recoveries in the year is generally representative of the uncertainties associated with the realisation of the loan portfolio.

5.74 Tricontinental anticipates to recover a further \$115 million in the 1996-97 financial year and beyond. However, the outcome of a number of legal disputes in relation to outstanding loans may impact on this amount. As at the date of preparation of this Report, litigation relating to these disputes remained pending.

PART 6

Consolidated Fund Payments



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CONSOLIDATED FUND PAYMENTS

Summary of financial transactions

6.1 The Consolidated Fund payments for the year totalled \$20.4 billion, which was \$4 billion greater than budget expectations. However, these payments included the application of \$4.7 billion of the proceeds received from the privatisation of State-owned enterprises mainly towards the retirement of budget sector debt.

6.2 When the transactions associated with the application of privatisation proceeds are excluded, the year's Consolidated Fund payments were \$706 million below budget expectations. Table 6A provides a summary of the year's gross payments.

TABLE 6A
1995-96 ACTUAL AND BUDGETED PAYMENTS
(\$million)

<i>Item</i>	<i>1994-95 Actual</i>	1995-96 Actual	<i>1995-96 Budget (a)</i>	Variance from Budget
Recurrent -				
Annual appropriations (b)	12 967	12 271	12 899	(628)
Special appropriations	1 821	1 695	1 665	30
Total recurrent	14 788	13 966	14 564	(598)
Works and services -				
Annual appropriations	2 210	1 759	1 803	(44)
Special appropriations	70	4 640	-	4 640
Total works and services	2 280	6 399	1 803	4 596
Total payments	17 068	20 365	16 367	3 998

(a) Budget Estimates, 1995-96 Budget Paper No. 3

(b) Does not include expenditure on finance charges of \$290 million (1994-95, \$123 million) which was refinanced from borrowings undertaken by the Treasury Corporation of Victoria on behalf of the Consolidated Fund and netted-off outside the Fund.

Major budget variances

6.3 Generally, departmental expenditure was below budget expectations. In particular, the following major factors favourably impacted on the year's outcome:

- budget sector debt financing charges \$393 million below budget estimates due to a combination of lower than anticipated borrowing requirements in the year, reduced interest costs resulting from lower than anticipated interest rates and the substantial retirement of debt through the application of privatisation proceeds, and certain debt restructuring transactions not proceeding in the year;
- spending on micro-economic reform projects \$76 million lower than budget, due to lower than anticipated identification of project opportunities by departments and subsequent delays in the commencement of approved projects;

CONSOLIDATED FUND PAYMENTS

- flexible electricity payments under the arrangements established in relation to the operation of the Portland and Point Henry aluminium smelters \$36 million below forecasts, due to increased world aluminium prices; and
- costs involved in the privatisation of State-owned enterprises \$29 million below estimates, due to reduced costs in relation to the sale of electricity businesses, arising from their disposal by trade sale rather than public float, and the slower than anticipated finalisation of port asset sales.

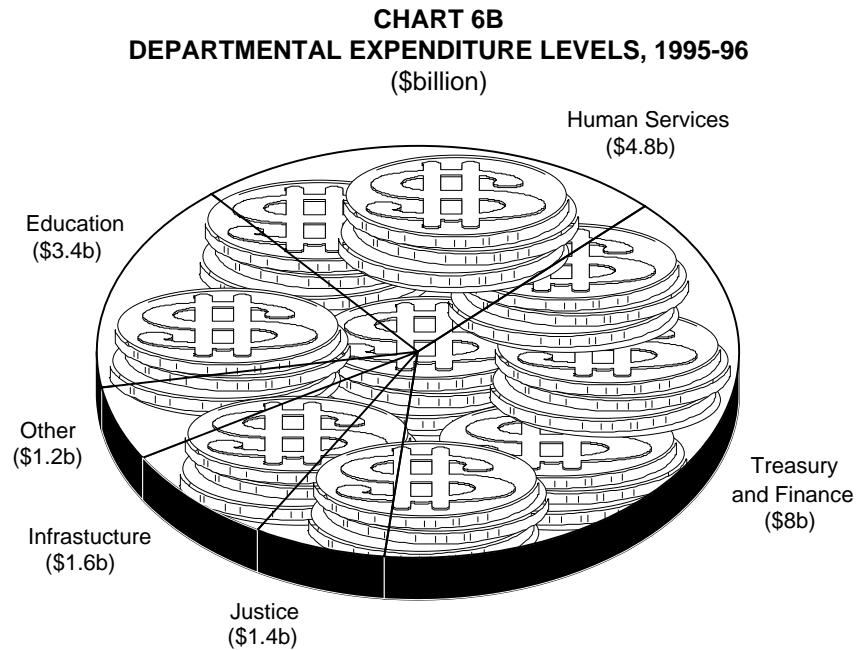
6.4 However, these savings were to an extent offset by the following expenditures that were not specifically budgeted:

- A refund of \$64 million to the purchaser of United Energy Ltd in accordance with the sale agreements, relating to State equivalent tax on company profits paid after a specified date, of which \$45 million was provided for in the budget;
- Contribution of \$50 million by the State towards the development of Federation Square between Flinders Street and the Yarra River, Melbourne. However, this payment was partly funded from a contribution in the form of a dividend of \$30 million from the Urban Land Authority, with the Authority expected to pay a further \$20 million in relation to this project over the next 2 years (further comment on this matter is provided later in this Part of the Report);
- Payment of \$48 million to the Treasury Corporation of Victoria to enable the purchase of bonds previously issued to finance public sector projects undertaken under the Government's Accelerated Infrastructure Program;
- Employment departure program payments were \$34 million above expectations, primarily due to the funding of a greater than anticipated number of employee departure packages; and
- Subsidies to private bus operators of \$33 million above budget, due to the elimination in the year of expenditure deferral arrangements established in prior years.

CONSOLIDATED FUND PAYMENTS

Major expenditure categories

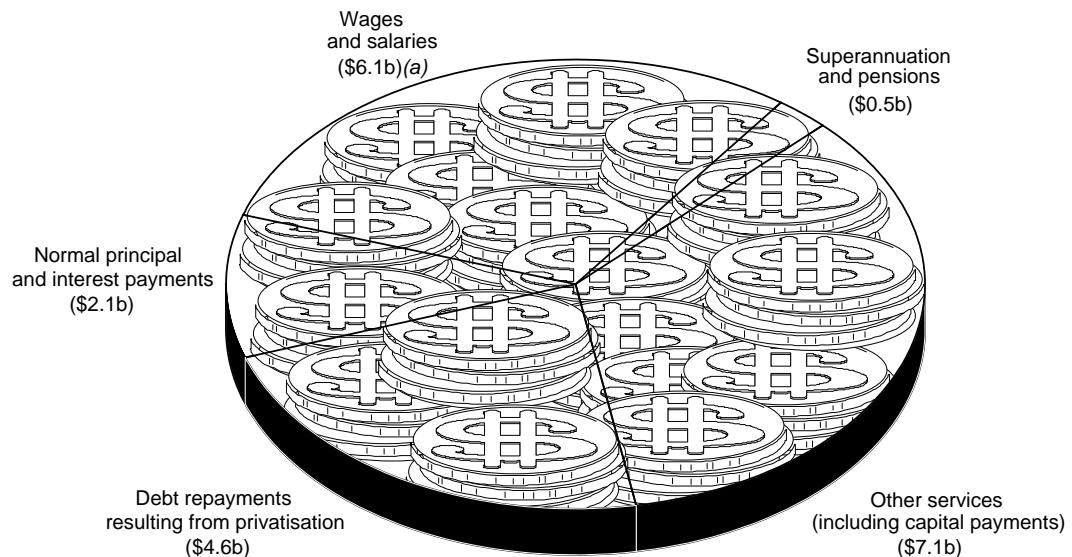
6.5 The key portfolios accounting for Consolidated Fund expenditure in the year were Treasury and Finance, Human Services, Education, Infrastructure and Justice. As illustrated in Chart 6B below, these portfolios collectively represent 94 per cent of total Consolidated Fund payments.



6.6 During 1995-96, debt-related payments, including principal repayments and finance costs, represented the major item of expenditure of the Consolidated Fund, accounting for around \$6.7 billion or 33 per cent of total payments. As previously outlined in this Report, the year's Consolidated Fund debt payments include debt repayments of \$4.6 billion resulting from the application of electricity industry privatisation proceeds. The next largest functional expenditure category was salaries and wages, which amounted to \$6.1 billion and accounted for a further 30 per cent of total payments. Chart 6C shows the major payment categories on a functional basis for the year.

CONSOLIDATED FUND PAYMENTS

CHART 6C
MAJOR FUNCTIONAL EXPENDITURE CATEGORIES, 1995-96
 (\$billion)



(a) Represents budget sector wages and salary costs as reported in 1996-97 Budget Paper No. 3.

Finance charges

6.7 As previously outlined, debt-related payments represent a major component of aggregate Consolidated Fund payments. In particular, **finance charges paid in the year, which represent the annual cost of borrowings previously raised by the Government to meet the State's obligations, in 1995-96 totalled \$2 billion.** Table 6D provides details of interest paid and incurred in the period in relation to Public Account borrowings, together with interest accrued at year-end. The table also highlights the reduction in accrued interest in the year.

CONSOLIDATED FUND PAYMENTS

TABLE 6D
INTEREST CHARGES ON PUBLIC ACCOUNT BORROWINGS
(\$million)

<i>Item</i>	<i>Interest incurred but not paid at 1 July 1995</i>	<i>Add 1995-96 interest incurred</i>	<i>Less 1995-96 interest paid</i>	<i>Interest incurred but not paid at 30 June 1996</i>
Treasury Corporation of Victoria (TCV) borrowings	(a) 613	1 724	1 945	392
Other financing (b)	15	59	60	14
	628	1 783	2 005	406
Finance charges off-set against borrowings outside the Consolidated Fund by TCV	-	290	290	-
Accrued interest at 30 June	628	2 073	2 295	406

(a) This amount is \$98 million higher than that included in my October 1995 Report on the Statement of Financial Operations due to the re-classification of costs relating to capital indexation from debt to accrued interest.

(b) Mainly comprises financing associated with the World Congress Centre and Public Transport Corporation leases.

6.8 While the Statement of Financial Operations discloses that finance charges paid in 1995-96 amounted to \$2 billion, given that the Statement is prepared on a cash basis of accounting, this figure does not reflect interest incurred but not paid in the period.

6.9 Audit analysis revealed that **interest incurred in 1995-96 (calculated on an accrual basis) was \$2.1 billion, which was comparable with that incurred in the previous year.** The difference of \$68 million between interest paid (as disclosed in the Statement of Financial Operations) and interest incurred was due to:

- the non-recording within the Consolidated Fund of finance charges offset outside the Fund against borrowings raised by the Treasury Corporation of Victoria on the Government's behalf (\$290 million); and
- the decrease in the year of interest incurred but not paid (\$222 million).

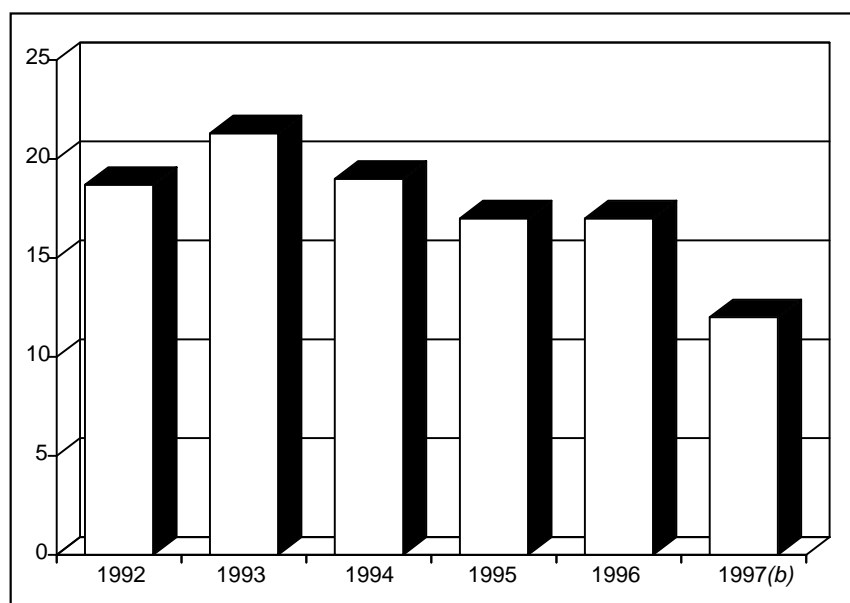
6.10 The major factor contributing to the decrease in accrued interest as at 30 June was the reduction of budget sector debt in the year resulting from the application of privatisation proceeds.

CONSOLIDATED FUND PAYMENTS

Impact of borrowings on the Consolidated Fund

6.11 Chart 6E highlights the impact of finance costs on the budget over the past 5 years and the projected financing costs for the 1996-97 financial year.

CHART 6E
FINANCE CHARGES PAID AS A PROPORTION OF TOTAL
CONSOLIDATED FUND REVENUE AVAILABLE FOR GENERAL APPLICATION (a)
 (per cent)



(a) Revenue available for general application excludes specific purpose Commonwealth grants, proceeds from borrowings and privatisation proceeds which are applied towards debt reduction.

(b) Based on estimates provided in the Government's 1996-97 Budget Paper No. 3.

6.12 The chart illustrates that the impact of finance charges on the budget has declined in recent years, reflecting the favourable outcome of government debt and budget management strategies.

Additional financing costs resulting from taxation ruling

6.13 My previous Reports on the Statement of Financial Operations have commented on **2 financial arrangements established in 1986 and 1987** by the former Victorian Public Authorities Finance Agency (VicFin) to raise funds from a major insurance institution (the investor) through the issue of a 12 year fixed rate *annuity* with a value of \$92 million and *gold loans*, mainly comprising floating rate instruments, with a value of \$200 million maturing in 2002. The arrangements were structured to raise such funds at a cost below the prevailing market rates, while enabling the investor to receive a required rate of return through the realisation of tax benefits. Under the arrangements, VicFin and ultimately the State, guaranteed the after-tax rates of return to the investor.

CONSOLIDATED FUND PAYMENTS

6.14 As explained in my previous reports to the Parliament, as from 1988 the Australian Taxation Office (ATO) commenced issuing amended taxation assessments to the investor associated with these financial arrangements. **The impact of the taxation assessments on the annuity and gold loan arrangements was to increase the financing costs of both arrangements by up to \$154 million**, including a taxation assessment for \$21 million received by the investor in September 1995 for which, based on legal advice received, the Corporation did not accept responsibility for meeting the penalties payable under the assessments. To facilitate the payment of this taxation liability, the Treasury Corporation of Victoria had advanced interest free loans of \$84 million to the investor and the Government had reimbursed the Corporation for these loans, with the balance of taxation assessments of \$60 million held in abeyance by the ATO, pending the outcome of an appeal lodged by the investor.

6.15 Subsequently, in May 1996, the Treasurer approved the termination of the gold loan arrangement due to the unfavourable impact of its taxation status on financing costs, resulting in the issue in June 1996 of a termination notice to the investor.

6.16 The Corporation has lodged a statement of claim with the Supreme Court of Victoria against the investor, which sets out the **Corporation's calculation of the estimated termination amount of approximately \$213 million**, including a termination payment of \$171 million and \$42 million required to meet future tax payments if the investor's appeal against the taxation assessments was unsuccessful. **However, the investor claims that the estimated termination cost of the financial arrangements should be \$354 million.**

6.17 In summary, the impact of the taxation rulings on the annuity and gold loan arrangements has been to increase the financing costs of both arrangements by up to \$154 million. However, the State may be liable for additional costs of up to \$183 million in terminating the gold loan arrangement, if the investor's claimed termination value for this arrangement is supported by the legal proceedings.

State's credit rating

6.18 One of the Government's key long-term objectives is "*... to reduce the State's debt and debt servicing ratios to levels consistent with the restoration of Victoria's former AAA credit rating*". The achievement of this objective is important, given that the State's credit rating plays a major role in the level of finance charges that are payable by the Government.

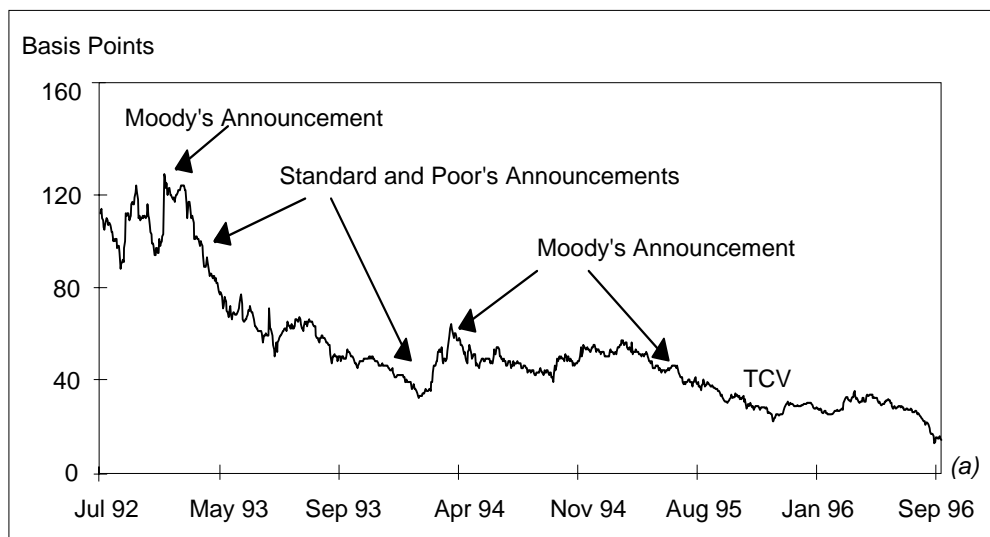
6.19 As outlined in my previous Reports to the Parliament, due to the difficulties experienced in the State's budgetary position and increasing debt levels, the State's credit rating was substantially downgraded between 1990 and 1992. However, the enhanced budgetary results and debt reduction strategies established by the Government since that time have positively impacted on the credit rating. In particular, in March 1994 and again in May 1995, the State's credit rating was upgraded, assisting in the reduction of costs incurred by the State in relation to new borrowings.

