DEDJTR.1020.001.0958

V I C T O R I A

Auditor-General
of Victoria

Report of the AUDITOR-GENERAL

on the

GOVERNMENT'S ANNUAL FINANCIAL STATEMENT 1996-97

Ordered by the Legislative Assembly to be printed

VICTORIAN GOVERNMENT PRINTER
1997

No. 65 - Session 1996-97

DEDJTR.1020.001.0959

ISSN 1327-6905
ISBN 0 7306 9295 7

Contents

PART 1

Executive Summary

VICTORIAN AUDITOR-GENERAL'S OFFICE

Auditing in the Public Interest

Overview

My *Report on the Government's Annual Financial Statement* for the year ended 30 June 1997 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 assets and liabilities at year-end, together with the privatisation of government business enterprises and the sale of surplus and underutilised properties.

The presentation to the Parliament for the first time of an audited consolidated financial report for the State is a welcomed development which will contribute to more transparent reporting of the State's financial operations, and enable more informed decision-making relating to financial strategies and public resource allocation.

It is important to recognise that the Government's Annual Financial Statement has been prepared by consolidating the financial statements of all public sector entities within the State, except for local government bodies and universities which the Minister for Finance has determined not to include in these whole-of-government financial statements.

As indicated in Part 3 of this Report, the State reported a substantial operating surplus for the 1996-97 financial year and a strong net assets position as at 30 June 1997, reflecting the positive impact of the Government's financial management reforms, including the privatisation program and the improved economic conditions within the State in recent years.

With the continuing stabilisation of the State's finances, in the 1997-98 *Budget Papers*, the Government announced a number of tax relief measures, including reductions in payroll tax rates. However, the *Budget Papers* identify that, based on the 1997 Commonwealth Grants Commission assessment of Victoria's relative revenue-raising effort, alignment with the average tax effort of all States would require further tax cuts estimated at around $500 million.

Finally, a major objective of the Government is to deliver high quality services at least cost to taxpayers. In this context, the completion of the development of comprehensive and robust output specifications and associated performance indicators as part of the Government's management reform program should assist in more conclusive assessments being undertaken on the extent to which the Government is achieving this key objective.

Summary of major findings

OPERATING RESULT AND FINANCIAL POSITION	Page 21

- The overall operating surplus for the year achieved by the State, after taking account of the impact of abnormal transactions mainly relating to the electricity industry privatisation program and the settlement of the petroleum resources rent tax dispute, was $3.4 billion.
Paras 3.1 to 3.7
- As at 30 June 1997, the State held net assets of $20.8 billion, comprising assets with an aggregate value of $71.4 billion and liabilities with an aggregate value of $50.6 billion.
Paras 3.4 to 3.8
- An audit analysis of the Consolidated Fund result indicated that the operating surplus for the year prior to the impact of abnormal transactions was $2 billion, compared with $1.2 billion in 1995-96.
Paras 3.15 to 3.20
- The improvement in the Consolidated Fund operating result over the past 6 years reflects the positive impact of the Government's budget and financial management reforms, and the improved economic conditions within the State.
Para. 3.19

ASSET SALES	Page 31

- The strengthening of the State's financial position has been achieved through, inter alia, the application of privatisation proceeds towards the reduction of State debt.
Paras 4.1 to 4.2
- The State obtained sale proceeds of $1.9 billion in excess of the book value of the Loy Yang A power station, with the sale result comparing favourably with business valuations provided by the Government's financial advisers.
Paras 4.12 to 4.43
- Under the arrangements established by the Government in relation to the disposal of the State's remaining 49 per cent interest in the Loy Yang B power station, the State received an up-front payment of $84 million for the disposal of an asset which was valued at around $1.6 billion, and agreed to terminate or restructure certain unfavourable arrangements which were established in the 1980s and gave rise to substantial future financial obligations on the State.
Paras 4.44 to 4.

ASSET SALES *- continued* **Page 31**

- Based on a financial analysis undertaken by the Government's financial and legal advisers, which was subject to substantial assumptions and uncertainties, the arrangements associated with the disposal of the State's interest in the Loy Yang B power station were estimated at worst to maintain the State's pre-existing financial position and at best achieve estimated savings in present value terms of $162 million.
Para. 4.65

- Under an indemnity provided by the State to the purchaser of United Energy Limited concerning the deductibility of franchise fees for taxation purposes, the State will be required to make a payment of $85 million to the purchaser in the event that an unfavourable tax ruling is not overturned.
Paras 4.66 to 4.68

- On the basis of current government projections, it is estimated that the State will derive ongoing net savings of approximately $622 million a year from electricity privatisation that has occurred at the date of preparation of this Report, which does not include the impact of the sale of Power Net Victoria.
Paras 4.31 to 4.32

- A competitive process was not established for the disposal of the State's remaining interest in HRL Limited as, according to SECV management, the disposal was complicated by the pre-emptive rights to the shares of the other shareholders, which made it difficult to sell the shares to parties other than the company or a buyer approved by the other shareholders.
Paras 4.69 to 4.80

- An analysis of the sale of the State's remaining interest in HRL Limited indicated that, while the sale proceeds were higher than its estimated share of the book value of the company's net assets, there was substantial uncertainty concerning the recovery of $8.5 million of interest-free loans provided by the SECV to the company, which are due for repayment in the years 2002 and 2003. ***Para. 4.81***

- An analysis of the sale of Melbourne Port Services Pty Ltd indicated that while the estimated proceeds to be received totalled $8.8 million the State incurred costs associated with the port reform process relating to the sale of $14 million, comprising the funding of redundancy packages and leave entitlements, unfunded superannuation liabilities and other costs of sale, giving an overall negative cashflow of $5.2 million.
Paras 4.85 to 4.102

- The purchaser of Melbourne Port Services Pty Ltd has acquired the rights to exclusive contracts for the provision of services to Melbourne Port Corporation and the Victorian Channels Authority until 30 June 1998 and 30 June 2000, respectively.
Para. 4.102

- The outsourcing of the management of the Port of Hastings will enable the State to receive annual management fees ranging between $1.3 million and $7.3 million, depending on the revenue levels achieved by the operator, with the State retaining the option to sell the port at a later time. ***Paras 4.103 to 4.133***

ASSET SALES *- continued* **Page 31**

- Despite the high risk profile associated with the research-based pharmaceutical industry, the nature of the business of AMRAD Corporation Limited and the fact that the State's accumulated investment of $15 million in the company would have been considered as highly speculative when it was made, the State received $20 million in December 1996 from the part sale of its shareholding and retained an investment in the company worth around $55.3 million.

  Paras 4.134 to 4.144

- The Country Fire Authority established a joint venture arrangement through the sale of 90 per cent of its vehicle manufacturing business, however, it will continue to be a major customer of the joint venture and will therefore significantly contribute to the profitability of the business for at least 2 years.

  Paras 4.157 to 4.174

- The gross proceeds received by the Transport Accident Commission from the sale of the Sheraton Towers Southgate Hotel were at the lower end of a valuation range of $117.5 million to $132.5 million for the property as provided by an independent valuer.

  Paras 4.183 to 4.195

- In July 1997, the settlement of the former Southern Cross Hotel property sale was finally completed, some 16 months subsequent to the initially agreed date, with the balance of the purchase price of $9.5 million together with a further $1.9 million of penalty interest paid into the Consolidated Fund.

  Paras 4.246 to 4.248

REVENUE **Page 93**

- During 1996-97, the receipts from gambling activities totalled $1.2 billion and represented 6 per cent of total Consolidated Fund receipts.

  Para. 5.23

- Inefficiencies in the administration of motor vehicle stamp duty identified by audit in 1991 continue to exist.