CONSOLIDATED FUND PAYMENTS

6.20 Subsequent to the Government's September 1996 Budget, the credit agency Standard and Poor's Australian Ratings further upgraded the State's credit rating from AA to AA+, reflecting "... *the significant reduction in the State's debt burden, the strong position of the Government's ongoing finances and the State's broad economic base*".

6.21 Chart 6F illustrates the impact of the credit rating reviews on the State's borrowing costs in comparison to the borrowing costs of the Commonwealth Government.

CHART 6F
HIGHER INTEREST RATES PAYABLE BY VICTORIA
ON LONG-TERM BORROWINGS COMPARED WITH THE
COMMONWEALTH GOVERNMENT, 1 JULY 1992 TO 3 SEPTEMBER 1996
 (basis points)



(a) Represents Commonwealth Government Securities (CGS).

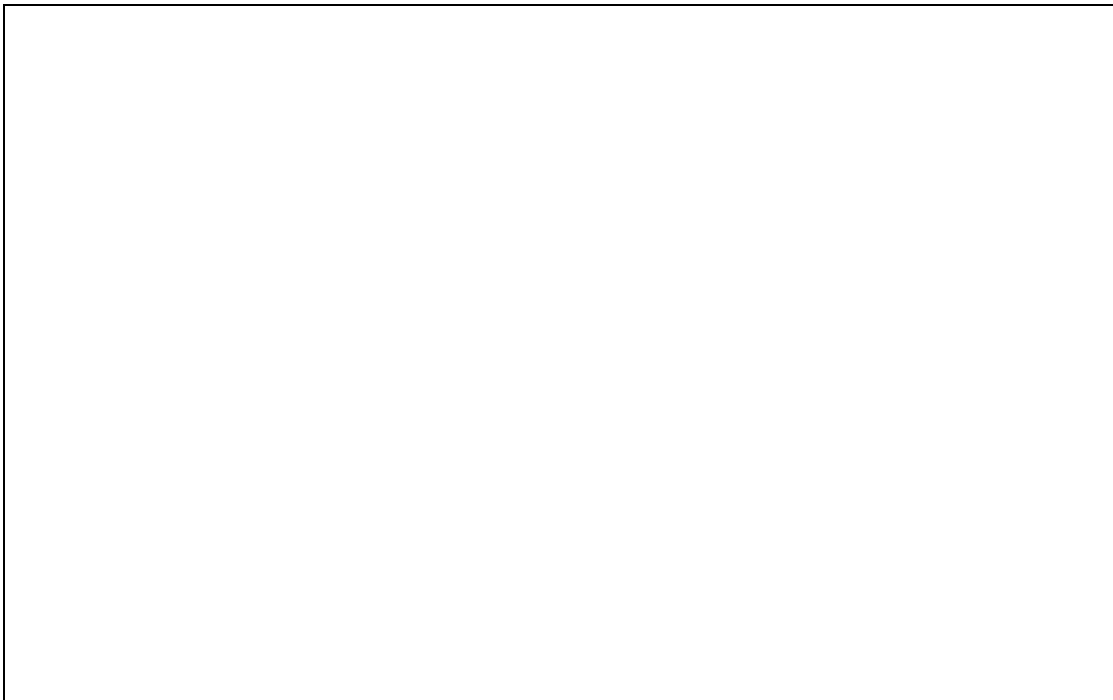
Source: Department of Treasury and Finance.

6.22 The chart illustrates that the differential in borrowing costs between Victoria and the Commonwealth Government, which has a AAA credit rating, has fallen significantly since 1992. As has been identified in my previous Reports, the key contributors to this positive outcome have been the improvements in the State's credit rating and the enhanced financial position of the State, together with a continuing focus by the Government on enhanced financial management.

Federation Square development

6.23 Under the Government's current capital works program, the Princes Gate Towers which were constructed on land vested in the Public Transport Corporation and were previously utilised by the Gas and Fuel Corporation of Victoria, are being demolished to enable the Federation Square development to proceed. The demolition of the existing towers commenced in March 1996 and is expected to be completed by April 1997. The Office of Major Projects will facilitate the development of the Square to provide open space between Flinders Street and the Yarra River.

CONSOLIDATED FUND PAYMENTS



Former Gas and Fuel Corporation of Victoria headquarters.

6.24 Under the terms of a March 1996 agreement between the State and the Melbourne City Council, a principal sum of \$100 million, including a \$50 million contribution in 1995-96 from the Consolidated Fund together with an equivalent contribution provided by the Melbourne City Council, is being held in a specific purpose trust account with State Trustees Limited, for use on this project.

6.25 The State's contribution of \$50 million was partially funded by a contribution in the form of a dividend from the Urban Land Authority of \$30 million, which was paid into the Consolidated Fund in March 1996. The Authority is expected to pay a further \$20 million into the Consolidated Fund via 2 yearly contributions of \$10 million in the 1996-97 and 1997-98 financial years.

6.26 Under the established arrangements, the Federation Square project is to be overseen by a committee comprising of State and Melbourne City Council representatives, with any drawdowns from the trust account requiring the approval of the respective State representatives. It is currently anticipated by the Government that the total cost of the project will be around \$110 million, with an expected completion date of June 2000.

Totalizator Agency Board litigation

6.27 My previous Report to the Parliament on the Statement of Financial Operations in October 1995 commented on a number of commercial disputes which were settled by the former Totalizator Agency Board of Victoria (TAB) prior to 30 June 1995 at a cost of \$17 million. At the date of preparation of that report, one dispute remained outstanding involving a claim relating to an unexecuted agreement for the purchase by the TAB of software and gaming machines.

CONSOLIDATED FUND PAYMENTS

6.28 The State assumed responsibility for any liabilities arising from the remaining legal action following the privatisation of the TAB, with the former Department of Arts, Sports and Tourism having responsibility for the settlement of the dispute. **Following consideration of legal advice received by the Department, an out-of-court settlement was reached in relation to this dispute during the 1995-96 financial year, involving the payment by the State of \$10 million.**

PART 7

Assets of the State



**VICTORIAN
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ASSETS OF THE STATE

ASSETS OF THE STATE

LEVEL OF FINANCIAL ASSETS

7.1 Financial assets included in the Statement of Financial Operations can be broadly described as those assets that can be readily liquidated by public sector agencies and generally do not include items of a fixed asset nature. The major categories of financial assets include investment holdings, loans and advances by public sector agencies to external parties, and cash and deposit balances.

7.2 The financial asset holdings of the public sector at 30 June 1996 stood at \$15.4 billion (30 June 1995, \$14.6 billion). Table 7A shows the composition of these balances.

TABLE 7A
FINANCIAL ASSETS OF THE STATE
(\$billion)

Type	Budget sector	Non-budget sector	Public financial enterprises	Total 1995-96 (a)	Total 1994-95 (a)
Loans and advances	1.7	0.4	24.4	1.4	1.7
Investments	0.7	0.3	8.8	9.5	8.8
Accounts receivable	0.3	0.7	1.2	1.8	2.1
Cash and deposits	1.3	0.8	0.6	2.3	1.6
Other	0.1	0.2	0.6	0.4	0.4
Total financial assets	4.1	2.4	35.6	15.4	14.6

(a) The total balances are presented net of inter-entity eliminations, that is, after deducting amounts receivable or invested in other public sector agencies.

7.3 The increase during the year in the level of the State's financial assets mainly reflects the liquid nature of these balances and increased investment holdings of the Treasury Corporation of Victoria as at 30 June 1996, predominantly relating to privatisation proceeds awaiting application towards debt reduction.

Asset management

7.4 A key focus of the Government's public sector reform program, in recent years, has been to enhance asset management and in turn improve the utilisation of public resources and the financial performance of the State. My previous Reports to the Parliament have commented extensively on the various initiatives introduced to enhance public sector, and in particular budget sector asset management. The key initiatives include:

- establishment of an asset identification and valuation program for budget sector agencies;
- implementation of accrual-based financial reporting by departments;
- provision of guidance to agencies, outlining the fundamental principles of effective asset management, including a strategic framework for the implementation of such principles;
- implementation of a capital charge payable by departments, to encourage improved asset management decisions and practices;

ASSETS OF THE STATE

- progressive establishment of a central asset register by the Department of Treasury and Finance, to enhance the central agency's capacity to maintain relevant and reliable information to assist in the analysis of public sector asset holdings; and
- establishment of the central Managed Insurance Fund, to provide insurance protection to departments and budget sector agencies.

7.5 These initiatives have significantly enhanced the management of the State's asset holdings and the financial performance of the public sector. To ensure that the benefits from their implementation are fully realised, it will be important that the current momentum and focus is maintained.

7.6 Comments are provided below on the key developments during the 1995-96 financial year in relation to public sector asset management.

Accrual accounting by departments

7.7 My previous Reports to the Parliament have commented on the progress of implementation of accrual-based financial reporting by departments. Under the framework established to facilitate the implementation of this Government initiative, all departments were required to prepare accrual financial statements, in a form suitable for audit, by the 1995-96 financial year.

7.8 For the 1994-95 financial year, all but 3 departments presented audited accrual-based financial statements as their primary financial statements in their Annual Reports tabled in the Parliament. The remaining departments, namely, the former Departments of Business and Employment, and Conservation and Natural Resources, and the Department of Education, continued to report on a cash basis, but also included unaudited supplementary accrual financial statements in their annual reports.

7.9 For the 1995-96 financial year, the Government's accrual financial reporting implementation program will be completed, with all departments presenting audited accrual-based financial statements as the primary statements in their annual reports to the Parliament.

7.10 While this improved form of financial reporting will inevitably contribute to enhanced financial accountability for the budget sector, to fully realise the benefits available from its implementation, it will now be important that accrual based financial reporting becomes an integral financial management tool, for departmental financial monitoring and decision-making. This represents the challenge faced by the Government and departments.

ASSETS OF THE STATE

Whole-of-government reporting

7.11 For many years, I have advocated the need for the Government to present consolidated whole-of-government financial reports for the State and, given the substantial benefits that would accrue from the implementation of this initiative, to establish a firm establishment timetable. As outlined in my previous Reports to the Parliament, the benefits that should accrue from this form of financial reporting include:

- provision of transparent reporting, enabling taxpayers to determine how their taxes are spent and what their future obligations are likely to be, including the financial implications and long-term sustainability of government policies;
- presentation of a more accurate picture of the financial result of government activities through the elimination of inter-entity transactions;
- more responsible decision-making and improved financial management, including the imposition of a stronger discipline on public sector managers to more effectively manage public assets and liabilities; and
- presentation of a single set of concise and meaningful financial statements, which allow assessments to be made on the government stewardship of public resources which include the assets of the State and, therefore, providing enhanced accountability to the Parliament and taxpayers.

7.12 To facilitate the realisation of these benefits, during the 1994-95 year, the Government commenced a program for the implementation of whole-of-government reporting for the State. Under the program, as a first step, whole-of-government financial statements were prepared on a trial basis in June 1996 by the Department of Treasury and Finance for the 1994-95 financial year, which were not subject to audit. The Department intends to again prepare trial consolidated statements for the 1995-96 financial year by December 1996. If the whole-of-government financial statements for the 1995-96 financial year comply with appropriate accounting standards, it is the Government's intention to publish the audited statements for the 1996-97 financial year.

7.13 **The implementation of whole-of-government reporting for the State and the ongoing availability of information on this basis for decision-making and accountability purposes, should significantly assist in the enhanced management of State resources.**

Capital charge

7.14 In July 1994, the Government introduced the capital charge to be levied on departmental capital outlays, in order to raise departmental awareness of the assets they control and the costs associated with their retention.

7.15 In 1994-95, the charge was levied at a rate of 8 per cent of departmental State-funded capital outlays, with departments fully compensated for the charge to prevent any adverse impact on service delivery. The Department of Treasury and Finance has advised that this interim arrangement is to operate until June 1997, with the Department reviewing the operation and calculation of the charge for the 1997-98 financial year.

7.16 **In 1995-96, capital charges were provided for in the Appropriation Act, with approximately \$153 million paid for this purpose back into the Consolidated Fund.**

ASSETS OF THE STATE

Managed Insurance Fund

7.17 The Managed Insurance Fund was established by the Government in March 1995 to provide central insurance coverage to all departments and budget sector agencies. Under the established arrangements, unless exempted by the Minister for Finance, all relevant agencies are required to purchase their insurance from the Fund, with the Fund re-insuring significant risks through other private sector insurers.

7.18 The key aims of establishing the Managed Insurance Fund were to encourage the identification and improved management of budget sector assets and other risk exposures, and to rationalise and enhance the budget sector insurance arrangements.

7.19 While the Managed Insurance Fund was initially established as a Trust Fund within the Public Account, responsibility for its management was assumed by the Victorian Managed Insurance Authority in October 1996 under the authority of the *Victorian Managed Insurance Authority Act 1996*.

7.20 The establishment of this central insurance management arrangement should assist in the enhanced identification of budget sector risks and exposures, and improved asset management.

PART 8

Liabilities and Commitments



**VICTORIAN
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LIABILITIES AND COMMITMENTS

AGGREGATE LIABILITIES OF THE STATE

8.1 In recent years, the strategic focus of the Government's overall policy framework has been to achieve 2 broad long-term objectives, namely, improving the competitiveness of the Victorian economy and strengthening the State's budgetary position. The effective management and reduction of State liabilities and associated financing costs have been key components assisting in the achievement of these key objectives.

8.2 While substantial improvement has been made in previous years in the State's finances, mainly through the implementation of various measures involving the privatisation of government business enterprises, revenue enhancements, expenditure reductions and improved liability management arrangements, Victoria nevertheless has a significant level of debt. In recognition of this unsatisfactory position, in its 1995-96 Budget Papers, the Government recognised that the State's debt levels will continue to demand significant attention, with its effective management critical to the achievement of the key government strategies.

8.3 Given the importance of the effective management of the State's liabilities to public sector financial operations, in this part of my Report I have presented an analysis of the State's future financial obligations and commitments, including an assessment of the impact of the year's developments on the State's financial position.

8.4 The audited Statement of Financial Operations discloses liabilities of the State totalling \$57.2 billion at 30 June 1996, compared with \$67.3 billion in the previous year. The substantial reduction of \$10.1 billion in the level of State liabilities was mainly due to the privatisation of 5 electricity distribution companies and one electricity generation company, and the application of the resultant sale proceeds mainly towards the reduction of State debt.

8.5 Table 8A illustrates the composition of the State's liabilities at 30 June 1996.

TABLE 8A
COMPOSITION OF STATE LIABILITIES
((\$billion))

Type	Budget sector	Non-budget sector	Public financial enterprises	Total June 1996	Total June 1995
Debt	17.4	8.9	25.8	26.4	35.9
Unfunded superannuation liabilities	14.7	0.9	-	15.6	15.1
Other employee entitlements	1.4	0.5	-	1.9	2.2
Payables and accrued expenses	3.9	2.7	8.9	13.3	14.1
Total State liabilities	37.4	13.0	34.7	(a) 57.2	(a) 67.3

(a) The total balances are presented net of inter-entity eliminations, that is, after deducting amounts payable to other public sector agencies.

8.6 As the table indicates, debt and unfunded superannuation liabilities represent the 2 largest components of State liabilities. Collectively, these items account for 75 per cent of total liabilities.

LIABILITIES AND COMMITMENTS

8.7 The notes to the Statement of Financial Operations disclose that the presentation of the State's liabilities does not include Universities as these bodies are principally funded by the Commonwealth Government and are not considered to constitute part of the State reporting entity. Furthermore, the Statement does not include the liabilities of public bodies which have either liabilities or financial assets with a value less than \$5 million, as these are not considered to have a material impact on the reported figures. In addition, the Statement of Financial Operations does not disclose liabilities relating to municipal councils and associated entities.

8.8 Further to the liabilities disclosed in Table 8A, **the State also has quantifiable contingent liabilities of around \$2 billion** (1994-95, \$2 billion). These liabilities, which are contingent in nature, represent potential commitments the occurrence of which is dependent on future events or outcomes.

LIABILITIES AND COMMITMENTS

STATE DEBT

8.9 Debt represents the largest component of State liabilities and predominantly comprises public sector borrowings raised domestically and overseas through the Treasury Corporation of Victoria, loans and advances from the Commonwealth Government, and finance leases entered into by public sector bodies.

8.10 As previously mentioned in this Report, in recent years, the reduction and management of State debt have been key elements of the Government's overall financial reform program. Major initiatives introduced by the Government to enhance the management and facilitate the reduction of State debt have included the establishment of the Treasury Corporation of Victoria as the State's central borrowing authority, improved risk management through the introduction of prudential supervision arrangements for public sector financial enterprises, and the establishment of a substantial privatisation and budget management program. The rewards achieved from the implementation of these initiatives, in terms of improvements in the State's financial position, have been substantial and are reflected through reduced debt levels and lower financing costs.

8.11 The debt liabilities of the State at 30 June 1996 stood at around \$26.4 billion, compared with \$35.9 billion in the previous year. Table 8B illustrates the major sectors contributing to this position.

TABLE 8B
STATE DEBT, 1995-96
((\$billion))

<i>Sector</i>	1996	1995
Budget	17.4	22.2
Non-Budget	8.9	14.1
Public Financial Enterprises	25.8	34.1
Inter-sector eliminations	(25.7)	(34.5)
Total State debt	26.4	35.9

8.12 The reduction of \$9.5 billion in the level of State debt in the year mainly reflects the impact of the Government's electricity industry privatisation program under which 5 electricity distribution companies and one electricity generation company were sold.

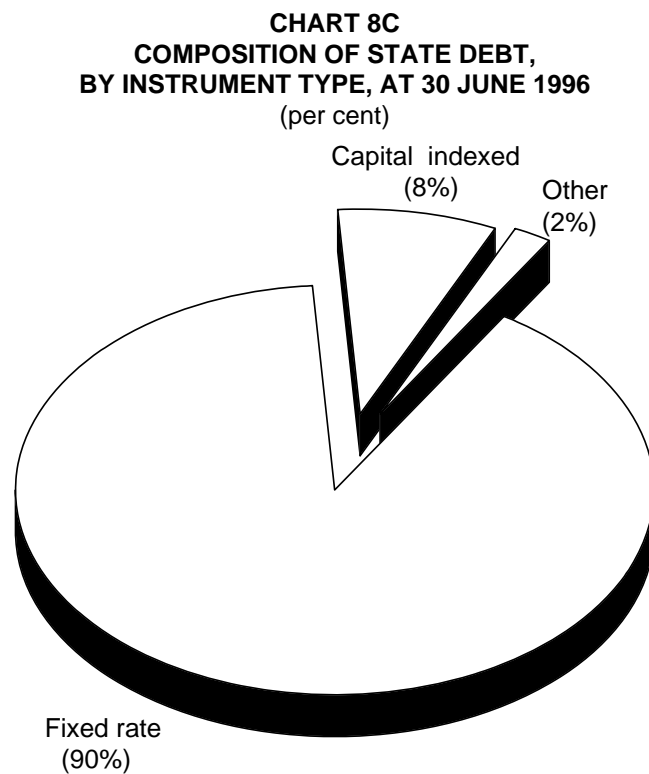
Borrowing composition and maturity profile

8.13 The Government's longer-term debt management objectives are to minimise borrowing costs, ensure continuing access to financial markets in order to satisfy financing requirements and ensure the effective management of the financial risks associated with debt. As explained in my previous Reports on the Statement of Financial Operations, the borrowing portfolio mix and maturity structure are significant determinants of the State's financing requirements in any one year, the level of financing costs and the State's exposure to adverse movements in interest rates. Accordingly, the management of the portfolio mix and maturity structure is critical to the achievement of the Government's overall debt management objectives.

LIABILITIES AND COMMITMENTS

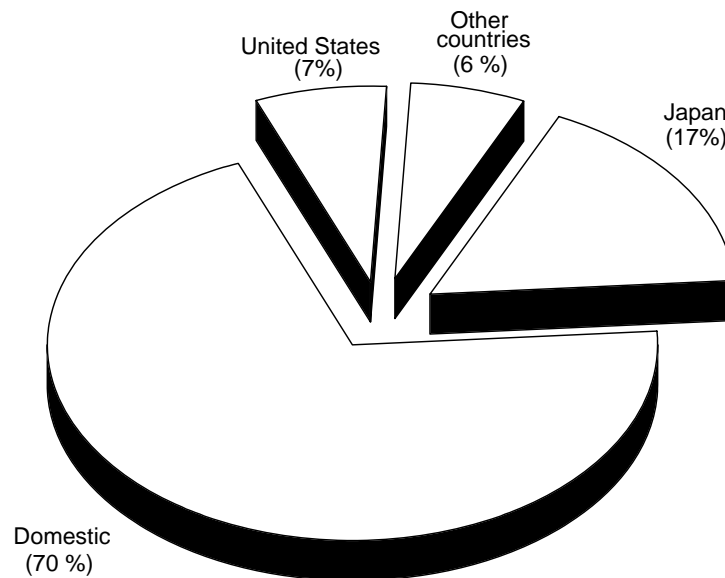
8.14 To minimise interest costs and exposures to specific financial markets, the State borrows domestically and overseas, and in various forms, commonly referred to as fixed rate, floating rate and capital indexed borrowings. These borrowings are complemented, as deemed appropriate, by the use of various debt management instruments. Debt maturities are also spread over future years to minimise the State's exposure to adverse interest rates that may prevail in any particular year in which debt is due for refinancing.

8.15 The maintenance of a diversified debt portfolio and the smoothing of the maturity profile are key strategies implemented by the Government in the management of the State's debt portfolio. Charts 8C and 8D show the composition of State debt at 30 June 1996 in terms of the forms of borrowing, and the markets in which they are raised.



LIABILITIES AND COMMITMENTS

CHART 8D
COMPOSITION OF STATE DEBT,
BY MARKET, AT 30 JUNE 1996 (a)
 (per cent)



(a) All State debt has been swapped to Australian dollars.

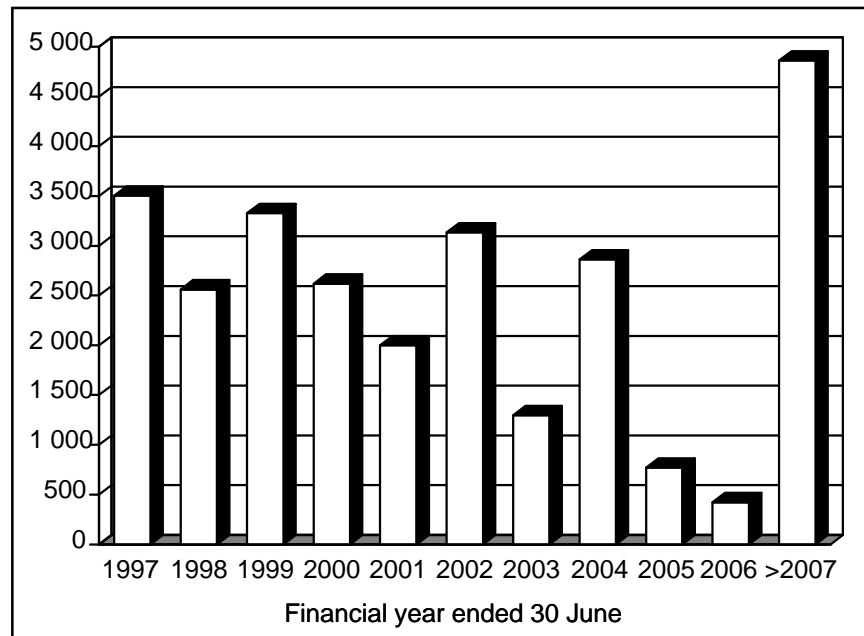
8.16 As illustrated above, the State's debt portfolio predominantly comprises fixed rate instruments, with these instruments accounting for 90 per cent of the debt portfolio at 30 June 1996. As a result of holding this type of instrument, the State's exposure to interest rate volatility has been minimised. While debt has been raised in both domestic and foreign markets, the State's exposure to foreign currency fluctuations has been minimised through the swap of all overseas debt to Australian dollars.

State debt maturity profile

8.17 An analysis of the State debt portfolio at 30 June 1996 indicates that around 88 per cent or \$24 billion (face value) of the portfolio will mature and require repayment or refinancing in the next 10 years. **During 1996-97, \$3.5 billion will require repayment or refinancing.** Chart 8E illustrates the maturity profile.

LIABILITIES AND COMMITMENTS

CHART 8E
STATE DEBT MATURITY PROFILE,
AT 30 JUNE 1996 (a)
 (\$million)



(a) Borrowings are shown in the chart at their face value.

Termination of transport sale and lease-back arrangements

8.18 During the 1989-90 financial year, the Public Transport Corporation, at the direction of the then Treasurer, entered into a series of sale and lease-back arrangements relating to transport rolling stock assets, including suburban trains, locomotives, articulated light rail vehicles and buses. These arrangements were initially classified by the Government as operating leases. However, following concerns expressed by audit regarding the substance of the arrangements, they were subsequently re-classified as finance leases and have been disclosed as part of the State's liabilities in the Statement of Financial Operations. As at 30 June 1996, an amount of \$365 million has been included in the Statement, representing the outstanding capital value of these lease-back arrangements.

8.19 As commented in my *Report on the Treasurer's Statement for the year ended 30 June 1990*, these lease arrangements, in substance, did not substantially transfer the risks and benefits incidental to ownership of the assets to an external party and were simply another form of borrowing. The audit examination, at that time, also concluded that under the established arrangements, the finance costs were higher than those payable for conventional forms of borrowings.

LIABILITIES AND COMMITMENTS

Locomotive and train lease-back

8.20 The major transaction entered into in 1989-90 involved the sale by the Public Transport Corporation of 33 G-class locomotives, 25 N-class locomotives and 50 Comeng trains for a total consideration of \$351 million, with the lease-back of these assets for an initial term of 7 years and an option to extend the lease term for a further 5 years. Under the terms of the arrangement, the Treasurer guaranteed the Corporation's lease obligations and was given an option to repurchase the equipment at the end of the lease term in January 1997. However, this option was required to be exercised by 30 June 1996 in order to acquire the equipment by June 1997.

8.21 In June 1996, the Department of Treasury and Finance estimated that the total cost of exercising the Treasurer's option to repurchase the leased assets and therefore terminating the transaction would be approximately \$291 million, comprising a capital cost of \$122 million to acquire the equipment and \$169 million for deferred rentals to be paid by the State to the lessor. However, there were a number of variables which could impact on this estimate, including the market value of the assets.

8.22 Under the arrangements, if the Treasurer did not exercise the purchase option by 30 June 1996, the residual value insurer, namely, the State Government Insurance Corporation of South Australia, was required to pay the termination amount of around \$122 million to the lessor in June 1997 and take possession of the rolling stock. However, the State was nevertheless still required to pay the estimated amount of \$169 million for deferred rentals in June 1997.

8.23 **Following consideration of these matters, in June 1996, the Treasurer exercised the option to purchase the leased assets at the end of the lease term. Accordingly, the costs associated with the option, estimated at \$291 million, will be met by the State in the 1996-97 financial year. In addition, the State may be liable for some further costs associated with this leasing arrangement.**

Bus and light rail vehicle lease-backs

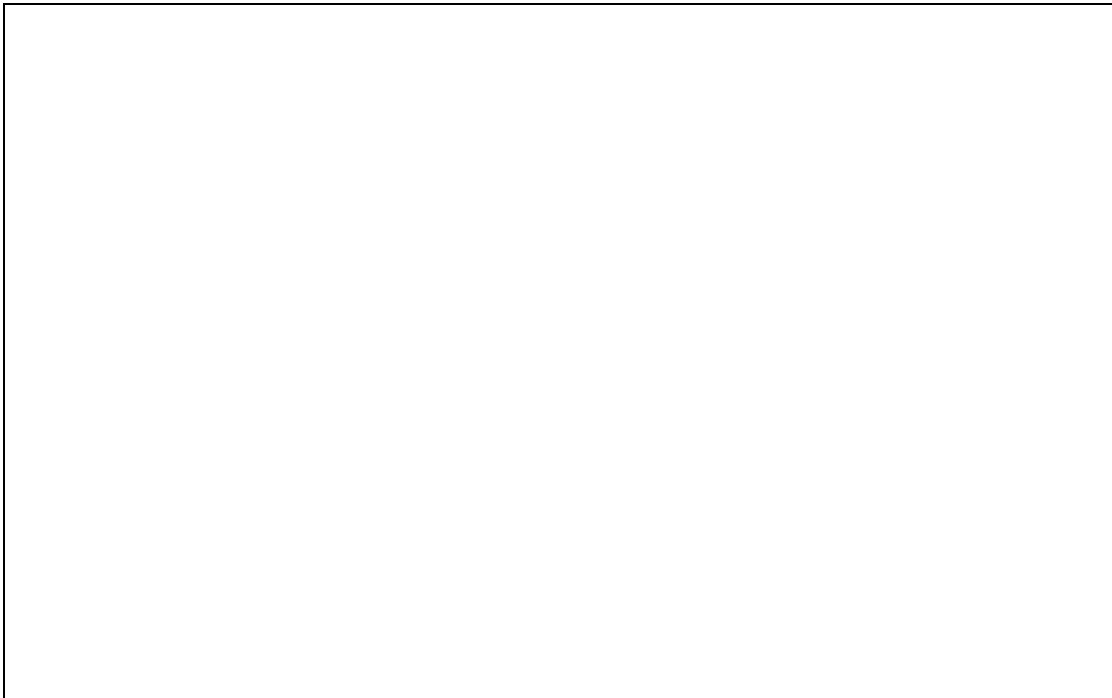
8.24 Further sale and lease-back transactions were established in the 1989-90 financial year involving the sale of 60 MAN buses, 154 Z-class trams, 13 A-class trams and 183 tram/train carriages, for a total consideration of \$97.2 million, with the lease-back of these assets for initial terms of between 7 to 10 years. As at 30 June 1996, an amount of \$54 million has been included in the Statement of Financial Operations, representing the outstanding capital value of these lease-back arrangements.

8.25 **Audit was advised by the Department of Treasury and Finance that the available options associated with these arrangements will be assessed closer to the expiry dates of the lease terms.**

LIABILITIES AND COMMITMENTS

Sale and lease-back of the Victoria Police Air Wing

8.26 The Victoria Police Air Wing operates 4 helicopters which are utilised in the provision of aerial support services to Victoria Police, the conduct of search and rescues, and the delivery of emergency medical services for the Metropolitan Ambulance Service. Prior to July 1996, the aircraft were owned and maintained by the Department of Justice and piloted by members of the Victoria Police.



Police helicopter.

8.27 Due to the ageing of the helicopter fleet and the significant cost associated with its maintenance and operation, opportunities for contracting out the fleet have been examined for a number of years. In July 1994, the Department of Justice and the former Department of Health and Community Services, on behalf of the Victoria Police and the Metropolitan Ambulance Service, called for registrations of interest for the delivery of all or part of the helicopter services. Following an evaluation in August 1994 of the 16 bids submitted, it was concluded that the proposal which would deliver the most significant benefits to the State was that provided by Lloyd Offshore Helicopters Pty Ltd, which provided for leased helicopters to be maintained and piloted by the private sector. However, the Victoria Police was strongly opposed to this proposal on the grounds that operational control and piloting of the helicopters should remain with Victoria Police.

8.28 Consequently, in late September 1995, 4 short-listed bidders were requested to re-submit their bids based on revised specifications, with an emphasis on the delivery of an option that provided for a 5 or 7 year lease term, whereby the leased helicopters would be maintained by the private sector but piloted by police personnel. In addition, the existing fleet of helicopters was to be utilised under a sale and lease-back arrangement, with the subsequent phasing-in of replacement helicopters. The revised bids were received in October 1995.

LIABILITIES AND COMMITMENTS

8.29 Following an assessment of the revised proposals submitted by the short-listed bidders, the Lloyd Offshore Helicopters Pty Ltd was selected as the preferred proponent for the provision of helicopter services to Victoria Police.

Sale and lease-back arrangements

8.30 In July 1996, the Minister for Police and Emergency Services entered into an agreement with the company for the sale of the existing fleet of 4 government-owned helicopters and associated spare parts and ground tooling equipment for a net amount of \$2.5 million, which was paid into the Consolidated Fund in August 1996. At the same time, the Minister also entered into an agreement for the supply of helicopter services by the company, with the key obligations of the company under the agreement including:

- Supply 3 dedicated helicopters for regular use and one additional helicopter for back-up purposes for a period of 7 years commencing July 1996, with an option for the State to extend the lease period for a further 3 years under the same conditions as the initial term;
- Meet the costs associated with helicopter ownership insurance, maintenance and overhaul, including costs relating to fuel and oil consumed. However, if the price of fuel exceeds 50 cents per litre, the residual cost is to be met by the State; and
- Replace the existing aircraft during the later part of the initial lease term.

8.31 On the other hand, the obligations of the State under the agreement include:

- Responsibility for the operation of the helicopters, with them piloted and crewed by police personnel. In addition, the State is to have responsibility for third party, passenger and cargo insurance relating to the operation of the helicopters;
- Indemnification of the company against any losses, damages or claims directly or indirectly arising from the operation of the helicopters, except where the loss or damage is due to the negligence of the company;
- Responsibility for costs relating to the storage of the helicopters, crew accommodation, en route charges, landing fees and security costs, when the helicopters are based at the existing facilities at Essendon Airport. In addition, the State is to pay rental for the use of new storage facilities for the helicopters at a proposed site at the Docklands to be built and financed by the company, and is to pay the cost of all associated charges while the helicopters are operating away from their base;
- Payment of monthly prescribed fees to the company for the 3 dedicated helicopters available for regular use, and daily prescribed fees for the back-up helicopter when in use. These fees are to be reviewed each January to take account of movements in prices and interest rates, insurance costs and certain employment costs;
- Payment of hourly flying charges to the company, which are to be reviewed twice yearly, once in January to take account of movements in prices and interest rates, the value of the Australian dollar and parts and fuel costs, and again in July to take account of movements in the price of fuel;

LIABILITIES AND COMMITMENTS

- Payment of supplementary hourly flying charges to the company when the helicopters are utilised in excess of a certain number of hours per month, which are to be reviewed each January to take account of movements in prices and interest rates, the value of the Australian dollar, parts and fuel costs; and
- Funding of any modifications to the helicopters to enhance their efficiency or capability.

8.32 Consistent with the terms of the lease agreement, if the company fails to remedy specified default events, enters into receivership or there is a significant change in ownership of the company, the State may at its discretion terminate the agreement and purchase all or any of the helicopters and related assets at a mutually agreed price.

Impact on State budget

8.33 The net present value of the prescribed fees and flying charges payable by the State over the initial term of the lease is \$29 million and, if the additional 3 year lease option is taken-up by the State, the net present value of payments over this extended period will be in the order of \$39 million.