  Paras 5.30 to 5.38

- An audit examination of an extensive sample of motor vehicle stamp duty transfer documents processed at VicRoads revealed that 58 per cent of declared market values were below the values listed in the dealers' guides for a vehicle purchased by a dealer in average condition, with up to $10.8 million of revenue forgone per annum.

  Paras 5.39 to 5.74

EXPENDITURE	**Page 119**

- Core departmental operating costs have increased in nominal terms by around 8 per cent over the past 5 years, however, in real terms the level of these costs has remained relatively constant since the 1992-93 financial year.
  Paras 6.9 to 6.13
- Given that considerable work remains to be undertaken in regard to the development of robust output specifications and associated performance indicators, it is difficult to undertake a comprehensive and conclusive assessment of trends in the level, quality and cost-efficiency of service delivery by departments, and to assess the extent to which the Government is achieving one of its key objectives, namely, the provision of high quality services at least cost to taxpayers. ***Para. 6.11***
- The progressive upgrade of the State's credit rating represents a substantial achievement by the Government, reflecting the strengthened financial market confidence in the State's financial standing. ***Paras 6.18 to 6.22***
- The net operating cost incurred by the State on the Formula One Grand Prix relating to the 1996-97 financial year was $6.7 million. ***Paras 6.23 to 6.27***
- Since the inception of the Formula One Grand Prix event, the net aggregate operating costs incurred by the State totalled $18.4 million, which included set-up and establishment costs of an operating nature of $4.8 million, and depreciation and amortisation of $6.6 million
  Paras 6.28 to 6.35
- The Treasurer has agreed to underwrite the annual deficits associated with the staging of the Australian Motorcycle Grand Prix event, which are estimated by the Corporation to be in the order of $3.2 million in relation to the first event, and potentially rising to $5.1 million by the year 2001. ***Paras 6.36 to 6.40***
- Payments primarily relating to electricity industry reform by the Department of Treasury and Finance to the 7 major external service providers, including consultants and contractors, totalled $96.9 million in the 3 year period covering 1994-95 to 1996-97.
  Paras 6.41 to 6.45
- The firms of CS First Boston and KPMG Peat Marwick were separately engaged during February 1994 as the financial and accounting advisers, respectively, for the electricity industry reform program, with payments made of $47 million and $26 million, respectively, during the 3 year period ending 30 June 1997, mainly comprising success fees that became payable upon the privatisation of individual electricity industry businesses.
  Paras 6.41 to 6.84
- Notwithstanding the unique nature of the Government's electricity industry reform program and the limited expertise available from the private sector to assist in the reform process, audit nevertheless concluded that there was greater scope for more competitive processes to be adopted by the Department of Treasury and Finance in the engagement of consultants and contractors given the magnitude of taxpayers' resources involved in the reform process and paid to these external service providers.
  Para. 6.85

EXPENDITURE- *continued*	**Page 119**

- The approval of expenditure on external service providers involved in the electricity reform process after the services had been provided was not considered to be consistent with proper management practice.

Paras 6.48 to 6.85

- A total of 207 200 prohibited firearms had been surrendered in Victoria at a total compensation cost of $101.8 million as at 30 September 1997 under the firearm buyback scheme, with an additional 15 800 non-prohibited firearms also surrendered which did not attract any monetary compensation.

Paras 6.86 to 6.92

- Formal contractual arrangements with the successful tenderer associated with the administration of the firearm buyback scheme were not finalised until January 1997, some 5 months after the commencement of the scheme.

Paras 6.93 to 6.97

- As at 30 September 1997, only 3 final claims and 135 intentions to claim for loss of business by firearm dealers had been received by the Department of Justice in relation to the firearm buyback scheme, however, at the date of preparation of this Report, no payments had been made by the Department.

Paras 6.107 to 6.109

LIABILITIES AND COMMITMENTS	**Page 157**

- The liabilities of the State totalled $50.6 billion at 30 June 1997, representing a reduction of $6.2 billion in the level of liabilities when compared with the previous year, which was mainly due to the privatisation of 2 electricity generation companies and the application of the resultant sale proceeds mainly towards the reduction of State debt.

Paras 8.1 to 8.5

- The aggregate value of the State's operating lease and capital commitments as at 30 June 1997 were $2.6 billion, however, these do not include the State's commitments under outsourcing contracts entered into for the provision of services to the public sector.

Paras 8.6 to 8.7

- In my opinion, in substance, the arrangements established by the Government for the sale and leaseback of motor vehicles within the budget sector constitute a financing facility, which should be included as part of the State's liabilities in the 1997-98 financial year.

Paras 8.21 to 8.40

- The arrangements for the sale and leaseback of motor vehicles within the budget sector are expected by the Government to generate substantial savings through the improved management of the motor vehicle fleet and reduced interest costs resulting from the application of the proceeds received by the Consolidated Fund towards debt retirement.

Para. 8.41

LIABILITIES AND COMMITMENTS *- continued* **Page 157**

- In January 1997, the Treasurer agreed to an offer for the early termination of a transport sale and leaseback transaction at a cost of $299.5 million.

  Paras 8.42 to 8.51

- 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 $1.8 billion at 30 June 1997, 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 arrangements is approximately $1.4 billion.

  Paras 8.82 to 8.85

- In February 1997, the State incurred costs totalling $157.3 million associated with the World Congress Centre financing arrangements, which ultimately resulted in the legal ownership of the Centre reverting to the State.

  Paras 8.86 to 8.108

- The total losses incurred by the State in relation to the inter-connector electricity trading activities with South Australia during the period July 1994 to May 1997 were $147 million, comprising a settlement payment of $74 million associated with the termination of the arrangements and accumulated trading losses of $73 million.

  Paras 8.109 to 8.124

- There had been no specific studies undertaken by the Department of Treasury and Finance relating to costs and efficiencies associated with the privatisation of public hospitals or the private provision of hospital services, such as the privatisation of health services in the Latrobe Valley.

  Paras 8.125 to 8.149

- The arrangements associated with the new Latrobe Regional Hospital 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 8.161 to 8.164

- Under the arrangements associated with the new Latrobe Regional Hospital, the private sector company is required to operate and maintain the Hospital and provide quality services, in return for receiving casemix funding and payments for specific health related activities, which include a capital component for the utilisation of the Hospital building, equipment and technology.

  Paras 8.157 to 8.160

- Technical problems continued to occur in relation to the pilot stage commissioning of the new automated ticketing system.

  Paras 8.189 to 8.198

- As at the date of the preparation of this Report, the matters in dispute in relation to the automated ticketing system were awaiting expert determination. Furthermore, the Corporation had issued the consortium with a contractual notice requiring performance under the service agreement in relation to the delivery of the pilot system.

  Paras 8.199 to 8.201

REVIEW OF GIPPSLAND WATER **Page 225**

- Serious deficiencies were identified in the processes established for the letting of contracts in relation to the engagement of external service providers.

  Paras 9.5 to 9.35

- The failure to specify clear measurable deliverables within certain contracts with external service providers precluded an audit assessment of whether the Authority obtained value for money from such arrangements.

  Para. 9.9

- Audit identified clear conflicts of interest associated with the letting of contracts, leading to a service provider being in an advantageous position.

  Paras 9.10 to 9.21 and 9.31 to 9.33

PART 2

Audit Opinion on Statement

VICTORIAN AUDITOR-GENERAL'S OFFICE

Auditing in the Public Interest

Financial accountability framework

2.1 The accountability framework relating to the State's finances is set out in the *Financial Management Act* 1994, *Audit Act* 1994 and *Constitution Act* 1975. These Acts collectively establish the external financial reporting and audit arrangements within the Victorian public sector which facilitate the Government's accountability to the Parliament and the public in relation to its financial operations.