8.34 In June 1996, the Minister for Police and Emergency Services determined that the net proceeds of \$2.5 million from the sale of the existing helicopters, parts and equipment would be used to offset the leasing charges to be incurred over the first 4 years of the lease agreement. However, budget supplementation over and above the existing airwing budget, estimated to be \$7 million, will be required for the remaining term of the initial lease period.

Assessment of the sale and lease-back arrangement

8.35 Based on the audit assessment of the risk allocation of the sale and lease-back arrangement, **it is my view that, in substance, the arrangement for the lease-back of the helicopters previously owned by the Government constitutes a finance lease, which should be included as part of the State's liabilities in the 1996-97 financial year.** The major considerations in support of this view include:

- the agreement is non-cancellable over the initial term of 7 years, from the State's perspective;
- the State has retained responsibility for the operation of the aircraft and must meet accommodation, security and landing charges;
- the major operating risks and risks associated with cost and price movements, covering interest rates, insurance, helicopter parts, fuel and certain employment costs, have been retained by the State; and
- the net present value of the monthly prescribed fees for these aircraft is in excess of the cost to the company of the acquisition of the helicopters originally owned by the State.

LIABILITIES AND COMMITMENTS

8.36 In relation to the lease of the replacement helicopters to be provided by the company, it is my view that the arrangement is of an operating lease nature. Significantly influencing this assessment is that, while the State may extend the lease period for a further 3 years, it is not obligated to do so. However, if the State extends the term of the lease, then the arrangement would, in substance, constitute a finance lease as the monthly prescribed fees payable by the State would sufficiently cover the company's cost of acquiring these replacement helicopters.

Financial obligations of the SECV

8.37 Following the disaggregation of the electricity and gas industries, the SECV has been retained as a so-called *shell* to manage the assets and obligations not allocated to the newly established entities. The role of the SECV Administrator is to effectively manage and, where appropriate, dispose of the assets and resolve the residual obligations of the entity. At the time of preparation of this Report, the key responsibilities of the SECV included:

- Management of rights and obligations under electricity supply contracts with the wholesale electricity market relating to the Loy Yang B power station, the Snowy Mountains power consortium inter-connecting agreement, the flexible electricity tariff arrangements relating to the Portland and Point Henry aluminium smelters, and the supply of power to South Australia;
- Completion of construction and commissioning of Unit 2 of the Loy Yang B power station. This Unit was operational and earning revenue for the SECV, however, the formal handover of the Unit to the joint venture of Mission Group and Loy Yang B Power Station Pty Ltd was planned for September 1996, with certain ongoing warranty obligations remaining with the SECV;
- Disposal of various properties, including surplus commercial and contaminated vacant land of the former Gas and Fuel Corporation of Victoria;
- Demolition of the former Yallourn Power Station complex, including the removal of hazardous metals and asbestos and site rehabilitation. Related clearance costs are estimated at \$50 million, with completion expected in August 1997;
- Administration of the unallocated electricity industry debt, which had a market value of \$42 million at 30 June 1996, with strategies currently under consideration for the retirement of this debt; and
- Resolution of other residual issues of the electricity and gas industries.

8.38 Based on the SECV's financial statements as at 30 June 1996, its financial position, not including its interest in (that is, the amount receivable from) the State's electricity businesses of \$2.5 billion, was a net deficiency of \$8 million.

LIABILITIES AND COMMITMENTS

Major developments since 30 June 1995

8.39 In my May 1996 *Report on Ministerial Portfolios*, I outlined the major developments and transactions of the SECV during the period 1 July 1995 to 31 January 1996. These developments, together with any further significant transactions to 30 June 1996, are summarised below:

- Reduction in the value of residual electricity industry debt from \$2.6 billion at 30 June 1995 to \$42 million at 30 June 1996, resulting from the application of proceeds, from the sale of 5 electricity distribution businesses and one generation company, towards debt reduction. However, \$1.5 billion of this debt was defeased to the Treasury Corporation of Victoria for subsequent retirement, in return for sale proceeds of a similar amount being forwarded to the Corporation;
- Resolution of legal proceedings against the former Gas and Fuel Corporation of Victoria by Gleem Pty Ltd in September 1996, relating to alleged damages arising from the withdrawal by the Corporation from a lease of proposed new head office accommodation. Under the terms of the settlement, no payment will be made by either party and each party will bear its own legal costs;
- Payments of \$3.6 billion of the electricity business sale proceeds to the Consolidated Fund, for subsequent application towards budget sector debt retirement;
- Payment of \$531 million to municipal councils relating to the net assets of Municipal Electricity Undertakings previously transferred to the distribution businesses;
- Sale of the Yallourn Mechanical Workshops in January 1996 for \$5 million;
- Sale of Utilities Insurance Company Pty Ltd for \$1.8 million (further detail on this sale is provided in Part 4 of this Report);
- Payment of \$56 million to the Consolidated Fund to recoup the cost of electricity supply industry privatisation met by the Department of Treasury and Finance; and
- Administration, on behalf of the State, of the remaining financial obligations and exposures, arising from the sale of the distribution companies and Yallourn Energy, as outlined in Part 4 of this Report.

8.40 In addition, during the 1996-97 financial year, the Government sold Hazelwood Power Corporation Ltd and Energy Brix Australia Ltd. As indicated previously, the results of these transactions will be analysed and reported in a subsequent Report to the Parliament.

LIABILITIES AND COMMITMENTS

Home Opportunity Loans Scheme

8.41 My previous Reports to the Parliament have extensively commented on the operations of the Home Opportunity Loans Scheme (HOLS), which was established in 1988 and administered by a company known as Home Opportunity Loans Limited.

8.42 The Scheme provides financial assistance to low and middle income earners who normally would not have the opportunity to borrow from traditional finance sources, with its financing raised by Victorian Housing Bonds Ltd through the issue of Victorian housing bonds. All funds raised by this company are subject to a government indemnity under the *Housing Act* 1983, with the indemnity supported by first mortgages over the properties subject to housing finance. The State's liability in relation to Victorian housing bonds issued as at 30 June 1996 amounted to \$751 million (face value of \$735 million), which have been included as part of the liabilities of public financial enterprises in the Statement of Financial Operations.

8.43 In view of significant losses being incurred by the Scheme over recent years, in January 1994, the Government announced that the Scheme would be restructured to enhance the management of its asset and liability portfolios. This restructuring was substantially completed by mid-1995.

8.44 Under the authority of the *Treasury Corporation of Victoria (Housing Finance) Act* 1995, the Government transferred the capital market liabilities (the housing bonds) issued by the Victorian Housing Bonds Ltd to the Treasury Corporation of Victoria, and transferred the assets and non-capital market liabilities of the Scheme to the Director of Housing as from 1 October 1996. While the transfer to these assets and liabilities was planned to be completed at an earlier time, they were delayed pending the receipt of a satisfactory tax ruling which confirmed that the transfer would not trigger a capital gains tax liability on the State. On completion of the transfer, the Home Finance Division of the Department of Human Services (which incorporates the Director of Housing) assumed management responsibility for these assets and liabilities.

Accelerated Infrastructure Program

8.45 As outlined in my previous Report on the Statement of Financial Operations, due to the substantial future exposures of the State arising from the financial arrangements established under the Accelerated Infrastructure Program, during the 1994-95 financial year, action was commenced by the Government to wind-up the Program.

8.46 The Accelerated Infrastructure Program was established in 1990-91 by the then Government, in conjunction with a major private bank, to provide accommodation for certain government agencies, principally for police stations and law courts. The arrangements under the Program involved the lease by the Government of buildings constructed by a special purpose public company established by a subsidiary of the bank. The building construction costs were financed through the issue of capital indexed bonds which would mature over a period of 20 years, with the Treasurer providing an indemnity to bond holders, under which the Government was required to meet any shortfall in the bonds raised by the company. This Government indemnity effectively negated the company's financing risk.

LIABILITIES AND COMMITMENTS

8.47 To initiate the wind-up of the Program, in June 1995 a payment of \$200 million was made from the Consolidated Fund to the Treasury Corporation of Victoria to finance the acquisition of a significant portion of the bonds issued by the financing company. During 1995-96, an additional payment of \$48 million was made to the Corporation for the acquisition of the majority of the remaining bonds.

8.48 At the date of preparation of this Report, bonds with a face value of around \$10 million were still held by private bond holders and it was expected that these would be acquired by the Government during the 1996-97 financial year. To facilitate the finalisation of the wind-up process, the Department of Treasury and Finance has also established a project team to consider the framework to be employed to collapse the current program arrangements. The value of the bonds not acquired by the Government as at 30 June 1996 is disclosed in the Statement of Financial Operations as a contingent liability.

LIABILITIES AND COMMITMENTS

UNFUNDED SUPERANNUATION LIABILITIES

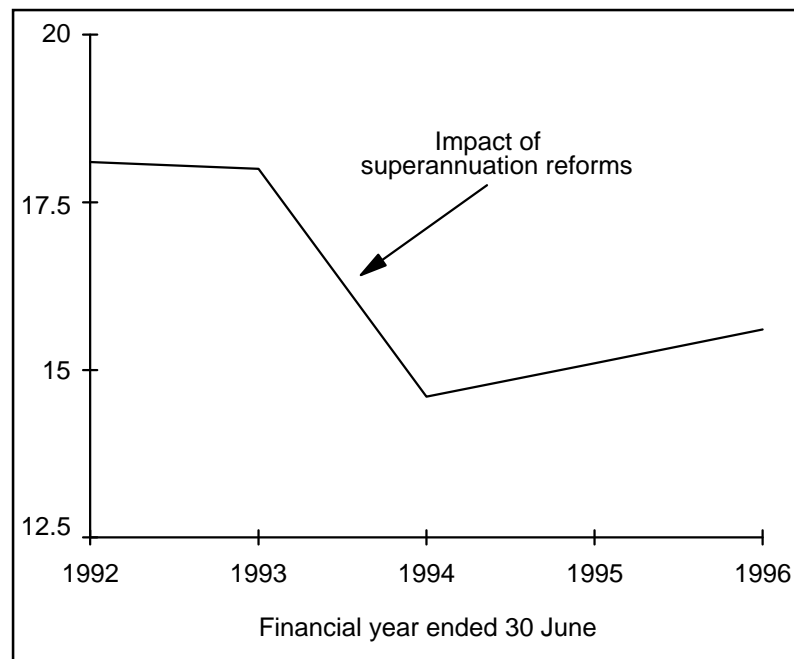
8.49 Unfunded superannuation liabilities represent the second largest component of State liabilities. These financial obligations comprise employer superannuation contributions yet to be paid by the Government and certain public sector bodies to superannuation schemes in respect of services previously provided by employees. The liabilities have arisen as a result of decisions of previous governments to progressively meet the employer share of superannuation benefits after employees retire, rather than as benefits accrue over the working lives of employees.

8.50 The unfunded liabilities of public sector superannuation funds at 30 June 1996 totalled \$15.6 billion, representing an increase of \$506 million or 3 per cent since the previous year. The unfunded superannuation liabilities relate to the following sectors:

- Budget - \$14.7 billion (30 June 1995, \$12.1 billion); and
- Non-budget - \$907 million (30 June 1995, \$3 billion).

8.51 Chart 8F shows the movement in the level of the State's superannuation liabilities over the past 5 years.

CHART 8F
MOVEMENT IN UNFUNDED LIABILITIES
OF PUBLIC SECTOR SUPERANNUATION FUNDS
((\$billion))



LIABILITIES AND COMMITMENTS

8.52 As explained in my previous Reports on the Statement of Financial Operations, the substantial reduction in the overall level of public sector unfunded superannuation liabilities since 1992 was principally due to the substantial reduction of the budget sector workforce resulting from the operation of the Government's employee departure programs; a low rate of growth in wages and salaries over this period; substantial one-off Consolidated Fund contributions to various superannuation schemes in the 1993-94 and 1994-95 financial years to meet the Government's liability for deferred employer contributions; and the effect of the various superannuation reforms introduced by the Government in 1993-94.

8.53 As the chart illustrates, there has been an upward trend in the level of unfunded superannuation liabilities since 1994-95. The reason for the increase in the aggregate level of these liabilities as advised by the Department of Treasury and Finance, was mainly due to Government superannuation contributions failing to keep pace with the increase in the accruing liabilities of the superannuation funds.

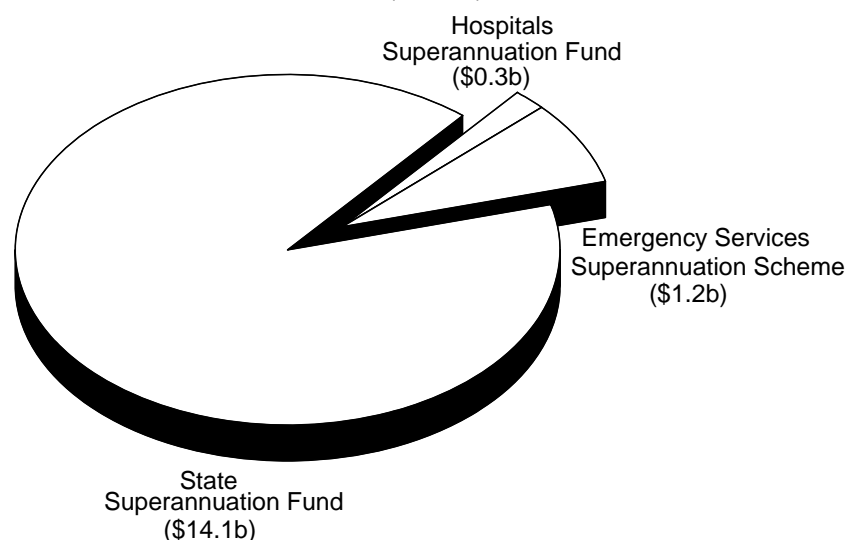
8.54 The overall reduction in unfunded superannuation liabilities for the non-budget sector was due to a change in the Government's accounting policy in the year, under which the Department of Treasury and Finance assumed the aggregate unfunded superannuation liability of certain non-budget sector agencies, except for the unfunded liabilities relating to certain self-funded agencies, and those that are wholly or partly funded by the Commonwealth Government, such as Universities.

8.55 In its *Autumn Economic Statement 1996*, the Government has identified that, despite the superannuation reforms implemented to date, the unfunded liabilities will continue to grow in real terms over the next 5 years, due to the present financing of such liabilities on an *emerging cost basis* and the increasing age and length of service profile of remaining scheme members.

8.56 Chart 8G illustrates the superannuation funds principally responsible for managing the unfunded liabilities of the State at 30 June 1996.

LIABILITIES AND COMMITMENTS

CHART 8G
UNFUNDED LIABILITIES OF PUBLIC SECTOR
SUPERANNUATION FUNDS, 30 JUNE 1996
 (\$billion)



Revised superannuation funding arrangements

8.57 Prior to November 1995, the employer share of superannuation contributions to public sector superannuation funds was mainly paid by the State on an *emerging cost* basis, that is, as superannuation benefits were actually paid to employees by the funds, rather than as benefits accrued. Given that the increase in the employer share of accrued benefits was substantially higher than the superannuation contributions paid by the State, this practice resulted in the accumulation of substantial unfunded superannuation liabilities of the State.

8.58 Amendments to the *State Superannuation Act* 1988, in June 1995, had the effect of rationalising the number of public sector superannuation schemes from 33 to 22 and changing the funding arrangements in respect of employer superannuation contributions as from November 1995. In particular, under the new arrangements:

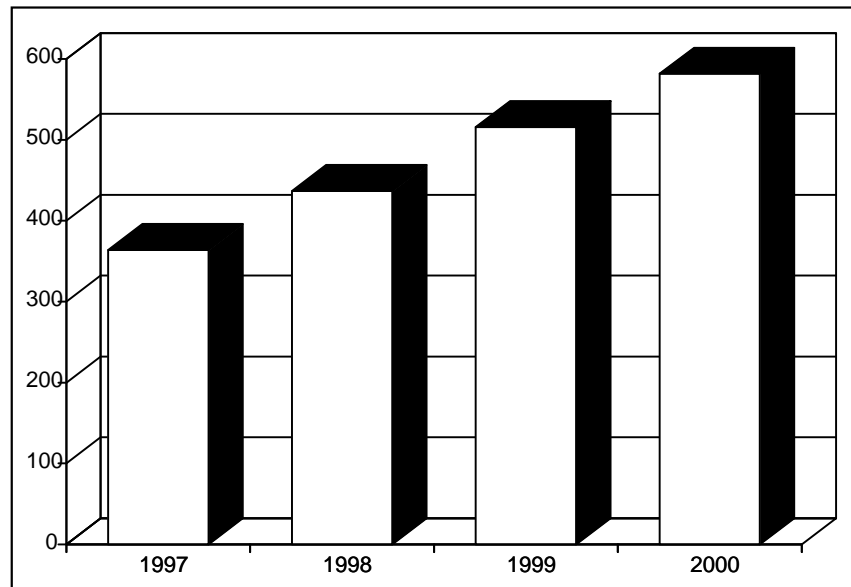
- employer contributions are, in most cases, to be made on an accrual basis; and
- the unfunded liability accrued up to November 1995 is to be progressively met from additional payments from the Consolidated Fund.

8.59 In October 1995, an actuary appointed by the Victorian Superannuation Board recommended that a minimum contribution of \$217 million for the 8 months to 30 June 1996 be made by the Government to the State Superannuation Fund to assist in meeting the Fund's unfunded liability accrued from July 1995 to November 1995. Consistent with the actuary's recommendation, the Consolidated Fund paid an equivalent amount to the superannuation fund in the 1995-96 financial year to assist in reducing the State's unfunded liabilities.

8.60 In July 1996, the actuary advised the Government of the estimated contributions that should be made in future years to the State Superannuation Fund to assist in reducing the State's unfunded liabilities. Chart 8H shows the actuary's recommended minimum contributions over the next 4 years.