2.2 As an integral element of the Government's financial management reform program, **the State's accountability framework has been subject to substantial change and strengthening in recent years, which has progressively enhanced the quality of the information available to the Parliament and the public regarding the Government's financial performance and position, including the Government's stewardship of public resources.**

2.3 Prior to the 1995-96 financial year, the Government was required under the former *Audit Act* 1958 to annually prepare and transmit to the Auditor-General a statement of the receipts and payments of the Consolidated Fund and the Trust Fund. While this statement, which was known as the Finance Statement, was not required to be audited, the Auditor-General was required to prepare a report which explained the statement in full and to transmit that report together with the Government's statement to the Parliament.

2.4 These accountability arrangements were enhanced in 1994 with the introduction of the *Financial Management Act* 1994 which required the Government to annually prepare a Statement of Financial Operations, which was required to be audited by the Auditor-General and presented to the Parliament, together with a Report of the Auditor-General on that Statement. In particular, the Act provided, and continues to require, that the Statement must be prepared in a manner and form approved by the Minister for Finance and must contain certain specified disclosures which broadly comprise information relating to 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.

2.5 Consistent with the above legislative requirements, for the 1994-95 and 1995-96 financial years, the Government prepared annual Statements of Financial Operations, which disclosed the cash-based transactions and balances of the Public Account for the relevant accounting periods, and the liabilities and financial assets of the State at the respective balance dates. Unqualified opinions were issued on these 2 Statements by audit.

2.6 For the 1996-97 financial year, pursuant to amendments to the *Financial Management Act* 1994, the title of the Government's major annual accountability statement was changed from the Statement of Financial Operations to the Annual Financial Statement. Furthermore, the Minister for Finance, under the authority of the existing legislative provisions of the Act, determined that the information to be presented in the Annual Financial Statement will be substantially enhanced to incorporate a consolidated financial report for the State, including an operating statement, balance sheet, statement of cashflows statement and accompanying notes, prepared consistent with the requirements of Australian Accounting Standard AAS31 *Financial Reporting by Governments*.

2.7 **The presentation to the Parliament, for the first time, of an audited consolidated financial report for the State is a welcomed development which builds on various other substantial financial management and reporting initiatives previously implemented by the Government, including accrual-based reporting (incorporating asset recognition and valuation) by departments. The introduction of this presentation will contribute to more transparent reporting of the State's financial operations and enable more informed decision-making relating to financial strategies and public resource allocation.**

2.8 As mentioned earlier, in addition to the presentation of the consolidated financial information for the State, the *Financial Management Act* 1994 requires certain financial disclosures in the Annual Financial Statement relating to the transactions and balances of the Public Account, which incorporates the Consolidated Fund and the Trust Fund.

2.9 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 via the passing of Appropriation Acts, which provide the key means by which parliamentary control is exercised over public finances.

2.10 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.

2.11 Eventhough the *Financial Management Act* 1994 disclosure requirements in relation to Consolidated Fund and Trust Fund operations were not changed for the 1996-97 financial year, the Government reduced the extent of information disclosed in the Government's Annual Financial Statement, especially in relation to Trust Fund operations. While recognising that, for the 1996-97 financial year, accountability in relation to Government financial operations has been significantly enhanced with the presentation in the Parliament of audited accrual-based whole-of-government financial statements, the reduced level of disclosure of Trust Fund operations is not considered appropriate, given that the Parliament has not considered any legislative changes in relation to this matter.

2.12 In particular, when compared with the prior year disclosure of Public Account operations, the 1996-97 Annual Financial Statement provides reduced disclosure in the following areas, which weakens the accountability to the Parliament:

- Consolidated Fund receipts within major revenue heads, particularly for categories other than State taxation; and
- Amounts paid into specific Trust Fund working accounts under section 23 of the Act and the subsequent application of these funds.

Audit opinion on the Annual Financial Statement

2.13 The Annual Financial Statement for the year ended 30 June 1997 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 1996-97 Annual Financial Statement is as follows:

Audit Scope

The accompanying Annual Financial Statement for the year ended 30 June 1997 of the Government of Victoria, excluding local government bodies and universities, which comprises the consolidated operating statement, the consolidated statement of financial position, the consolidated statement of cash flows and the accompanying notes contained in Section 3 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 Australian Accounting Standards and other mandatory professional reporting requirements, and comply with the requirements of the *Financial Management Act* 1994 so as to present a view which is consistent with my understanding of the financial position of the Government of Victoria and the results of its operations and its cash flows.

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

Qualification

As indicated in note 1 to the Annual Financial Statement, these accounts represent the inaugural audited consolidated financial statements of the Government of Victoria. The opening balances of these statements as at 1 July 1996 have not been audited and, accordingly, I am not in a position and do not express an opinion on these balances or the effect, if any, of any misstatements in these balances on the consolidated operating statement and the consolidated statement of cash flows.

Qualified Audit Opinion

In my opinion, except for the effect, if any, of the matter referred to above, the financial statements present fairly the financial position of the Government of Victoria as at 30 June 1997 and the results of its operations and its cash flows for the year ended on that date in accordance with Australian Accounting Standards and other mandatory professional reporting requirements and comply with the requirements of the *Financial Management Act* 1994.

Inherent uncertainty regarding business franchise fees

Without qualification to the opinion expressed above, attention is drawn to note 31 to the Annual Financial Statement, which highlights the significance of a High Court ruling that impacts on the State's ability to raise business franchise fees which totalled $1.3 billion in the 1996-97 financial year. The High Court on 5 August 1997 ruled that the New South Wales tobacco franchise fee legislation was unconstitutional. As a consequence of this ruling, the Government is of the view that the *Business Franchise (Tobacco) Act* 1974 administered by the State is no longer sustainable and uncertainty exists as to the validity of all business franchise fees collected and collectable since the State enacted this legislation. However, the Commonwealth Government has agreed to protect the revenue base of the States by enacting Federal legislation which will introduce new taxes which will have the effect of discouraging taxpayers from taking legal action to recover franchise fees paid in the past.

Scope of the Annual Financial Statement

2.14 The Annual Financial Statement has been prepared in accordance with the requirements of the *Financial Management Act* 1994, relevant Australian Accounting Standards and, in particular Australian Accounting Standard AAS31 *Financial Reporting by Governments* which requires the presentation by the Commonwealth and individual State and Territory Governments of general purpose whole of government financial reports for their relevant jurisdictions, prepared on the accrual basis of accounting.

2.15 **In depicting the Government as a single economic entity, the Government's Annual Financial Statement has been prepared by consolidating the financial statements of all public sector entities within the State, except for local government bodies and universities which the Minister for Finance has determined not to include in these whole-of-government financial statements.**

2.16 Substantially due to the implementation of the Government's asset identification and valuation program in recent years, most of the State's assets have been appropriately recognised within the financial statements. The major asset group yet to be recognised as at 30 June 1997 represents certain Crown land parcels mainly vested in or under the control of the Department of Natural Resources and Environment. Further comments on the progress made during the 1996-97 financial year and action proposed for future years in relation to the valuation and recognition of State assets are included in Part 7 of this Report.

Auditor-General's Report on the Government's Annual Financial Statement

2.17 As mentioned earlier, the Government's Annual Financial Statement discloses the financial operations and financial position of the State, including the financial transactions of the Public Account. 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:

- Operating result and financial position;
- Asset sales;
- Revenue;
- Expenditure;
- Assets of the State; and
- Liabilities and commitments.