LIABILITIES AND COMMITMENTS

CHART 8H
RECOMMENDED MINIMUM CONTRIBUTIONS TO THE STATE
SUPERANNUATION FUND TO REDUCE UNFUNDED LIABILITIES,
1996-97 TO 1999- 2000 (a)
 (\$million)



(a) In nominal dollars.

8.61 Based on the advice provided by the actuary, the minimum contributions to be made by the Government in meeting the accrued unfunded liability will increase over a number of years, before starting to decline. In fact, the actuary estimated that the minimum contributions will peak to \$1.7 billion, in nominal terms, by the financial year ending June 2020. The actuary further estimated that, based on the continued payment of the minimum contributions, the unfunded liability in nominal terms would increase to \$21.8 billion as at 30 June 2011.

8.62 The Department of Treasury and Finance is currently evaluating the merit of using proceeds from the future sale of electricity businesses towards the reduction of the unfunded liability.

LIABILITIES AND COMMITMENTS

Agency funding of superannuation liabilities

8.63 Under the arrangements established over a number of years, specified self-funded agencies with employees which are members of the State Superannuation Fund have been required to progressively meet the employer share of superannuation contributions by making payments to the Consolidated Fund. However, these contributions were not immediately paid to the Superannuation Fund but were retained by the Consolidated Fund to finance the employer share of subsequent benefit payments made by the State Superannuation Fund.

8.64 The audit review of the unfunded superannuation liabilities of the State Superannuation Fund relating to non-budget sector agencies has identified that, based on the records maintained by the Department of Treasury and Finance, there were **a number of agencies whose aggregate employer superannuation contributions paid to the Consolidated Fund as at 30 June 1996 exceeded the superannuation liabilities relating to their employees by \$42 million.** Table 8I discloses the key entities whose contributions to the Consolidated Fund exceeded their superannuation liability.

TABLE 8I
AGENCIES WITH SUPERANNUATION
CONTRIBUTIONS IN EXCESS OF
SUPERANNUATION LIABILITIES, 30 JUNE 1996
((\$million))

<i>Agency</i>	<i>Liability</i>	<i>Cumulative employer contribution s</i>	<i>Excess contribution s</i>
Transport Accident Commission	22	32	10
Rural Finance Corporation	23	31	8
Construction Industry Long Service Leave Board	3	11	8
Victorian Legal Aid Commission	7	12	5
Estate Agents Board	1	4	3

8.65 While the excess contributions by the respective agencies have benefited the Consolidated Fund over previous years, it is important that future employer contributions are consistent with the related accrued liabilities.

LIABILITIES AND COMMITMENTS

OTHER EMPLOYEE ENTITLEMENTS

8.66 In addition to the State's obligation to meet unfunded superannuation liabilities in respect of services previously provided by employees, the State has an obligation to meet other employee entitlements, including accrued annual leave and long service leave.

8.67 The State's financial obligations in respect of accrued employee entitlements, excluding unfunded superannuation liabilities, at 30 June 1996 stood at \$1.9 billion (1994-95, \$2.2 billion). Table 8J outlines the key components of these obligations.

TABLE 8J
OTHER EMPLOYEE ENTITLEMENTS,
AS AT 30 JUNE
((\$billion))

<i>Type</i>	1996	<i>1995</i>
Long service leave	1.4	1.5
Recreation leave	0.4	0.4
Other employee entitlements	0.1	0.1
Total	1.9	2.2

8.68 The decrease of \$306 million in the year in the level of outstanding employee entitlements was mainly due to the impact of the Government's electricity privatisation program and the budget sector workforce reduction program.

LIABILITIES AND COMMITMENTS

PAYABLES AND ACCRUED EXPENSES

8.69 Financial obligations in the nature of *payables and accrued expenses* mainly comprise amounts payable by the State under the flexible electricity tariff arrangements established in relation to the operation of the Portland and Point Henry aluminium smelters, State obligations associated with the development of the World Congress Centre and St Vincent's Hospital, accrued interest on State debt, transport accident and workers compensation claims liabilities, amounts owing to creditors, and various other amounts payable and accrued at year-end.

8.70 The State's financial obligations in respect to amounts payable and accrued expenses at 30 June 1996 totalled \$13.3 billion, compared with \$14.1 billion in the previous year. Table 8K outlines the key components of these obligations.

TABLE 8K
PAYABLES AND ACCRUED EXPENSES,
AS AT 30 JUNE
(\$billion)

<i>Type</i>	<i>Budget sector</i>	<i>Non-budget sector</i>	<i>Public financial enterprises</i>	Total 1995-96 (a)	<i>Total 1994-95 (a)</i>
Outstanding claims liabilities	-	-	5.5	5.5	5.0
Flexible electricity tariff obligations	1.3	-	-	1.3	1.3
Infrastructure projects (b)	0.3	-	-	0.3	0.3
Accrued interest	0.4	0.2	0.7	0.7	1.0
Payables	1.1	0.8	1.1	1.4	3.2
Other accrued expenses	0.8	1.7	1.6	4.1	3.3
Total payables and accrued expenses	3.9	2.7	8.9	13.3	14.1

(a) The total balances are presented net of inter-entity eliminations, that is, after deducting amounts payable to other public sector agencies.

(b) Includes the State's financial obligations in respect to the World Congress Centre and St Vincent's Hospital developments.

8.71 The decrease of \$850 million in the year in the level of payables and accrued expenses was mainly due to the privatisation of the electricity businesses during the year, off-set by increased outstanding claims liabilities.

Flexible electricity tariff arrangements

8.72 As outlined in my previous Reports to the Parliament on the Statement of Financial Operations, the State has incurred significant financial obligations under the flexible electricity tariff arrangements established by the Government in 1984 in relation to the Portland and Point Henry aluminium smelters. Under these arrangements, which extend to the year 2016, the Consolidated Fund is responsible for meeting the Government's obligations to make payments to the SECV when aluminium prices fall below a stipulated level, a situation that has occurred consistently in recent years.

LIABILITIES AND COMMITMENTS

8.73 Payments made by the Consolidated Fund under the flexible electricity tariff arrangements in 1995-96 totalled \$124 million (1994-95, \$147 million), which was \$36 million less than budget expectations. The favourable budget result in the year was mainly attributable to increased world aluminium prices, which were not anticipated at the time of the preparation of the budget.

8.74 Based on current expectations of future aluminium prices and inflation levels, the present value of the State's aggregate exposure under the arrangements is estimated by the Department of Treasury and Finance to be \$1.6 billion at 30 June 1996, comprising \$1.2 billion in relation to the Portland smelter and \$400 million associated with the smelter at Point Henry.

8.75 However, given the State's 25 per cent interest in the Portland smelter, from a whole-of-government perspective, the net exposure of the State under the flexible tariff arrangements is approximately \$1.3 billion. This amount has been included in the Statement of Financial Operations as part of budget sector liabilities. Nevertheless, the State's exposure is ultimately dependent on future aluminium prices and inflation levels.

8.76 While the Government has pursued various strategies to manage the State's exposure under these arrangements, given Alcoa's reluctance to re-negotiate the terms of the agreements, discussions between the Government and Alcoa on this matter were terminated in July 1995. No further developments have occurred as at the date of preparation of this Report.

St Vincent's Hospital redevelopment

8.77 My previous Reports to the Parliament have commented on the complex financial arrangements entered into by the Government in 1991 to finance the redevelopment of part of the St Vincent's Hospital, which is owned by the Sisters of Charity religious order. The redevelopment project commenced in January 1993 and was completed in October 1995 at an estimated cost of \$146 million.

8.78 Under the financial arrangements, the redevelopment is to be initially funded from a combination of borrowings raised by the Hospital and equity finance provided by banks. Ultimately, the financial obligations associated with the redevelopment are to be serviced by the Hospital from funds provided by the State over a 25 year period, in accordance with a Health Services Agreement entered into between the Hospital and the former Department of Health and Community Services. The State will continue to fund the redevelopment of the Hospital, provided that health services continue to be provided to the public over the agreed period. Ownership of the redevelopment will rest with the financiers for the first 15 years and, following the settlement payment, will pass to the Sisters of Charity.

8.79 As at 30 June 1996, the Hospital had raised \$142 million to finance the redevelopment, comprising \$80 million raised through the issue of bonds and \$62 million in equity financing provided by the banks. **This amount, which is to be ultimately financed by the Department of Human Services in accordance with a Health Services Agreement, is included as part of the State budget sector's liabilities.**

Current developments

LIABILITIES AND COMMITMENTS

8.80 In 1992, the project financiers received a taxation ruling from the Australian Taxation Office which did not allow the claiming by the project financiers of taxation deductions associated with the depreciation of certain chattels. Consequently, in November 1995, the financiers proposed a number of amendments to the financial arrangements which would enable the restructuring of the leasing arrangements and facilitate the deductibility of depreciation of chattels for taxation purposes.

8.81 Following an assessment of the proposed changes, during 1995-96, the Hospital sought the Treasurer's approval to certain amendments to the arrangements, on the basis that they would result in financial benefits to the State. In response, the Treasurer advised the Hospital that the Government did not wish to revise the existing arrangements.

World Congress Centre

8.82 The World Congress Centre is located at the corner of Spencer and Flinders Streets, Melbourne and was constructed in 1990 at a cost of \$149 million. The Centre caters for national and international conventions, exhibitions and related activities, and together with the World Trade Centre and the Melbourne Exhibition Centre, has contributed to Melbourne's prominent role in the convention and exhibition market.

8.83 My previous reports to the Parliament on the Finance Statement have provided detailed comment on the complex financial arrangements established in the mid-1980s by the Government in relation to the construction and financing of the World Congress Centre. These arrangements consisted of bank financing to construct the Centre and refinancing of the debt through an equity arrangement from funds invested by a major Australian private bank and 4 foreign financial institutions. In order to redeem the private sector investment provided under the equity arrangements, banking finance is required to be obtained by February 1997. The arrangements also provide for the sale of the Centre in the year 2002, at which time all outstanding debt will be repaid.

8.84 In summary, the State's obligations over a 12 year period ending in 2002, are as follows:

- the funding of any shortfall between the net operating income generated by the Centre and the servicing of interest payments on the debt obtained to construct the Centre;
- the provision of operating subsidies to the Centre; and
- a series of indemnities to the trustee of the property trust and the respective banks, as protection against losses which may be incurred by them during their involvement in this development.

LIABILITIES AND COMMITMENTS

8.85 Audit has maintained that the financial arrangements established by the Government to sponsor the construction of the Centre increased the State's liabilities by \$149 million, as the risks and benefits associated with these arrangements remained with the State. This position was also supported in May 1992 by the Estimates Sub-Committee of the then Economic and Budget Review Committee of the Parliament. Consequently, since that time, the Government has recognised an amount of \$149 million associated with these arrangements as a liability of the State.

8.86 Given that the redemption of the private sector equity investment in the Centre is due to occur in February 1997, the Department of Treasury and Finance in 1994 considered various options in relation to the arrangements.

8.87 Following consideration of advice provided by the Department and its legal advisors, in May 1996 the Treasurer approved the commencement of negotiations by the Department for the purchase of the World Congress Centre, which would result in the termination of the arrangements as at February 1997, at an estimated overall cost of up to \$176 million. In the Statement of Financial Operations, as at 30 June 1996, the Department has recognised a liability of \$149 million relating to the World Congress Centre.

New Prisons Project

8.88 My Report to the Parliament on the Statement of Financial Operations for the 1994-95 financial year commented on the establishment by the Government in December 1993 of the New Prisons Project. Under the project arrangements, private sector participation was sought for the delivery of 3 new prisons in Victoria to replace Pentridge, the Metropolitan Reception Prison, Fairlea Women's Prison and the prison located at Sale. The 3 new facilities, which are to accommodate approximately 75 per cent of the female prisoners and 50 per cent of the male prisoners of the State, are to comprise:

- a 125 bed metropolitan women's prison;
- a 600 bed male medium-security facility to be located in country Victoria; and
- a 600 bed male maximum-security and remand facility to be located in the Melbourne metropolitan area.

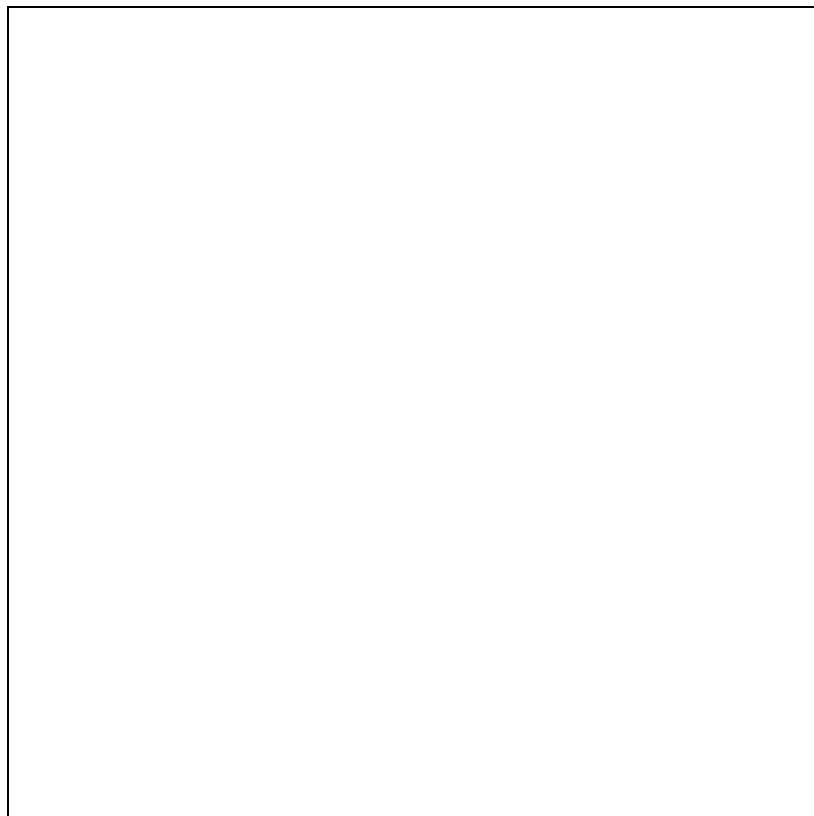
8.89 As stated in my previous Report, the key objectives of the project are to:

- replace inadequate and ageing prisons with new facilities and increase the capacity of correctional facilities to meet projected demand;
- reduce the costs of infrastructure development;
- ensure the scope and quality of services to prisoners is maintained and/or enhanced without compromising security and safety;
- meet government policy objectives for private sector involvement in prison operations;
- establish competition among private and public sector providers of correctional services; and
- introduce new approaches to the design, construction and management of prisons.

LIABILITIES AND COMMITMENTS

Appointment of project developers and operators

8.90 In July 1994, the Government issued a project brief for the design, construction and operation of the new metropolitan *Women's Correctional Centre* at Deer Park, west of Melbourne. In December 1994, following a detailed assessment of 3 tenders which were received, a private sector consortium was selected as the preferred tenderer to build, own and operate the new facility. Subsequently, the arrangements for the establishment of the correctional centre were finalised in June 1995.



Women's Correctional Centre, Deer Park.

8.91 The construction of the **Women's Correctional Centre** was completed and the facility was commissioned in August 1996 at a **total project cost to the private sector consortium of \$21 million, funded from \$17 million debt financing and a \$4 million equity contribution.**

8.92 The Government, in November 1994, issued a project brief for the **design, construction and operation of the Rural Men's Prison** at Fulham near the City of Sale. Following the detailed evaluation of 4 tenders received, in May 1995, the preferred tenderer for the construction, ownership and operation of this facility was selected. Subsequently, in October 1995, the contractual arrangements with the preferred bidder in relation to the facility were finalised. Construction of the 600 prisoner facility at Fulham is expected to be completed by April 1997, at an **estimated total cost to the consortium of \$63 million, to be funded from \$54 million debt financing and \$9 million equity contributions.**

LIABILITIES AND COMMITMENTS

8.93 In August 1995, the Government issued a project brief for the design, **construction and operation of the Metropolitan Men's Prison** at Laverton North, which is west of Melbourne. In November 1995, tender submissions were received from 3 bidders who had been previously short-listed. However, in February 1996, the Government advised the bidders that their submissions did not meet all the criteria of the project brief. Consequently, all bidders were requested to resubmit their bid proposals by March 1996. Following an evaluation of these proposals, the Government announced the successful bidder in April 1996 and finalised the completion of the arrangements by July 1996. Construction of the prison facility is expected to be completed by December 1997 at an **estimated total cost to the consortium of \$60 million, funded from \$55 million debt financing and \$5 million equity contributions.**

8.94 A chartered accounting firm was appointed by the Government in April 1994 to perform the role of probity auditor of the bid evaluation process relating to each of the 3 new prisons. In relation to all of the prison projects, the probity auditor concluded that the methodology and criteria used for the evaluation of the bids was fair and reasonable.

Financial and operating arrangements

8.95 As indicated in my previous Report, the financial and operating arrangements relating to each facility are set out in a series of complex agreements between the State, the companies established by each private sector consortium and the projects' financiers. The primary agreements comprise a Ground Lease Agreement, a Prison Services Agreement and a Multi-Party Agreement. The key terms of these agreements include:

- The facilities to be constructed on land leased by the companies from the Government for a term of 40 years in relation to the Women's Correctional Centre and the Rural Men's Prison, and for a term of 50 years in relation to the Metropolitan Men's Prison. The lease rentals payable by the companies are to be set at commercial rates which are subject to regular review, based on Valuer-General or private valuer assessments;
- Specified prison accommodation services to be provided by the companies over a 20 year period, with allowance for a further 10 year extension to this period in relation to the Women's Correctional Centre and the Metropolitan Men's Prison, and a 20 year extension in the case of the Rural Men's Prison. **An accommodation service charge is to be payable by the Government for the provision of these services and is intended to finance the debt obligations associated with the construction of the facilities, including principal and interest payments, over the initial period of the contract;**
- **Specified correctional services and programs to be provided by the companies over an initial 5 year period, with correctional services fees to be payable by the Government for the delivery of these services.** The contracts for the delivery of these services is renewable at the Government's option for 5 further terms of 3 years or could be put to tender by the Government at the end of the initial term or upon expiry of each term thereafter;

LIABILITIES AND COMMITMENTS

- Ownership of the facilities to rest with the private sector companies, with **annual performance-linked fees payable by the State to the companies** based only on the achievement of specified service delivery outcomes. These fees are intended to **provide a return on the equity investments by the consortiums**; and
- The company financiers to hold a security interest in the new facilities.