PART 3

Operating Result and Financial Position

VICTORIAN AUDITOR-GENERAL'S OFFICE

Auditing in the Public Interest

Operating result and financial position

3.1 The operating result is a key measure of the Government's financial performance and highlights the extent to which the costs of service delivery are covered by the revenues raised in the year. In addition, when assessed over a number of years, the operating result is an important indicator of the sustainability of the Government's financial strategies and policies.

3.2 Given that the Government's Annual Financial Statement represents the first audited whole-of-government financial report for the State of Victoria, audit analysis of the year's outcome within my Report is predominantly focused on the key items contributing to the result. In future years, more comprehensive assessments will be possible, through inter-period comparisons of the results achieved by the Government and the key trends in the financial performance of the State.

3.3 The Government's Annual Financial Statement discloses that **the State achieved an operating surplus of $1.6 billion for the 1996-97 financial year, prior to abnormal items**. **However, after taking account of the impact of abnormal transactions during the year, mainly relating to the impact of the electricity industry privatisation program ($2.2 billion) and the settlement of the petroleum resources rent tax (PRRT) dispute ($339 million), the overall operating surplus for the year was $3.4 billion**. Detailed comment on the electricity industry privatisation program and the PRRT dispute settlement is provided in Parts 4 and 8 of this Report, respectively.

3.4 The Statement of Financial Position is an important indicator of the Government's financial strength and, when comparative balances are presented, of changes in its overall financial position. In this regard, the Government's Annual Financial Statement shows that, **as at 30 June 1997, the State held net assets of $20.8 billion, comprising assets with an aggregate value of $71.4 billion and liabilities with an aggregate value of $50.6 billion**.

3.5 Table 3A presents a summary of the operating result achieved by the State for the year and its financial position as at 30 June 1997.

TABLE 3A
STATE OF VICTORIA
OPERATING RESULT AND FINANCIAL POSITION, 1996-97
($billion)

Item	*Amount*
Operating result	
Revenues	24.7
Expenses	23.1
Operating surplus for the year before abnormal items	**1.6**
Net abnormal items *(a)*	1.8
Operating surplus for year	**3.4**
Financial position	
Assets -	
Cash and Investments	12.8
Physical assets	53.1
Other	5.5
	71.4
Liabilities -	
Borrowings	21.0
Unfunded superannuation	15.2
Employee entitlements	2.4
Other	12.0
	50.6
Net assets	**20.8**

(a) Includes the impact of electricity industry privatisations and the PRRT dispute settlement.

3.6 An analysis of the State's revenues and expenses is provided in Parts 5 and 6 of this Report, respectively. The major revenue sources contributing to the year's outcome were State taxation, grants from the Commonwealth Government and proceeds from the sale of goods and services provided by public sector entities. During the 1996-97 financial year, these items collectively represented $22.6 billion or around 91 per cent of the State's revenues. The major components of the State's expenditure included costs incurred in relation to employee entitlements, the purchase of supplies and consumables, grants to third parties, and superannuation and financing costs. These items collectively represented $17.8 billion or around 77 per cent of State operating expenditures for the 1996-97 financial year.

3.7 As indicated previously, abnormal items relating to the sale of State assets and the settlement of the PRRT dispute significantly influenced the overall operating result for the year.

3.8 As shown in Table 3A, the State's financial position is substantially impacted by the level of physical assets, which mainly comprise Crown and freehold land and buildings, plant and equipment and other infrastructure, which account for $53.1 billion or around 74 per cent of the State's assets. The major financial obligations of the State comprise borrowings and unfunded superannuation liabilities, which represent $36.2 billion or around 71 per cent of total liabilities. A further analysis of the State's assets and financial obligations is provided in later parts of this Report.

Consolidated Fund result for the year

3.9 As previously commented, in addition to the presentation within the Government's Annual Financial Statement of the State's consolidated financial statements, the *Financial Management Act* 1994 requires the presentation of certain additional information relating to the financial operations of the Public Account, which comprises the Consolidated Fund and the Trust Fund. In this regard, Note 29 to the Government's Annual Financial Statement provides these statutory disclosures.

3.10 The Government's Annual Financial Statement discloses that **the overall Consolidated Fund result for the 1996-97 financial year, not including receipts from borrowings, was a deficit of $543 million, which was $74 million higher than budget expectations**.

3.11 **However, the result for the budget sector when calculated under the Government Financing Statistics (GFS) format was a surplus of $5.3 billion**. While the Government's Annual Financial Statement discloses the overall Consolidated Fund result, the GFS format classifies certain Consolidated Fund transactions such as debt repayments as financing transactions and takes into account the relevant outlays and revenue transactions relating to the Trust Fund and those public bodies subject to substantial central budgetary control.

3.12 The difference of $5.8 billion between the Consolidated Fund and the GFS reporting format results largely relates to borrowing repayments. Table 3B presents a summary of the key differences between these results for the year.

TABLE 3B
RECONCILIATION OF 1996-97 CONSOLIDATED FUND SURPLUS WITH THE REPORTED RESULT UNDER THE GFS REPORTING FORMAT
($million)

Item			*Amount*
Budget sector surplus (GFS reporting format)			**5 305**
Less -			
Appropriations for repayment of borrowings -			
Treasury Corporation of Victoria managed debt	5 514		
Public Transport Corporation leases	325		
Computer lease facility	2	*(a)* 5 841	
National Rail Corporation share purchase		9	
Net effect of other items (mainly changes in cash, investments and other items)		(2)	
Total reconciling items			**5 848**
Consolidated Fund deficit			**543**

(a) Does not include a $10 million payment to purchase bonds previously issued to finance projects undertaken under the Accelerated Infrastructure Program and a $149 million payment relating to the termination of the World Congress Centre financing arrangements (refer to Part 8 of this Report for further comment on these matters).

Key factors impacting on result

3.13 Consistent with the previous financial year, **as a result of the Government's privatisation program, during the 1996-97 financial year, the Consolidated Fund received substantial proceeds 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, which totalled $4.4 billion during the 1996-97 year, were the most significant factor positively impacting on the budget sector's result.**

3.14 In addition, the Consolidated Fund result for the year was substantially impacted by additional debt retirement payments of $1.2 billion made on account of Public Account cash surpluses arising in the year, which were offset by:

- Expenditure savings achieved by departments in areas such as finance charges, non-utilisation of the Treasurer's advance and lower than expected spending in relation to repatriation services transferred from the Commonwealth to the State; and
- Higher than expected receipts from taxation sources and public authorities.

Re-statement of Consolidated Fund result by audit

3.15 As commented in my previous Reports to the Parliament, while Consolidated Fund transactions are classified 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 Government's Annual Financial Statement to ascertain and assess the Consolidated Fund's operating result for the year. However, the appropriations for the 1997-98 financial year provide a clearer differentiation between current and capital items, which should assist in addressing the above deficiency.