Key risks associated with construction, ownership and operation of the facilities

8.96 The arrangements associated with the new prison facilities have been structured by the Government with the aim of transferring certain of the risks associated with the construction, ownership and operation of the facilities to the private sector. The key risks are detailed below:

- The Government can withdraw from the prison service agreements or sue the companies for compensation in the event that construction of the facilities is not completed by the targeted dates. Furthermore, the risks associated with construction cost overruns are borne by the companies. However, the State retains responsibility for any costs that may be incurred in relation to the removal of any site contamination;
- While the property lease terms for the 3 prisons extend from 40 to 50 years, the service agreements with the companies cover 20 years. **At the end of this initial lease term, the Government has no commitment to purchase or continue utilisation of the facilities** and the companies may use the sites for other purposes or "remove" the correctional facilities. However, the Government has an option to increase the term of the service agreements by 10 years or 20 years, depending on the facility;
- Performance bonds are required to be provided by the companies to the State for both the construction and operational phases of the projects to ensure the companies perform their obligations under the service agreements;
- The companies are responsible for maintaining specified insurances during the construction and operational phases of the respective facilities but the associated insurance costs are recouped via service charges payable by the Government. Furthermore, in the event that a facility is damaged or destroyed during the term of the service agreement, the respective company and financiers are responsible for its re-instatement. However, in relation to the Metropolitan Men's Prison and the Rural Men's Prison, if the facility is destroyed beyond repair and the insurance proceeds are insufficient to meet the cost of its re-instatement, the company is obligated to endeavour to re-instate the facility. However, if the State and the company are unable to agree on the nature of the re-instatement, then the company may use the insurance proceeds for other purposes and the service agreement may be terminated;
- The risks relating to the maintenance, repair and refurbishment of the facilities are borne by the companies;
- The companies bear responsibility for the day-to-day operations of the facilities, consistent with government-established standards;

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- The accommodation services charge payable by the Government over the period of the service agreements, which is designed to finance the companies' debt servicing obligations, site lease payments and the provision of certain other accommodation services, **may be reduced or stopped in the event that the companies do not provide specified levels and standards of accommodation. Furthermore, under certain default conditions, the Government may, inter alia, take temporary control of the prison facilities, terminate the service agreements and sue the companies for compensation.** Under the established arrangements, the State generally may terminate the service agreements in specified circumstances, including where the companies breach their probity obligations, enter into liquidation, or commit accommodation service defaults which have a material adverse effect on the public interest or the safe custody or welfare of the prisoners;
- The risk associated with the companies receiving reduced accommodation service charges from the Government to meet their debt servicing obligations is mitigated, given that the service charges are required to be regularly reviewed to take account of, inter alia, the level of outstanding debt, any additional compliance costs arising from any changes in law and movements in prices (CPI), wages and salaries. But adjustments to the debt component of accommodation services charges may only be made under limited circumstances, involving the damage of a facility beyond repair where there is a shortfall in insurance proceeds for the re-instatement of the facility;
- The State, although not legally bound, is obliged to consider the re-negotiation of the accommodation services charge in relation to the Metropolitan's Men's Prison, in the event of a change in the *Income Tax Assessment Act* 1936, a material change in the *economic circumstances* of the company or the imposition of a consumption tax or other taxes to similar effect by the Government. However, the term *economic circumstances* is not defined in the service agreement; and
- The provision of correctional services by the companies covers an initial term of only 5 years. Thereafter, the services may be put to tender by the Government. Also, if the operators default on the provision of such services, the Government may require the appointment of new operators or may terminate the service agreements. However, if the service agreements are terminated due to a correctional services default and the Government assumes operating responsibility for the prisons, the Government is required to discharge or assume the project debt.

8.97 Under the arrangements, the State is obligated to provide *start-up funding* to the companies responsible for the commissioning of the Metropolitan Men's Prison and the Rural Men's Prison, for initial working capital purposes, prior to the commencement of the operation of the new prison facilities. The aggregate level of such funding, which is not to exceed \$7 million (subject to indexation for price movements), is not repayable by the companies to the State.

8.98 Furthermore, the State is required to compensate the companies, through additional fees or one-off payments, for any additional costs incurred as a result of certain changes in law or government policy. Depending on the facility, changes in law or government policy generally cover:

- changes to prison management specifications;

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- new laws requiring a physical addition or alteration to the facility or causing a reduction in the gross amount of the accommodation services charge receivable by the companies; and
- changes in law relating to stamp duty and sales tax obligations.

Overall assessment of arrangements

8.99 In summary, under the arrangements relating to the provision of the new prison facilities, private sector companies will build, own and operate the 3 new prisons which are to be situated on Crown land, with the Government purchasing accommodation and correctional services from these companies over an initial period of 20 years under individual service agreements.

8.100 The fees payable by the Government for the delivery of these services are designed to enable the companies over the initial period to meet their debt servicing and lease obligations, and to attain a return on equity. However, under certain circumstances where the companies do not provide the required prison accommodation or correctional services, the Government is entitled to pay reduced accommodation and correctional services and performance-related fees to the companies or to terminate the accommodation service agreements. In the event that specified accommodation service defaults occur, the State *inter alia*, may take temporary control of the facilities while alternative facilities to relocate prisoners are obtained, and may claim compensation from the companies for costs incurred.

8.101 However, the State has retained certain responsibilities and risks in relation to the new prison facilities, including:

- Increased service provision costs, resulting from movements in prices (CPI), wages and salaries. Furthermore, the State must meet any additional compliance costs caused by certain changes in law or government policy;
- Provision of start-up funding of up to \$7 million, which is not repayable by the companies to the State;
- Exposure to possible increases in the accommodation services charge, payable by the State, resulting from a shortfall in insurance proceeds in the event of the total destruction of a prison facility;
- Costs associated with dealing with certain emergency situations within the facility, which did not result from a company default; and
- Development of a co-ordinated disaster plan, dealing with the event that one or more prison facilities experience a materially adverse accommodation services default.

8.102 In my opinion, despite these obligations retained by the State, the companies substantially bear the overall risks associated with financing the new prison facilities.

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8.103 The arrangements are anticipated by the Government to result in substantial benefits to the State, through the achievement of service provision costs lower than the benchmark costs of the existing public prisons. Table 8L discloses the estimated net present value of savings in service provision costs expected to be achieved by the Government under the new arrangements when compared with the benchmark costs of existing public prison facilities as determined by the Department of Justice.

TABLE 8L
ESTIMATED SAVINGS IN COST OF SERVICE PROVISION FOR THE
NEW PRISON FACILITIES

<i>Facility</i>	<i>Number of prisoners</i>	<i>Initial term of agreement</i>	<i>Estimated savings in service provision costs (a)</i>
	<i>(no.)</i>	<i>(years)</i>	<i>(\$m)</i>
Women's Correctional Centre	125	20	16
Rural Men's Prison	600	20	157
Metropolitan Men's Prison	600	20	62

(a) Total net present value over the term of the service agreements.

8.104 As indicated in the table, for each new prison facility, there are considerable savings in service provision costs over the term of the service agreements.

Tax deductibility of project expenses

8.105 As explained in my October 1995 Report to the Parliament, the deductibility for taxation purposes of certain project expenditure can impact on a project's financial viability. Given the potentially significant impact of the taxation status of the financial arrangements relating to the new prison facilities, in December 1994, the Government commenced discussions with the Australian Taxation Office and the Commonwealth Government to facilitate the development of tax rulings on infrastructure projects, including the new prison projects.

8.106 During 1995-96, the Australian Taxation Office handed down favourable private rulings in relation to these facilities, thus enabling the respective consortiums to successfully claim deductions relating to depreciation and obtain other tax benefits.

CONTINGENT LIABILITIES OF THE STATE

8.107 The Statement of Financial Operations discloses that the estimated contingent liabilities of the State at 30 June 1996 arising from Government guarantees and indemnities were around \$2 billion. In addition, various other contingent liabilities existed at 30 June 1996 which could not be reliably quantified. These contingent liabilities are summarised in the Statement of Financial Operations.

8.108 Contingent liabilities represent potential commitments of the State, the occurrence of which is dependent upon future events or outcomes. Such commitments do not constitute actual liabilities but arise from the provision of guarantees, indemnities, sureties, letters of comfort and other forms of financial support. These instruments are issued for various purposes, but generally to provide assistance to entities in raising funds by reducing the level of risk to private sector institutions.

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

8.110 While instruments giving rise to contingent liabilities place no immediate demand on public finances, they are nevertheless significant as the Government may be required to honour its undertakings many years after such undertakings are given.

8.111 In my previous Report on the Statement of Financial Operations, I expressed concern that the momentum previously established to improve the recording, reporting and management of the State's contingent liabilities had not been maintained during 1994-95. In particular, it was identified that the Department of Treasury and Finance had not yet completed the upgrade of its central contingent liability database, a policy and procedures manual for the control and monitoring of contingent liabilities had not been issued to departments, and a significant number of departments had not established contingent liability registers.

8.112 An audit review of progress made during 1995-96 in addressing the above outstanding issues identified that:

- All departments, except for the Departments of Education and Justice, had developed individual contingent liability registers;
- A policy and procedures manual for the control and monitoring of contingent liabilities had not been issued to departments. However, the Department of Treasury and Finance has developed a manual for the control and monitoring of guarantees for internal purposes, which is to be made available to departments as necessary; and
- The Department of Treasury and Finance had not yet fully established its central contingent liability database. However, the Department advised audit that the database should be completed by early 1997. In addition, the Department is currently determining whether to establish an interface between the individual departmental registers with the central contingent liability database.

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8.113 To ensure the effective recording, reporting and management of the State's contingent liabilities, it is critical that prompt action is taken to complete the implementation of the above initiatives.

8.114 In order to form an opinion as to whether the contingent liabilities of the State are fairly presented in the Statement of Financial Operations in accordance with the *Financial Management Act 1994*, audit performed the following key verification procedures:

- as part of the financial audits of all major public sector entities, a review was undertaken of procedures in place for the identification, recording and reporting of contingent liabilities;
- examination, on a test basis, of documentation supporting the major contingent liabilities, as disclosed in surveys returned to the Department of Treasury and Finance which were used in the preparation of the Statement of Financial Operations, to assess the completeness and accuracy of disclosure;
- review of the procedures adopted by the Department of Treasury and Finance for the recording and monitoring of contingent liabilities; and
- confirmation of the accuracy and completeness of contingent liabilities disclosed in surveys used to prepare the Statement, through the receipt of appropriate certifications from departmental secretaries and chief executive officers of major public bodies.

8.115 Based on the results of these procedures, I am satisfied that the contingent liabilities of the State have been presented fairly in the Statement of Financial Operations. Comments follow on the more significant contingent liabilities of the State.

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Australian Grand Prix Corporation

8.116 My previous Reports on the Statement of Financial Operations have commented on the State's financial commitments and exposures under the financial arrangements entered into by the Government for the staging of the Formula One Grand Prix event in Melbourne and the Australian Motorcycle Grand Prix event to be held at Phillip Island.

8.117 During the 1993-94 financial year, Melbourne Major Events Company Ltd (MMEC), which was established by the Government to assist in identifying and attracting major sporting and cultural events to the State, secured the Formula One Grand Prix race for Melbourne for a number of years. In April 1993, the Government authorised MMEC to establish a wholly-owned subsidiary company, known as Melbourne Grand Prix Promotions Pty Ltd (MGPP), to be solely responsible for the promotion and staging of the event.

8.118 The Treasurer provided an indemnity to MGPP in June 1994 against any liability arising from, or relating to, the carrying out of any activities associated with its objectives as set out in the Memorandum of Association, with further indemnities also provided to the Directors of the company against any liability arising in specified circumstances.

8.119 In October 1994, the Australian Grand Prix Corporation was established under the provisions of the *Australian Grands Prix Act 1994* and was given the authority, with the approval of the Minister, to assume the rights, assets and liabilities of MGPP. Under the Act, the Corporation's functions in relation to Grand Prix events include to:

- negotiate, enter into and vary agreements for the staging of the events;
- undertake the management and promotion of the events; and
- undertake the financial and commercial management of each event promoted by the Corporation.

8.120 In November 1994, the Corporation assumed certain rights, assets and liabilities of the MGPP by agreement with the company.

Formula One Grand Prix

8.121 As highlighted in my previous Reports to the Parliament, the State's commitments and exposures in relation to the staging of the Formula One Grand Prix events include:

- provision of initial operating contributions to the company and the Corporation; and
- funding of certain works in the Albert Park area and the acquisition of Grand Prix infrastructure.

LIABILITIES AND COMMITMENTS

8.122 The first Formula One Grand Prix event was staged in Melbourne in March 1996, generating considerable interest from within the State, interstate and overseas. Audit analysis revealed that **total cash contributions provided by the Government to the Corporation and the MGPP which were directly related to the Grand Prix event, to 30 June 1996, amounted to \$21.3 million.** These contributions included an amount of \$8.3 million provided for operating costs since the inception of the project and \$13 million provided to assist in the acquisition of race infrastructure, including grandstands, barriers and overpasses.

8.123 However, **the operating cost incurred by the State since the inception of the Formula One Grand Prix project, determined on an accrual basis, to 30 June 1996 totalled \$11.7 million, of which \$6.2 million related to the 1995-96 financial year.** The total cost includes depreciation and amortisation of \$3.4 million relating to the utilisation of associated infrastructure and other assets. Table 8M illustrates this outcome.

TABLE 8M
COSTS INCURRED BY THE STATE IN RELATION
TO THE STAGING OF THE FORMULA ONE GRAND PRIX EVENT
(\$ million)

<i>Item</i>	<i>1994-95</i>	<i>1995-96</i>	<i>Total</i>
Australian Grand Prix Corporation and predecessor bodies -			
Set-up and establishment costs	4.8	-	4.8
Operating loss in staging the 1996 event, excluding other costs detailed below	-	1.7	1.7
	4.8	1.7	6.5
Add - Depreciation and amortisation costs	0.1	3.3	3.4
Protester-related, and other costs attributable to works in Albert Park	0.5	1.1	1.6
Compensation to Albert Park residents (a)	0.1	0.1	0.2
Total operating cost to the State (b) (c)	5.5	6.2	11.7

(a) These costs were included in the Department of State Development's financial statements.

(b) This amount includes \$8.3 million provided by the State and \$3.4 million of depreciation and amortisation costs.

(c) A further amount of \$1.2 million was contributed by public sector agencies relating to sponsorships which were negotiated on a commercial basis.

8.124 While the Formula One event to 30 June 1996 has resulted in a net cost to the State, the event has facilitated the provision of improved public infrastructure, including roadworks, and improvements to parklands and transport facilities, which the Government has also funded at a cost of around \$48 million, including works undertaken by the Corporation under licence for Melbourne Parks and Waterways at a cost of \$33 million and works undertaken by other public sector agencies at a cost of \$15 million. This does not include race infrastructure of \$13 million funded by the Government.

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Albert Park.

8.125 In relation to future Formula One Grand Prix events, the Corporation's objective is to achieve a self-funding position. However, there are a number of risks that could potentially have an adverse impact on the Corporation's financial projections, including exchange rate movements relating to fees payable to the international bodies involved in the promotion of the Formula One championship; poor weather on race days impacting on attendances and possibly causing race cancellation; tobacco advertising restrictions possibly resulting in reduced promotional revenues or the cancellation of the event; any revisions to the contractual arrangements between the international bodies involved in the promotion of the Formula One championship and racing teams, resulting in event cancellation; and delays in the establishment of the required temporary facilities.

8.126 As indicated in my October 1996 report to the Parliament, the Corporation has taken action to address certain of these risks through:

- maintenance of insurances relating to certain commercial risks;
- establishment of a hedging contract to manage its exposure to exchange rate movements impacting on fees payable to the international bodies involved in the promotion of the Formula One championship; and
- maintenance of close liaison with individuals and organisations involved in the Formula One World Championship to protect the State's interests in the event.

LIABILITIES AND COMMITMENTS

8.127 In March 1996, the Treasurer approved the provision by the Corporation of an indemnity in favour of the race promoter against any costs arising from certain third party actions against the promoter, employees, agents and race drivers. However, the State's exposure was to a large extent mitigated by the Corporation's acquisition of public liability insurance for the 1996 Grand Prix event. Nevertheless, the State retained certain exposures, including claims in excess of the insurance policy limits and certain commercial risks.

8.128 A study undertaken in July 1996 at the request of the Department of State Development to assess the impact of the 1996 Grand Prix event on the Victorian economy, concluded that the event provided substantial economic benefits to the State, which were estimated to be in the order of \$95.6 million. These benefits represented additional estimated expenditure by overseas and interstate visitors to the State, and enhanced expenditure by Victorian residents resulting from the event. The study also concluded that the event generated additional taxation receipts to the State of around \$6.9 million. The conclusions in this study were not subject to my Office's scrutiny.

Australian Motorcycle Grand Prix

8.129 As outlined in my October 1996 Report to the Parliament, following the conclusion of extensive negotiations between MMEC, MGPP and the race promoters, in May 1995 the Government announced the return of the Australian Motorcycle Grand Prix to Phillip Island. The event is to be managed by the Australian Grand Prix Corporation and will be held at Phillip Island in the period 1997 to 2001.

8.130 The key agreements in relation to this event include an agreement with the race promoters to secure the event, which was entered into in December 1994, and an agreement with the owner of the Phillip Island circuit for the use of the track during the race periods and the provision of track management and other support services, which was entered into in May 1995.

8.131 **The Treasurer has agreed to underwrite the annual deficits associated with the staging of this event, which are estimated by the Corporation to be in the order of \$3.4 million in relation to the first event and potentially rising to \$5.1 million by the year 2001.** However, an evaluation by a consultant of the impact of the event on the Victorian economy, conducted on behalf of the Department of Treasury and Finance, concluded that the event would provide additional tax revenues in the order of the annual deficits.

8.132 The financial risks in relation to this event are similar to those relating to the staging of the Formula One Grand Prix. The Corporation has revised its business plan to include the Australian Motorcycle Grand Prix and proposes to take similar steps to those taken in relation to the Formula One Grand Prix to manage the key risks associated with the staging of the Australian Motorcycle Grand Prix.

8.133 During the 1995-96 financial year, Consolidated Fund contributions of \$365 000 were made to the Corporation to meet costs incurred by the Corporation in relation to the Motorcycle Grand Prix event.

LIABILITIES AND COMMITMENTS

Confidentiality provisions

8.134 The agreements which have been established with race promoters to secure the Formula One Grand Prix and the Australian Motorcycle Grand Prix events contain certain provisions which deal with the disclosure of the contents of these agreements and, in particular, the race promoters' fee. Under these agreements, the disclosure of the restricted information could give rise to the loss of the event to the State.

8.135 In my previous Reports to the Parliament, I have expressed concern on the use of confidentiality provisions in contractual arrangements entered into between the Government and third parties, which adversely impact on the level of accountability to the Parliament and Victorian taxpayers. But in the case of the Grand Prix events, the Parliament has considered the confidentiality provisions included in the agreements with race promoters and has ratified these provisions through the passing of the *Australian Grands Prix Act 1994*, which provides an exemption to the Corporation from publicly disclosing information relating to certain agreements entered into in relation to the staging of the Formula One Grand Prix and the Australian Motorcycle Grand Prix events. In addition, the Act prevents the Corporation's business plan from being publicly disclosed within a period of 5 years after the end of the year to which it applies, without the prior approval of the Corporation, the Treasurer and the Minister for Tourism.

8.136 As part of the audit process, access was obtained to the arrangements established in relation to the staging of the Grand Prix events. The Corporation's financial statements include the fees paid associated with holding the Formula One Grand Prix. However, consistent with the abovementioned legislative provisions, these payments have been included but were not separately disclosed.

Melbourne City Link

8.137 At an estimated total cost of \$2 billion, the Melbourne City Link represents one of the largest infrastructure projects ever undertaken in Australia. It covers approximately 22 kilometres of road, tunnel and bridge works and involves the linking of 3 of Melbourne's most important freeways, namely, the South Eastern Arterial, and the West Gate and Tullamarine Freeways, together with the upgrading of parts of the South Eastern Arterial and the Tullamarine Freeway.

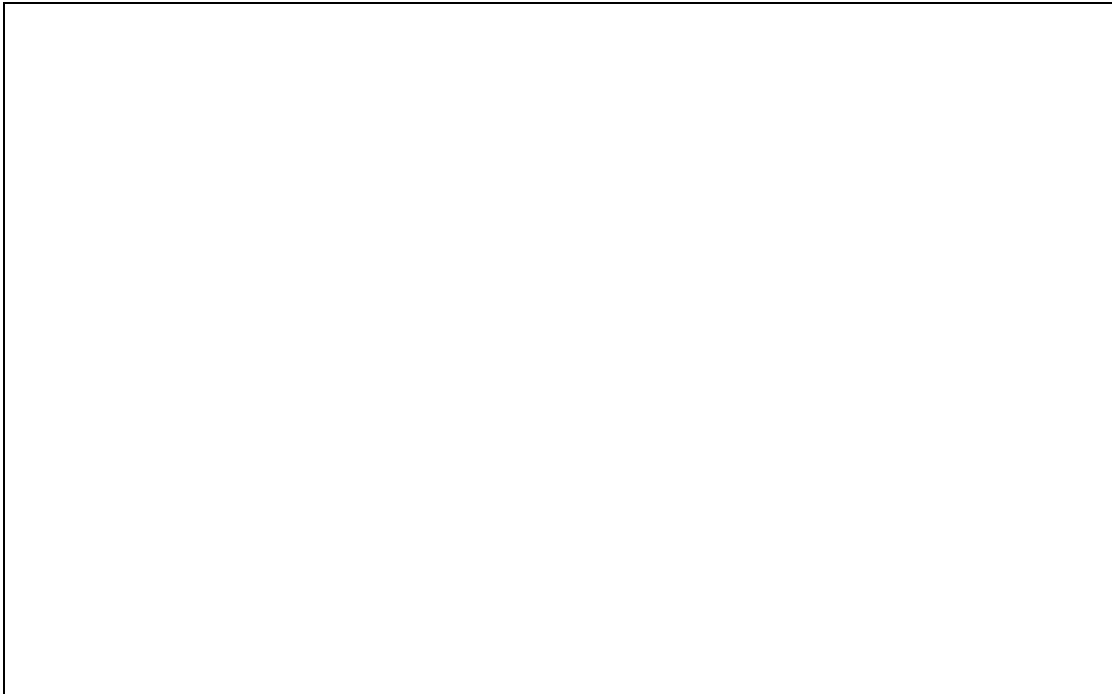
8.138 In my May 1996 Report on Ministerial Portfolios, I provided a detailed analysis of the highly complex arrangements established between the Government and Transurban, a private sector consortium, for the financing, construction and operation of the Melbourne City Link.

8.139 The key elements of the development include:

- *Southern Link* - an 8 kilometre freeway connecting the West Gate Freeway east of Kings Way to the South Eastern Arterial, and involving two tunnels under the Kings Domain and the Yarra River; and
- *Western Link* - 13 kilometres of new and upgraded freeway-standard roadway, connecting the Tullamarine Freeway to the West Gate Freeway, via a new elevated roadway and a bridge over the Yarra River.

LIABILITIES AND COMMITMENTS

8.140 The expected opening dates for the Western and Southern Links are April 1999 and December 1999, respectively.



City Link works.

8.141 As outlined in my May 1996 Report to the Parliament, the arrangements that are to operate in relation to the financing, delivery and operation of the City Link are set out in numerous agreements. However, the primary contractual document establishing the basis upon which the project is to proceed is the Concession Deed entered into between the Government and Transurban in October 1995. In addition, the *Melbourne City Link Act 1995*, which was passed by the Parliament in December 1995 and incorporates the Concession Deed, provided the Melbourne City Link Authority with certain powers in relation to land and roads affected by the project and empowered the charging and collection of tolls on the City Link.

8.142 Under the established arrangements, Transurban will design, finance, construct and operate the project at an estimated cost of \$1.8 billion. However, the State will finance \$266 million of associated works, including property acquisitions, the widening of the Tullamarine Freeway from Moreland Road to Bulla Road and the implementation of certain agreed traffic management measures.

8.143 Once completed, Transurban will operate the roadway as a public tollway for an estimated period of 34 years, with toll revenues collected from motorists to be mainly applied towards the cost of its construction, operation and maintenance, with a return on investment available for the investors in the project. At the end of the specified period, ownership of the City Link will revert to the State at no cost and in a fully maintained condition.

LIABILITIES AND COMMITMENTS

8.144 The risks relating to the project are to be shared between the private sector, the State and users of the Link. Key aspects of the project arrangements and risk allocation are discussed in more detail below.

Project arrangements

8.145 As mentioned previously, under the established arrangements, Transurban is expected to operate the Link as a tollway for a period of approximately 34 years and is obligated to handover the Link to the State at the end of this period in a fully maintained condition. However, the State has the right to terminate the arrangement at either 25 years and 6 months, 27 years, 29 years, 31 years or 33 years after the date of the Link's construction, if Transurban investors achieve a real internal rate of return (after tax) of greater than 17.5 per cent, and the initially contemplated project debt facilities have been fully repaid. This provision acts to cap the level of returns to be obtained by Transurban investors.

8.146 However, the Concession Deed specifies a number of events which may have a material adverse effect on the financial viability of the project and sets out the methods of redress that are available to the respective parties to address the effect of these events. An extension of the concession period is identified as one negotiable method of redress available to the parties.

8.147 In consideration for the concession granted by the State, the following fees are payable by Transurban to the State during the concession period:

- \$95.6 million per annum for the construction period and the first 25 years of operation;
- \$45.2 million per annum from year 26 to year 34 of operation; and
- \$1 million per annum from year 35 until the end of the concession period.

8.148 In addition, Transurban is required to pay to the State further concession fees where actual tolling revenues exceed financial projections agreed with the State. The Concession Deed also provides for the implementation of *compensable enhancements* at a future date. These are defined as circumstances or events that occur after the date of the Deed relating to the road transportation network but do not include events otherwise specified in the Deed, which result in additional net revenue being derived by Transurban. Under the arrangements, half of any net additional revenue derived from the compensable enhancements shall be paid to the State. These provisions act to ensure that any benefits generated from unanticipated enhancements to the transport network are shared between the State and Transurban.

LIABILITIES AND COMMITMENTS

Project risk allocation

8.149 A detailed analysis of the allocation of key project risks and obligations between the relevant parties reveals that, **while certain project responsibilities and risks have been assumed by the State, substantial risks and exposures have been transferred to Transurban and users of the City Link.** The risk allocation between the State, Transurban and users, relating to various aspects of the project which were outlined in my May 1996 Report to the Parliament can be summarised as follows:

- ***Operating environment*** - Given the substantial value and nature of Transurban's investment in the project, it has been imperative for the State to establish a level of certainty for Transurban and its financiers on the general operating environment relating to the City Link project. Consequently, certain significant events which may impact on the project have been identified in the related agreements together with a regime of available remedies to reinstate the financial position of the project if the specified events eventuate. These events can be broadly classified as:
 - actions taken by the State which hinder or prevent the delivery or operation of the project;
 - certain contamination, and Aboriginal or heritage claims relating to project land leased by the State to Transurban;
 - changes in Commonwealth law which have a specific effect on the project; and
 - certain catastrophic (force majeure) events which adversely impact on the project.

Under the available remedies established to address these events, the risks are to be mainly borne either by the users of the City Link, i.e. the motorists, or the State.

- ***Events that may cause termination of project arrangements*** - The agreements relating to the project provide for various circumstances under which the arrangements may be terminated, including abandonment of the project by Transurban, certain project defaults by Transurban which cover such circumstances as failure to complete the project by the expected completion date, and the failure to re-instate the City Link following certain uninsurable catastrophic events. In all such circumstances, Transurban has accepted the risk that the City Link (or the relevant parts thereof) will revert to the State with no compensation payable to Transurban.

However, the State has accepted the risk of paying compensation to Transurban in certain circumstances where either State or Commonwealth laws or requirements ultimately prevent the completion or operation of the City Link, the collection of tolls, or an Environmental Impact Statement is issued by the Commonwealth Government which materially adversely impacts on the project.

- ***Design and construction phase*** - Transurban is responsible for the cost and execution of the project design in a manner consistent with the project scope and technical requirements. In addition, Transurban must finance and implement the construction of the project in a suitable standard, in accordance with specified construction documentation. Consequently, the risks associated with the design and construction of the City Link are principally borne by Transurban.

LIABILITIES AND COMMITMENTS

- **Collection of tolls** - The key risks associated with the collection of tolls have been effectively transferred to Transurban. These risks relate to the achievement of projected traffic volumes and the development and operation of an effective and efficient electronic toll collection system. However, the State has undertaken to implement certain traffic management measures and that, once the City Link is established, future transport policies will treat it as a central part of Melbourne's transport network.

To protect the taxpayers' interests, provision has been made within the arrangements for the sharing of certain toll revenues between Transurban and the State or the early termination of the arrangements, in certain circumstances where higher than projected profits are achieved by Transurban from the operation of the City Link.

- **Operating phase (including repairs and maintenance)** - Transurban bears the key risks associated with the operation, maintenance and repair of the City Link. The State has a limited right to step in and remedy an *operating default* by Transurban where such an event is likely to result in a material risk to the health and safety of its users, or will result in damage to the City Link. In these circumstances, the State may operate, repair or undertake maintenance to address the risk or mitigate the consequences associated with the default, and the State must be reimbursed for any costs incurred.
- **Financing of project** - The key financing risks associated with the delivery and operation of City Link have been effectively transferred to Transurban. The State has not absorbed these risks, given that no indemnities have been provided to Transurban or its lenders in relation to the repayment of the project debt or the level of toll revenue. However, the State has undertaken to assume responsibility for any outstanding project debt in the event that the arrangements are terminated as a result of any changes in State or Commonwealth laws or policies which absolutely prevent Transurban from delivering or operating the City Link.

LIABILITIES AND COMMITMENTS

Assessment of the State's obligations

8.150 Under the established arrangements, while the users of the City Link via toll payments will in substance be the financiers of the project, Transurban has ultimately accepted substantial obligations in relation to the delivery and operation of the project.

8.151 The State has accepted certain obligations, mainly relating to the maintenance of the current overall operating environment for the project. In addition, the State has undertaken to implement certain traffic management measures involving specific changes to the existing road network in the vicinity of the Link (known as *Agreed Traffic Management Measures*) to enable the most efficient use of the overall road network and provide benefits to the local communities. The toll revenue estimates to be collected by Transurban are based on traffic flows after taking account of these measures. Furthermore, the Government may implement future traffic enhancement measures over the life of the project which could assist Transurban in enhancing the revenues of the project. However, any revenue generated by these additional traffic management measures will be shared between the State and Transurban.

8.152 In summary, other key obligations of the State under the project arrangements include:

- provision to Transurban of the required parcels of land and the associated planning scheme amendments, by the agreed dates, to enable the project to be completed;
- meeting any costs associated with the clean-up of certain contaminated land;
- funding of certain works associated with the project, at an estimated cost of \$159 million;
- future transport policies to ensure that the City Link continues to be a central part of Melbourne's transport network;
- indemnification of Transurban against costs incurred from any physical damage to the City Link caused by the State, its agencies or contractors;
- exemption granted to Transurban for the payment of local government, and water and sewerage rates and charges relating to project land, excluding usage; and
- assumption of Transurban debt obligations if it is fundamentally prevented from completing or operating the project as envisaged, due to a change in State or Commonwealth laws or policies.

8.153 In addition, the State has assumed the following key risks:

- provision of financial contributions to Transurban, under certain circumstances which fundamentally alter the operating environment for the project;
- assumption of project responsibility and a requirement to make early termination payments to Transurban, under certain circumstances substantially within the control of the State that cause the project arrangements to be terminated, including new laws which prevent the project from completion or operation as envisaged, and the issue of an Environmental Impact Statement by the Commonwealth Government in relation to the project;
- assumption at no cost of the City Link or part thereof in a damaged condition, under certain catastrophic and uninsurable events; and

LIABILITIES AND COMMITMENTS

- delays in the collection of concession fees from Transurban in the event that the project experiences financial difficulties.

8.154 As stated in my May 1996 Report to the Parliament, in my opinion these obligations are not sufficient to constitute, or support the recognition of, the financing of the project as a debt of the State. Significantly influencing this assessment is that, while the State may implement additional traffic enhancement measures to indirectly provide financial support to the project, it is not obligated to do so and therefore has not undertaken to "underwrite" the revenues of the project. On the other hand, if the State was obligated to implement additional traffic management measures to assist the project under specified circumstances, such an obligation would have constituted an indemnity or guarantee which would have resulted in the assumption by the State, in substance, of the significant obligations associated with the project.

Recent developments and status of project

8.155 During the project bid evaluation process and prior to the engagement of Transurban as the project developer, the Authority identified that Transurban's submission for the construction of the Domain and Burnley tunnels did not provide for the construction of an additional emergency tunnel, the absence of which could constitute a potential safety risk in the event that emergency access was required. Given that tunnel operations and safety involve complex technical issues, the State retained the option of requiring the construction of an emergency access tunnel at a fixed price to the State of \$9.6 million. Subsequently, in April 1996, the Authority commissioned an international expert to investigate this safety issue and provide advice on the matter.

8.156 In May 1996, the expert concluded that the safety of the tunnels should be enhanced by using pro-active measures such as a high quality traffic management system, rather than the construction of an additional escape route which would cater for infrequent emergency events. However, the Victorian emergency services did not support this conclusion and considered that sole reliance on the existing tunnels was unacceptable, given potential accidents involving fire and dangerous goods. Consequently, in June 1996, Cabinet approved the construction of a separate emergency tunnel by Transurban in accordance with the State Works Agreement at an additional cost to the State of \$9.6 million.

8.157 The Authority has advised that the construction of the Link is on target and that the expected opening dates for the project remain unchanged. Expenditure incurred by the Authority during the 1994-95 and 1995-96 financial years in relation to the project amounted to \$56 million, comprising \$22 million expended towards the acquisition of land, \$10 million towards specified State works and \$24 million for other costs, including salaries and administrative expenditure.

8.158 The State's capital commitments which amounted to \$218 million as at 30 June 1996 in relation to the City Link have not been disclosed in Part C of the Statement of Financial Operations, however, have been included in my assessment of the State's capital commitments, provided later in this Part of the Report.

*LIABILITIES AND COMMITMENTS***Petroleum Resources Rent Tax**

8.159 My previous Reports to Parliament have commented on a dispute involving GASCOR and Generation Victoria, and ESSO and BHP, in relation to the Commonwealth Government-imposed Petroleum Resources Rent Tax (PRRT) on Bass Strait oil and gas production.