3.16 Table 3C presents the Consolidated Fund result for the year, segmented according to operating and capital transactions, and highlights 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)

Item	***1996-97***	*1995-96*
Operating transactions -		
Receipts	**15 955**	14 985
Payments	**13 921**	13 769
Operating surplus prior to abnormal items	**2 034**	1 216
Add - Abnormal items *(b)*	**4 154**	4 594
Operating surplus for the year	**6 188**	5 810
Capital transactions (excluding borrowing transactions) -		
Receipts	**833**	934
Payments	**1 599**	1 649
Capital deficit prior to abnormal items	**(766)**	(715)
Add/(Less) - Abnormal items *(c)*	**34**	46
Capital deficit for year (excluding borrowing transactions)	**(732)**	(669)
Consolidated Fund surplus prior to borrowing transactions	**5 456**	5 141
Borrowing repayments	**(5 999)**	(4 761)
Overall Consolidated Fund surplus / (deficit) funded from borrowings) for year	**(543)**	380
Less - Reconciling items (refer to Table 3B of this Report)	**5 848**	4 794
Budget sector surplus (GFS reporting format)	**5 305**	5 174

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

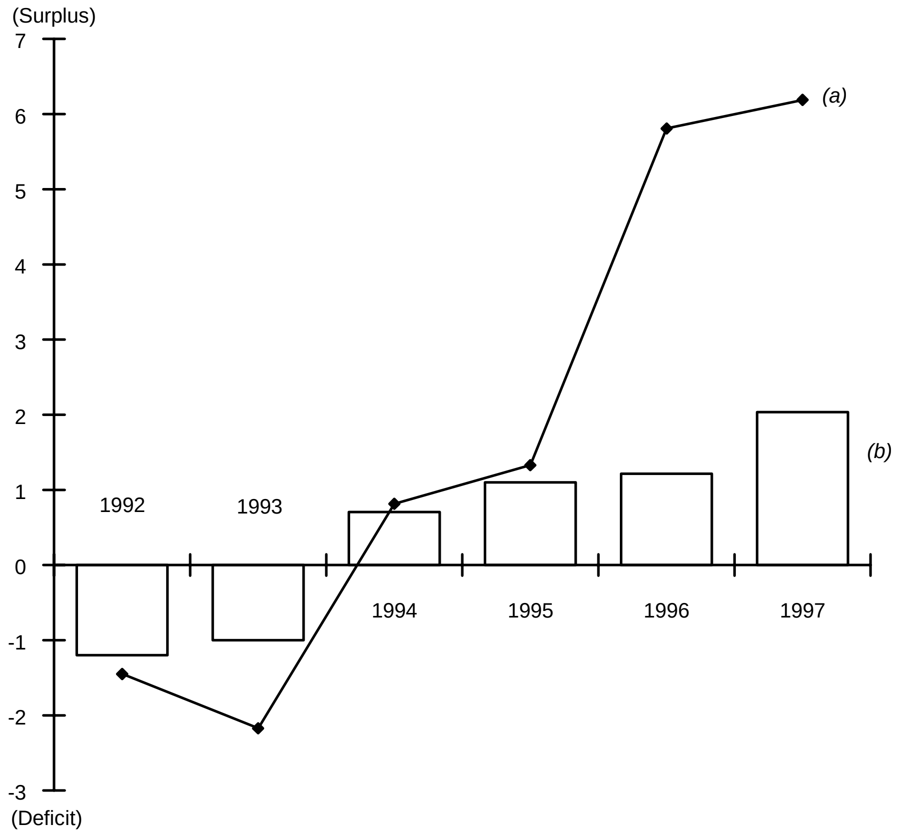
(b) Abnormal items of an operating nature include the receipt of $4.4 billion representing part of the profit on the sale of State-owned business enterprises ($4.8 billion, 1995-96), employee departure program payments of $149 million (1995-96, $89 million), special dividends of $135 million received from the Transport Accident Commission and the former State Insurance Office, the reversal of a prior year expenditure deferral arrangement $nil (1995-96, $33 million), a contribution of $154 million (1995-96, $nil) towards the Commonwealth Government's deficit reduction program and costs of $94 million (1995-96, $64 million) associated with electricity industry privatisation.

(c) Abnormal items of a capital nature comprise the receipt from Crown Casino of $34 million (1995-96, $46 million) for the right to operate the new casino.

3.17 **An analysis of the restated result indicates that the operating surplus for the year prior to abnormal items was $2 billion, compared with $1.2 billion in 1995-96.** The improved operating result in the year was due to higher taxation receipts resulting from improved economic conditions and higher collections from electronic gaming machines, increased grants from the Commonwealth Government, general expenditure restraint by departments and lower finance charges as a result of debt reduction.

3.18 Chart 3D discloses the Consolidated Fund operating result as re-stated by audit over the period 1991-92 to 1996-97.

CHART 3D
CONSOLIDATED FUND OPERATING RESULT,
1991-92 TO 1996-97
($billion)



(a) Consolidated Fund result after taking into account abnormal items.
(b) Consolidated Fund operating result prior to abnormal items.

3.19 **The above chart clearly illustrates the improvement in the Consolidated Fund operating result over the past 6 years, reflecting the positive impact of the Government's budget and financial management reforms, and the improved economic conditions within the State.**

Re-classified transactions

3.20 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, 1996-97
($million)

Item	*Amount*
Receipts	
Operating receipts classified as works and services -	
Portion of privatisation proceeds in excess of book value of assets sold	2 826
Special dividends *(a)*	135
Capital receipts classified as recurrent -	
Casino premium payment	34
Re-classified receipts	**2 995**
Payments	
Operating payments classified as works and services -	
Employee departure programs	149
Other operating costs	171
Grants and subsidies	19
	339
Less - Capital payments classified as recurrent -	
Repayment of borrowings (principal)	(358)
Other	(179)
Re-classified payments (net)	**(198)**

(a) Received from the Transport Accident Commission ($100 million) and the former State Insurance Office ($35 million).

PART 4

Asset Sales

VICTORIAN AUDITOR-GENERAL'S OFFICE

Auditing in the Public Interest

GOVERNMENT ASSET SALES PROGRAM

4.1 Among the Government's key economic and budget strategies in recent years have been the transfer of public activities to the private sector and the implementation of various management initiatives aimed at enhancing the State's financial performance and financial position. Collectively, these strategies have aimed to improve the:

- productivity of the Victorian economy;
- efficiency and effectiveness of service delivery within the public sector; and
- management of the State's assets and liabilities.

4.2 The privatisation of government business enterprises and the sale of surplus and underutilised properties have been key elements of the Government's program associated with the implementation of its strategies. The strengthening of the State's financial position has been achieved through, inter alia, the application of privatisation proceeds towards the reduction of State debt.

4.3 This part of the Report outlines the major business and property sales undertaken or completed by the Government during the 1996-97 financial year, and up to the date of preparation of this Report. The sales covered in this Report include:

Business sales

- Electricity businesses;
- HRL Limited;
- Port-related assets;
- AMRAD Corporation Limited shareholding;
- Health Computing Services;
- Country Fire Authority vehicle manufacturing business; and
- Grain Elevators Board.

Property and equipment sales

- Sheraton Towers Southgate Hotel;
- South East Water Moorabbin site;
- Chevron Hotel complex;
- Queen Victoria Market site;
- South Melbourne property;
- Southern Cross Hotel site; and
- Educational properties.

Victorian electricity industry privatisation

4.4 My previous Reports to the Parliament have provided detailed comment on the Government's electricity industry reform program which commenced in 1994. The program initially involved the restructure of the Victorian electricity industry from a State-owned monopoly to a new competitive structure mainly comprising electricity distribution businesses and generation companies and, subsequently, the progressive privatisation of these newly established distribution and generation businesses.

4.5 The State's 5 electricity distribution businesses were privatised during the 1994-95 financial year. A detailed analysis of the sale of these businesses was provided to the Parliament in my October 1995 *Report on the Statement of Financial Operations* and my May 1996 *Report on Ministerial Portfolios*.

4.6 The electricity generation companies in Victoria are located in the Latrobe Valley, approximately 150 kilometres east of Melbourne. The major generation companies include:

- *Yallourn Energy Ltd* - which owns and operates the Yallourn W Power Station and the associated brown coal mine. In March 1996, the company was sold by the State to a consortium comprising foreign and local investors. A comprehensive analysis of the sale was outlined in my October 1996 *Report on the Statement of Financial Operations*;
- *Hazelwood Power Corporation Ltd* - which owns and operates the Hazelwood Power Station and the associated brown coal mine. This power station was sold in August 1996 to the National Power consortium. An analysis of this sale was outlined in my May 1997 *Report on Ministerial Portfolios*;
- *Energy Brix Australia Corporation* - which owns and operates the Morwell briquette plant and a 170 megawatt power station. The Government sold the Corporation in August 1996 to Lacemore Tower Pty Ltd, a company controlled by HRL Limited (90 per cent) and Lend Lease Ltd (10 per cent). This sale was analysed in my May 1997 *Report on Ministerial Portfolios.* The State Electricity Commission of Victoria's (SECV) 40 per cent shareholding interest in HRL Limited was sold in June 1997;
- *Loy Yang Power Ltd* - which operates the Loy Yang A Power Station and the associated brown coal mine. The Government announced the sale of this company in April 1997; and
- *Loy Yang B Power Station Pty Ltd* - which was a wholly-owned subsidiary of Power Net Victoria, holding a 49 per cent interest in the Loy Yang B Power Station under a joint venture arrangement with the Latrobe Power Partnership, an organisation controlled by a United States-based utility, Edison Mission Energy (EME). In April 1997, the Government announced an agreement with EME under which the State's 49 per cent interest in the Loy Yang B power station was acquired by EME and certain associated financial obligations of the State were terminated or restructured.

4.7 The State's electricity industry also includes a number of smaller generation entities, generally supplying power to meet intermediate and peak capacity requirements. These include 2 gas-fired stations operated by Generation Victoria: one in the Melbourne suburb of Newport and the other at Jeeralang, in the Latrobe Valley. The Government anticipates to sell these power stations in 1998, when the national electricity and gas markets are more established. In addition, Southern Hydro Ltd operates 3 hydro-electric schemes at Kiewa, Dartmouth and Eildon, as well as some minor plants at other locations. The Government has also announced plans to sell these power stations.

4.8 In addition to the power produced by the Victoria-based generation companies, electricity is received by the State from the Snowy Mountains Hydro-Electric Scheme in southern New South Wales, which is a joint undertaking between the Commonwealth Government of Australia and the State Governments of Victoria and New South Wales. The State also owns:

- *Victorian Power Exchange*, which is responsible for the provision of a wholesale electricity market to Victorian electricity participants and the operation of the electricity transmission network; and
- *Power Net Victoria*, whose primary function is to operate and maintain the high-voltage electricity transmission grid which provides transmission services to electricity participants by transmitting electricity from the generators to the distributors. In October 1997, the Government announced the sale of this business to a United States-based company. This privatisation represents a change from previous plans that the national electricity market would involve a single grid owned by all participating States and Territories.

4.9 As previously mentioned, **in April 1997 the Government announced the sale of Loy Yang Power Ltd, which controls and operates the Loy Yang A power station, and the disposal of the State's 49 per cent interest in the Loy B Power Station. In this Report, I have provided a comprehensive analysis of these 2 sales.**

4.10 **To the date of preparation of this Report, the total proceeds to the State from the sale of electricity businesses, including the present value of franchise fees receivable from the distribution businesses, totalled $18.5 billion.**

4.11 Consistent with my previous Reports on the electricity privatisation program, while audit has conducted a financial analysis of the sale results, the audit 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.

Loy Yang A power station

4.12 Loy Yang Power Ltd commenced operations in February 1995, following the disaggregation of Generation Victoria, which itself was formed following the disaggregation of the SECV in January 1994. The company's principal activities included:

- Operation of the Loy Yang A power station, Victoria's largest power station and the equal third largest in Australia. The power station, which is situated near Traralgon in the Latrobe Valley, is equipped with four 500 megawatt generation units which commenced operations between 1984 and 1988. The facility has a useful life which is expected to exceed 40 years;
- Operation of the Loy Yang mine, which is the largest brown coal mine in Australia. The mine was expected to produce 28 million tons of coal for the year ended 30 June 1997 for delivery to the power station and external customers, comprising Loy Yang B power station, and Dry Coal Pty Ltd and Valley Char Pty Ltd which operate a pulverised dried brown coal (PDBC) plant which supplies start-up fuel for the Loy Yang B power station. The current estimated operating life of the mine is 40 years, although the total winnable resources are estimated to be sufficient to supply the current demand for more than 70 years, if required;
- Provision of various infrastructure services to the Loy Yang B power station, the PDBC plant, Yallourn Energy Ltd, Hazelwood Power Corporation Ltd and the SECV, on a contractual basis. These services include the supply of low and high quality water, gas, auxiliary fuel, electricity, Latrobe Valley air monitoring information, the disposal of saline and chemical waste, and the management of a drainage system and water treatment plants.

4.13 According to the Government's Information Memorandum, which was issued to prospective buyers in January 1997, Loy Yang Power Ltd's strong financial forecasts reflect its position as a large base-load power station. In addition, the company's output and revenues are forecast to increase in subsequent years as a result of additional capacity to be absorbed through load growth and interstate trade.

4.14 The Information Memorandum also highlighted that:

- Future bidding behaviour by electricity market participants was expected to become more aligned to the participants' need to cover costs and provide reasonable returns on investment;
- In the longer-term, wholesale electricity prices and hedging contract prices were forecast to approximate the long run marginal cost of new plant, which was estimated in Loy Yang Power Ltd's revenue modelling to be approximately $43 per megawatt hour (1996 dollars). The Victorian Power Exchange has advised that the current wholesale electricity price at the time of the preparation of this Report was about $13 per megawatt hour;

- Loy Yang Power Ltd was substantially insulated from the effects of excess supply and aggressive bidding in the early stages of the electricity market, until December 2000. In particular, approximately 73 per cent of forecast revenue from generation in the year ended 30 June 1997 was covered by vesting contracts with Victorian electricity distributors and the SECV;
- Loy Yang Power Ltd has a significant competitive edge, as it is the lowest incremental cash cost base-load power station in Australia; and
- A major issue concerning the future operations of all electricity generators, including Loy Yang Power Ltd, was the possible introduction by the Commonwealth Government of new environmental taxes, such as a carbon tax. However, the memorandum stated that such a tax would have to operate at very high levels before it could significantly affect Loy Yang Power Ltd's competitiveness in the wholesale electricity market. In addition, the existing vesting contracts allow for the pass-through of certain new taxes, such as environmental taxes, to electricity distribution businesses, and ultimately to electricity consumers.

Loy Yang A power station.

Sale process

4.15 In November and December 1996, advisers employed by the Department of Treasury and Finance consulted with potential purchasers of Loy Yang Power Ltd in Australia, Asia, Europe and the United States of America. Those parties who subsequently expressed an interest in the acquisition of the company were issued with an Information Memorandum in January 1997, as outlined above.

4.16 In February 1997, expressions of interest in the company were lodged by 4 consortia and 2 individual investors and, subsequently, the 4 consortia were shortlisted to further participate in the sale process. In April 1997, all shortlisted parties were advised of the final bid requirements, which included:

- A strong preference by the State for the final bids not to include any price adjustment mechanism in respect of the final value of net assets acquired;
- The non-inclusion of certain adjoining land parcels owned by the SECV in the sale. The arrangements for any future development of this area is outlined in the Loy Yang Complex Agreement, which is discussed in further detail later in this Part of the Report;
- The assignment of responsibility to Loy Yang Power Ltd for the continuation of the provision of coal supply and infrastructure services to the Loy Yang B power station. In addition, the buyer of Loy Yang Power Ltd was required to enter into certain supplementary security arrangements with EME (the owner of Loy Yang B power station); and
- The assumption by Loy Yang Power Ltd of the SECV's rights and obligations under a PDBC plant purchase agreement, dated August 1991, with Dry Coal Pty Ltd and Valley Char Pty Ltd. The arrangements under the agreement essentially comprised take-or-pay contracts for the purchase of 150 000 tonnes of PDBC plant output a year for a period of 10 years and 100 000 tonnes thereafter until the year 2011.