8.160 As previously outlined, Bass Strait gas production is, in the main, purchased from ESSO and BHP by GASCOR and Generation Victoria (the purchasers). GASCOR, in turn, supplies natural gas to industrial, commercial and domestic consumers, while Generation Victoria utilises the acquired gas in the operation of its power stations.

8.161 In July 1990, the Commonwealth Government imposed a PRRT on Bass Strait oil and gas production. The new tax regime imposed a 40 per cent taxation rate on the producer's taxable profit from the extraction of gas and oil. Prior to that date, Bass Strait gas production attracted a 10 per cent to 12.5 per cent royalty under the Commonwealth Government's excise and royalty regime.

8.162 A dispute subsequently arose between the purchasers and ESSO and BHP as a consequence of action taken by ESSO and BHP to pass on the costs associated with the PRRT to the purchasers. The purchasers do not believe that ESSO and BHP have a right to pass on these costs under the existing gas supply agreements between the parties. Arbitration proceedings relating to this dispute commenced in early 1992, however, at the date of the preparation of this Report, these proceedings were either incomplete or subject to litigation.

8.163 The Victorian Government has indicated a desire to seek a negotiated resolution of the dispute, involving ESSO, BHP and the Commonwealth Government. In addition, the Government has indicated its desire to renegotiate the terms of the gas supply arrangements with ESSO and BHP to ensure that they are consistent with the emerging more competitive gas market in south-east Australia.

8.164 Prior to November 1995, Generation Victoria recognised, as a liability, a possible exposure of around \$185 million relating to the PRRT dispute. However, in November 1995, the Treasurer agreed to indemnify the business against any PRRT liabilities arising from an adverse litigation outcome for the period up to 31 December 1996, the date of expiration of the gas supply agreement between Generation Victoria, ESSO and BHP.

LIABILITIES AND COMMITMENTS

Possible exposure to the State

8.165 The Statement of Financial Operations includes a contingent liability of around \$625 million in relation to the PRRT exposure as at 30 June 1996, comprising \$422 million for GASCOR and \$203 million for Generation Victoria.

8.166 However, the Department of Treasury and Finance has estimated a **maximum total PRRT exposure in nominal terms of around \$3 billion (net present value of \$1.9 billion)** under the existing gas supply agreements which are expected to conclude in 2008, excluding any interest that may be payable on outstanding amounts.

8.167 If ESSO and BHP are successful in passing on the PRRT cost, the above substantial exposure ultimately will be met by Victorian taxpayers.

Automated Ticketing System

8.168 My previous Reports to the Parliament have commented on the arrangements established between the Public Transport Corporation and a private sector consortium for the supply, installation, testing, commissioning, maintenance and management of a new ticketing system which is to involve the operation of automated ticketing dispensers and validation machines on all trams, buses and railway stations.

8.169 Under the established arrangements, the Corporation is not obliged to make any payments until the consortium can demonstrate that it has successfully installed and commissioned the equipment. However, in May 1994, the Treasurer provided a guarantee to the consortium which obligated the State to honour the Corporation's financial obligations under the service agreement between the parties, if it defaults on the payments for services provided.

8.170 As stated in my previous report to the Parliament on the Statement of Financial Operations, the key milestones that were to be met by the consortium under the service agreement comprised:

- prototypes of ticket validation and vending machines to be delivered to the Corporation by December 1994;
- automated ticketing system to be tested within a defined geographical area by February 1995; and
- the system to be fully commissioned across the entire transport system by February 1996.

8.171 However, due to the inability of the consortium to meet these milestones, the Government in April 1995 commenced negotiations with the consortium to re-schedule the delivery of the prototype machines and the introduction of the automated ticketing system. Consequently, in September 1995, the Corporation and the consortium entered into a collateral agreement to allow the consortium to concentrate on delivering a fully-commissioned piloted system by November 1996, some 20 months later than originally planned. The effect of the collateral agreement was to suspend certain rights of both parties under the service agreement in relation to any disputed matters, with these suspended rights being re-instated on completion of the collateral agreement, or if the collateral agreement is terminated prior to its completion.

8.172 The collateral agreement contains a number of specific milestones relating to the completion of the system, including:

LIABILITIES AND COMMITMENTS

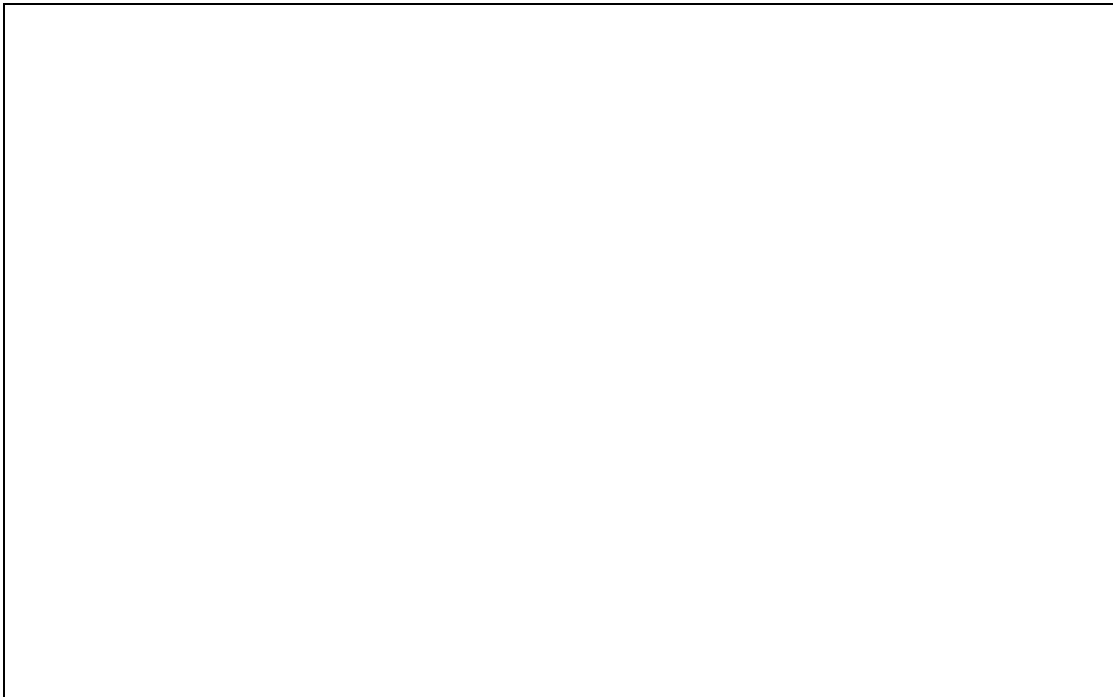
- *formal qualification testing*, planned for completion by May 1996 and aimed at achieving verification by the system development contractors that the system software, hardware and other components meet the Corporation's specified requirements;
- *first article acceptance testing*, planned for completion by July 1996 and aimed at ensuring that the individual sub-systems delivered by the consortium meet the Corporation's functional specifications when installed in an operational environment; and
- *roll-out acceptance testing*, planned for completion by September 1996, including the installation of the system and the successful completion of system acceptance testing.

8.173 The first milestone of *formal qualification testing* was only partially met by the consortium in May 1996. As a result, the Corporation issued qualified compliance certificates to the consortium, on the grounds that system integration was not yet fully effective. At the date of preparation of this Report, the consortium was in the process of addressing the Corporation's concerns.

8.174 In relation to the second milestone of *first article acceptance testing*, the Corporation issued *qualified acceptance certificates* in relation to the bus sub-system, and the rail and tram sub-systems in June 1996 and July 1996, respectively.

8.175 The completion of the third milestone under the collateral agreement requires the installation and satisfactory performance of *roll-out acceptance testing* for all ticketing sub-systems. In this respect, system trials were being conducted at the time of preparation of this Report.

LIABILITIES AND COMMITMENTS



Trialing of automated ticketing machines.

8.176 The consortium's access to project financing is dependent upon it meeting certain thresholds with its financiers, including the satisfactory completion of key milestones pursuant to the collateral agreement. In January 1996, the financiers permitted an initial drawdown of funds, however, they advised that they were not prepared to proceed with any further drawdowns until such time that the qualifications over the second milestone were removed by the Corporation.

8.177 The consortium has lodged a number of notices of delays with possible cost implications to the State. However, the Corporation has not admitted any responsibility for these delays. On the other hand, at the date of preparation of this Report, no penalties had been paid by the consortium to the Corporation as a result of the delays in commissioning, pursuant to the terms of the collateral agreement. **While the Corporation may incur additional costs in relation to the notices of delays issued by the consortium, it has the right to receive compensation from the consortium for the late commissioning of the system.**

*LIABILITIES AND COMMITMENTS***Pyramid litigation**

8.178 My previous Reports to the Parliament have commented on the financial obligations and the associated costs to the State arising from the closure of the Farrow Group of Building Societies in 1990 (consisting of the Pyramid, Geelong and Country Wide Building Societies).

8.179 In 1990 and 1993, legal action was initiated against the State by certain non-withdrawable shareholders in the Pyramid, Geelong and Country Wide Building Societies to ascertain their eligibility to participate in the distributions from the liquidation and to claim losses incurred when the Administrator was appointed. The State has refuted the claims made by the non-withdrawable shareholders and is pursuing counter-claims against various parties. Proceedings have also been initiated by the State against the Reserve Bank seeking an indemnity in respect of claims made by these shareholders. **At the date of preparation of this Report, these cases were being heard in the Supreme Court of Victoria.**

8.180 In 1993, the Australian Securities Commission initiated 3 legal actions on behalf of investors of Farrow Finance Limited. These actions were against ANZ Executors & Trustee Co., Day Neilson, Jenkins & Johns, and Price Waterhouse, for certain losses incurred by investors. The State, former Ministers and the former Registrar of Building Societies among others, had been joined as third parties to this litigation. The Government, during the 1995-96 financial year, successfully defended these proceedings on behalf of the State, the former Ministers and the former Registrar of Building Societies.

LIABILITIES AND COMMITMENTS

OTHER FINANCIAL COMMITMENTS OF THE STATE

8.181 In addition to the financial obligations commented upon earlier in this Part of the Report, public sector bodies have entered into a number of arrangements which will impact on the future financial operations of the State. At 30 June 1996, the public sector had financial commitments relating to operating leases and works not performed under existing contracts, valued at \$2.7 billion (1994-95, \$2.1 billion).

Operating lease commitments

8.182 The public sector's financial commitments include future obligations under operating lease arrangements. The audit examination revealed that such commitments, at 30 June 1996, amounted to \$918 million (\$980 million, 30 June 1995). Table 8N details the timing and extent of these commitments.

TABLE 8N
OPERATING LEASE COMMITMENTS
(\$million)

<i>Period payable</i>	<i>Budget sector</i>	<i>Non-budget sector</i>	<i>Public financial enterprises</i>	Total 1995-96	<i>Total 1994-95</i>
Within 1 year	115	14	14	143	280
Between 1 and 2 years	109	7	14	130	180
Between 2 and 5 years	197	9	29	235	233
Over 5 years	384	10	16	410	287
Total commitments	805	40	73	918	980

8.183 Obligations relating to the provision of office accommodation form the major portion of the operating lease commitments.

Capital commitments

8.184 The capital commitments of the public sector, in respect of works not yet carried out under existing contracts at 30 June 1996, amounted to \$1.8 billion (30 June 1995, \$1.1 billion). Table 8O details the amount and likely timing of these commitments.

TABLE 8O
CAPITAL COMMITMENTS
(\$million)

<i>Year</i>	<i>Budget sector</i>	<i>Non-budget sector</i>	<i>Public financial enterprises</i>	Total 1995-96	<i>Total 1994-95</i>
1996-97	308	184	32	524	893
1997-98	165	289	-	454	138
1998-99	35	222	-	257	63
1999 onwards	1	525	-	526	11
Total commitments	509	1 220	32	1 761	1 105

LIABILITIES AND COMMITMENTS

8.185 The increase in the level of the State's capital commitments at year-end was mainly due to the State's obligations relating to the City Link project and increased capital works activity by non-budget sector agencies, consistent with the Government's commitment of improving the State's infrastructure.

PART 9

Other matters



**VICTORIAN
AUDITOR-
GENERAL'S
OFFICE**

*Auditing in the
Public Interest*

OTHER MATTERS

Balances of Public Account

9.1 The transactions recorded in the Public Account for the past 2 years and the investment of the resultant balances are summarised in Table 9A.

TABLE 9A
RECEIPTS AND PAYMENTS OF THE PUBLIC ACCOUNT
((\$million))

<i>Item</i>	1995-96	1994-95
Balance 1 July	606	584
Receipts -		
Consolidated Fund	21 198	16 234
Trust Fund -		
Various trust accounts	31 838	23 129
Borrowings to finance Consolidated Fund deficits	2 179	1 037
	55 821	40 984
Payments -		
Consolidated Fund	20 365	17 068
Trust Fund -		
Works and Services Account	-	78
Repayment of Trust Fund borrowings	2 932	164
Other trust accounts	31 740	23 068
	55 037	40 378
Balance 30 June	784	606
Represented by the following investments -		
Trust Fund -		
Cash at bank	19	4
Fixed deposit accounts	566	485
Stocks and securities	190	113
Advances -		
Consolidated Fund	-	833
Departments and other purposes	9	4
Trust Fund	784	1 439
Consolidated Fund deficit	-	(833)
Total investments at 30 June	784	606

9.2 The net effect of the year's transactions was an increase of \$178 million in the total balances of the Public Account, brought about by a decrease of \$655 million in the balance of the Trust Fund and a \$833 million increase in the balance of the Consolidated Fund. This movement largely reflects the repayment to the Trust Fund in the year of a Consolidated Fund advance of \$833 million raised in 1994-95 to assist in financing the deficit incurred in the year, combined with increased Trust Fund balances, including Public Account borrowings of \$120 million not required as at 30 June 1996.

OTHER MATTERS

Trust Fund

9.3 The *Financial Management Act* 1994 allows the Minister for Finance to establish trust accounts within the Trust Fund and to define the purposes for which they are to be used. The Trust Fund, which is separate from the Consolidated Fund, records transactions relating to:

- various suspense and clearing accounts which have been established to facilitate accounting procedures and to improve cash management;
- several Commonwealth and joint Commonwealth/State accounts used for on-passing specific Commonwealth grants to educational institutions and local government bodies;
- various State trust accounts established by legislation for specific purposes, such as the Hospitals and Charities Fund; and
- accounts established to manage bequests, scholarships etc.

9.4 A summary of the transactions and balances of the various trust accounts comprising the Trust Fund are provided in the Statement of Financial Operations. Details of new accounts opened within the Trust Fund in 1995-96 and their specified purposes are set out in Table 9B.

**TABLE 9B
NEW TRUST ACCOUNTS**

<i>Account or Fund</i>	<i>Purpose for which established</i>
Traffic Accident Information Trust Account	To record transactions relating to the operations of the traffic accident information system, which was established to co-ordinate the distribution of accident data to agencies responsible for road traffic programs and the administration of road accident legislation.
Prostitution Control Board Fund	To record the receipt of funds by the Prostitution Control Board, including interest on investments, and the payment of costs incurred by the Board.
Domestic Builders Trust Fund	To record the receipt of funds by the Domestic Building Tribunal, including interest on investments, and the payment of costs incurred by the Tribunal.
Debt Portfolio Trust Account	To facilitate the recording within the Public Ledger of the cash transactions associated with Public Account borrowings and their management, aimed at enhancing administrative and operational efficiency.
Department of the House Committee (Parliament) Cash Suspense and Revenue Suspense Accounts	To improve efficiency of agency cash management and accounting procedures.
Department of Infrastructure Cash Suspense and Revenue Suspense Accounts	" " "

OTHER MATTERS

9.5 Table 9C details accounts closed within the Trust Fund in the 1995-96 financial year.

**TABLE 9C
TRUST ACCOUNTS CLOSED**

<i>Account or Fund</i>	<i>Reason for closure</i>
Department of Energy and Minerals Special Projects Trust Account and Revenue Suspense Account	The accounts were closed following the amalgamation of the former Departments of Agriculture and Energy and Minerals, with the balances transferred to the Agriculture Projects Trust Account and the Agriculture Revenue Suspense Account.
Forest Education Projects Trust Account	Following completion of the specified educational projects, the account was closed .
Mildura High School Scholarship Fund	The account was closed when trusteeship for the Scholarship Fund was transferred to the Mildura High School Council.
Mildura Schools Fund	In accordance with the provisions of the <i>Mildura College Lands (Amendment) Act 1995</i> , the account was closed. All moneys standing to the credit of the account were transferred into a fund established by a trustee company, to be administered for the benefit of beneficiaries.
Police Pensions Fund	The account was closed in accordance with the provisions of the <i>Superannuation Acts (Further Amendment) Act 1994</i> , with the remaining balance transferred to the Emergency Services Superannuation Scheme.
Small Business and Farming 1993 Flood Trust Fund	Following the disbursement of private donations received to provide relief to victims of the 1993 floods, the account was closed.
Special Purpose Trust Account	The account was closed following the transfer of the remaining funds and responsibility for Farrow-related assets and liabilities to the Transport Accident Commission, in accordance with the <i>Transport Accident (Amendment) Act 1992</i> .
Vicomp Working Account	Following the sale by the Government of Vicomputing, the account was closed.

Availability of reports

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

- Corporate Communications Section
Victorian Auditor-General's Office
Level 14, 222 Exhibition Street
Melbourne Vic. 3000
Phone: (03) 9651 6059 Fax: (03) 9651 6361
- Information Victoria Bookshop
318 Little Bourke Street
Melbourne Vic. 3000
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