  In 1991, the SECV expected the output purchased from the PDBC plant to be used at the other brown coal fired power stations in the Latrobe Valley, and possibly for other applications, however its output has been rarely required except for the Loy Yang B power station for use as a starter fuel. Accordingly, the SECV was purchasing an estimated 3 000 tonnes of PDBC per annum for re-selling to the Loy Yang B power station, although it was paying for approximately 150 000 tonnes a year.

4.17 The parties were advised that all bids would be evaluated using consistent criteria, featuring both quantitative and qualitative aspects, relating to the certainty of completion of the sale arrangements and any proposed special conditions of sale, as well as the bid price.

4.18 Following the dissolution and subsequent withdrawal of one of the consortia in March 1997, the 3 remaining consortia submitted final binding bids in April 1997. Following the review of these bids and subsequent clarification of certain issues, the Horizon Energy consortium was selected as the preferred bidder.

4.19 Subsequently, the Government announced the sale of the assets and liabilities of Loy Yang Power Ltd to the preferred bidder, Horizon Energy consortium, which comprised:

- *CMS Generation Horizon Energy Holdings Ltd*, a subsidiary of a United States-based generation company, CMS Energy Corporation (25 per cent interest);
- *Horizon Energy Holdings Ltd*, another subsidiary of CMS Energy Corporation (24.6 per cent interest);

- *NRGenerating Holdings (No. 4) BV*, a wholly-owned subsidiary of NRG Energy Inc. which operates generation businesses in the United States and other countries (25.4 per cent interest). This body is ultimately controlled by a major United States-based utility, Northern States Power Company; and
- *Horizon Energy Investment (No. 2) Pty Ltd*, an institutional investment vehicle controlled by Horizon Energy Investment Ltd and Horizon Energy Investment Trust, comprising the following equity investors:
  - *Infrastructure Trust of Australia*, a company listed on the Australian Stock Exchange and managed by Macquarie Infrastructure Investment Limited (11.25 per cent interest);
  - *Macquarie Underwriting Ltd*, a subsidiary of the Macquarie Bank (5.5 per cent interest);
  - *ANZ Securities Limited*, a company affiliated with the ANZ Investment Bank which co-ordinated the consortium of banks financing the purchase arrangements (5.5 per cent interest); and
  - *Unisuper Ltd*, (2.75 per cent interest).

4.20 In April 1997, Macquarie Bank announced that Horizon Energy Investment Ltd and Horizon Energy Investment Trust would be listed on the Australian Stock Exchange 12 months after the completion date of the sale.

4.21 A private sector accounting firm was appointed by the Department of Treasury and Finance in February 1997 to perform the responsibilities of process auditor for the sale of Loy Yang Power Ltd. The firm concluded that all bidders were accorded fair and equitable treatment and that tenders were evaluated and ranked fairly against the agreed selection criteria.

Sale result

4.22 **Under the arrangements established for the sale of Loy Yang Power Ltd's net assets, the gross proceeds to the State from the sale were $4.9 billion**, comprising amounts relating to:

- sale of the State's interest in the net assets of the business ($3.5 billion);
- repayment of outstanding business debt owed to the Treasury Corporation of Victoria ($1.1 billion); and
- stamp duty payable on the sale transactions ($261 million).

4.23 However, the value of the gross sale proceeds was reduced by $109 million on account of the assumption by the purchaser, as part of the sale arrangements, of certain financial rights and obligations associated with the Lurgi Output Deed, which are outlined later in this part of the Report.

4.24 Table 4A outlines the key components of the proceeds received from the sale of Loy Yang Power Ltd.

TABLE 4A
COMPOSITION OF SALE PROCEEDS
($million)

Details	*Total*
Proceeds in excess of book value	1 940
Proceeds equal to the State's interest in the book value of the business	*(a)* 1 519
	3 459
Repayment of outstanding debt of the business *(b)*	1 135
Stamp duty on sale transaction	261
Gross proceeds	4 855
Less - Deduction relating to the assumption by the purchaser of financial obligations associated with the Lurgi Output Deed *(c)*	(109)
Total cash proceeds	**4 746**

(a) Represents the SECV's interest in Loy Yang Power Pty Ltd's net assets as at the date of sale.

(b) Under the sale arrangements, the State retained responsibility for the repayment of the company's loan and accrued interest payable to the Treasury Corporation of Victoria.

(c) The purchaser agreed to assume the SECV's rights and obligations under contracts for the purchase of pulverised dried brown coal from Dry Coal Pty Ltd and Valley Char Pty Ltd.

4.25 The above table shows that the State received $3.4 billion for the sale of the net assets of Loy Yang Power Ltd, which at the effective date of sale had a book value of $1.5 billion. In effect, this resulted in **the State obtaining proceeds of $1.9 billion in excess of the book value of the business**.

4.26 The cash proceeds of $4.7 billion received by the State were mainly applied towards the reduction of budget sector debt ($1.8 billion), the retirement of debt with the Treasury Corporation of Victoria relating to Loy Yang Power Ltd ($1.1 billion) and Loy Yang B Power Station Pty Ltd ($1.1 billion), with the balance ($746 million) retained by the SECV to meet costs associated with the divestment of the State's 49 per cent interest in the Loy Yang B power station and other obligations. Detailed comment on the divestment of the State's interest in Loy Yang B is provided later in this Report.

4.27 **The costs incurred by the Department of Treasury and Finance in relation to the sale totalled $15.8 million.**

Adequacy of sale result

4.28 **The cash proceeds of $4.7 billion received from the sale of the business compared favourably with the valuations of the business provided by the Government's financial advisers in February 1997, on the basis of a trade sale**. These valuations are summarised as follows:

- *$3.9 billion to $5.2 billion*, based on the forecast earnings of Loy Yang Power Pty Ltd and the sale proceeds and earnings multiples achieved for the Yallourn and Hazelwood power stations;
- *$3.3 billion to $4.6 billion*, based on an implied value of the purchase price per megawatt of generating capacity for the Yallourn Power Station;

- *$2.9 billion to $6.2 billion*, based on an implied value of the purchase price per megawatt of generating capacity of the Hazelwood Power Station. However, the advisers considered that the purchase price for the Hazelwood power station was not an appropriate indicator for a valuation of Loy Yang Power Pty Ltd as it reflected a substantial perceived upside in its operations beyond the first 3 years following its sale and, as such, application of its relative purchase price to other operations did not provide a meaningful basis for comparison; and
- *$2.5 billion to $3.9 billion*, in the event of a public float, rather than a trade sale.

4.29 Table 4B compares the sale result achieved by the State in relation to Loy Yang Power Ltd, on the basis of price to earnings multiples, with the result achieved from the earlier sales of Hazelwood and Yallourn Energy.

TABLE 4B
SALE PROCEEDS AND EARNINGS MULTIPLES
ACHIEVED FROM THE SALE OF POWER STATIONS *(a)*

Details	*Loy Yang Power Ltd*	*Hazelwood and Energy Brix (b)*	*Yallourn Energy*
	Price to earnings multiples		
1995-96	11.9	20.1	9.7
1996-97	13.1	24.1	9.3
1997-98	12.1	13.5	8.1
1998-99	10.2	13.5	-
Average	**11.8**	**17.8**	**9.0**
Sale proceeds ($m) *(c)*	4 594	2 261	*(d)* 2 146

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

(b) The EBDIT for Energy Brix only represents 2 per cent of the total combined EBDIT for Hazelwood and Energy Brix for the period July 1995 to June 1999.

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

(d) This amount is $2 million lower than that included in my *Report on the Statement of Financial Operations, 1995-96,* due to a refund by the State to the buyers of Yallourn Energy, relating to an adjustment for working capital at the date of sale completion.

4.30 **The table indicates that the price to earnings multiple achieved by the State from the sale of Loy Yang Power Ltd was favourable when compared with the result achieved for the sale of Yallourn Energy.** A comparison with the result achieved for the combined sale of Hazelwood and Energy Brix is limited as, according to the Department of Treasury and Finance, the purchasers of Hazelwood expected to substantially improve the utilisation rate of the power station which was projected by the State to be only 46 per cent during the year ended 30 June 1996. This utilisation rate was significantly below the equivalent annual projections for Yallourn Energy of 80 per cent and Loy Yang Power Ltd of 87 per cent.

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

4.31 My previous Reports to the Parliament have provided an analysis of the impact of the electricity privatisation program on State finances, in terms of the net interest savings to be achieved from the repayment of State debt from the sale proceeds, after taking into account revenue forgone in the form of dividends and State equivalent taxes. Table 4C provides an update of the estimated annual impact on State finances of the electricity industry privatisation program at the date of preparation of this Report.

TABLE 4C
PROJECTED NET ANNUAL SAVINGS FROM PRIVATISATION OF ELECTRICITY BUSINESSES
($million)

Details	*1996-97*	*1997-98*
Revenue forgone -		
Dividends *(a)*	287	357
State equivalent tax *(b)*	11	43
	298	400
Less income entitlement payments to municipal councils	(26)	(28)
	272	372
Interest savings *(c)* -		
Budget sector debt	586	736
SECV debt	258	258
	844	994
Net savings	**572**	**622**

(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. In addition, the estimated dividend forgone for Loy Yang Power Ltd is based on the actual dividend paid in the financial year ended 30 June 1996.

(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 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.

4.32 As previously mentioned, the State has received $18.5 billion from the sale of electricity businesses to date, the majority of which has been applied to the reduction of State debt which, in turn, has resulted in a significant reduction in interest costs. **On the basis of current government projections, it is estimated that the State will derive ongoing net savings of approximately $622 million a year from the electricity privatisation that has occurred at the date of preparation of this Report.**

Obligations of the purchaser

4.33 Under the sale arrangements, the purchaser of Loy Yang Power Ltd agreed not to sell a substantial part of the business, except with the prior written consent of the Treasurer, for a period of 3 years from the date of sale. However, if a controlling entity of a member of the purchasing consortium demonstrates to the Treasurer that the book value of its investment is less than 50 per cent of that entity's book value of the total assets (other than intangibles, cash and short-term marketable securities), then that member is entitled to dispose of up to 49.9 per cent of the assets of the consortium in an unrestricted manner.

4.34 Furthermore, investors in Horizon Energy Investment (No. 2) Pty Ltd, a member of the purchasing consortium, may dispose of their interests as follows:

- *Infrastructure Trust of Australia Group and UniSuper Ltd*, up to 50 per cent of their interests may be disposed to passive financial investors, without the consent of the Treasurer, within 2 months of completion;
- *Macquarie Underwriting Ltd and ANZ Securities Ltd*, 100 per cent of their interests may be disposed to passive financial investors, without the consent of the Treasurer, within 2 months of completion; and
- *All investors*, between 2 months and 12 months of sale completion, are permitted to dispose of their interest, with the consent of the Treasurer. Beyond the 12 month period, the sale of the investors' interest is unrestricted.

4.35 The purchasing consortium has also retained the following specific obligations:

- To use its best endeavours to complete a specified property sale transaction and to grant a lease over the property to the seller;
- To continue Loy Yang Power Ltd's compliance with existing obligations under a Smelter Information Deed entered into between Loy Yang Power Ltd and SECV in September 1995. Under this Deed, the company together with the operator of the Loy Yang B power station are required to annually provide certain information to the SECV to enable the calculation of electricity tariffs associated with electricity supply agreements with the operators of the Portland and Point Henry aluminium smelters; and
- To provide all reasonable assistance in enabling the State to evaluate the possibility of increasing the capacity of the Loy Yang B power station, including the viability, cost of design, plant modifications and an assessment of the projected net present value of future cash flows resulting from any increases in capacity.

Assumption by purchaser of PDPC plant output obligations

4.36 As part of the sale arrangements, the purchaser also assumed the obligations of the SECV under agreements with Valley Char Pty Ltd and Dry Coal Pty Ltd for the purchase of PDBC plant output. The value of the obligations assumed was estimated at $109 million based on an offer made by the owners of the PDBC plant for the termination of the obligations, representing the estimated net present value of costs payable by the State over the remaining life of the obligations.

4.37 Under the arrangements, while the purchaser has accepted the performance of the SECV's rights and obligations under the purchase agreements, the SECV has provided an indemnity for any liability arising from any act or omission caused by the SECV under the agreements, other than those acts or omissions resulting from the purchaser or its employees in the performance of their duties.

Obligations of the State to the purchaser

4.38 While substantial financial benefits have accrued to the State from the sale of Loy Yang Power Ltd, the State has provided certain indemnities and warranties to the purchaser. In addition, the final purchase price may be subject to adjustment by way of a refund by the State to the purchaser by December 1997, if:

- certain equipment finance leases including those relating to generation turbines, dredgers and conveyors are not terminated and the title transferred to the purchasers by November 1997; and
- the lessor of a further finance lease with respect to one generation turbine has not unconditionally agreed by November 1997 to terminate the lease and transfer title to the purchasers by November 1998.

4.39 The State also retained the following general obligations:

- A requirement for the SECV to use its best endeavours to assist the purchaser in dealing with contracts relating to the PDBC plant. In particular, the SECV is required to accommodate the purchaser with regard to any restructuring of the arrangements relating to the plant, provided the SECV's interests are not adversely affected;
- A requirement to initially meet the costs associated with a diversion of the Hyland Highway and any upgrade to the Highway to meet required standards. However, the purchaser is required to reimburse the State for these costs;
- An indemnity to the purchasers against any additional stamp duty payable to the State as a consequence of the purchasers' restructuring, within 3 months of sale completion, their finances or ownership; and
- An undertaking to use its best endeavours to procure the early termination of the Interconnection Operating Agreement. Detailed comment on the termination of this agreement , which occurred in April 1997, is provided later in this Report.

Further obligations arising under other major supplementary agreements

4.40 **As part of the arrangements established to facilitate the sale of Loy Yang Power Ltd and the divestment of the State's residual interest in the Loy Yang B power station, the State arranged for the completion of a number of other substantial supplementary agreements between the parties, which gave rise to various rights and obligations**.

4.41 Loy Yang Power Ltd, its purchasing consortium, EME (the owner of the Loy Yang B power station) and the security trustee for EME's financiers, have entered into a *"Deed of Acknowledgment"* with the SECV. Under this deed, the purchasing consortium and the SECV have consented to the existence of any security interest given by EME in favour of its financiers over EME's right and interest in the *Coal Procurement Agreement*, an *Infrastructure Services Agreement* and the *Loy Yang Complex Agreement*.

4.42 Loy Yang Power Ltd and EME entered into a *"Coal Procurement Agreement"* and an *"Infrastructure Services Agreement"* for the supply of coal and infrastructure services to EME. In addition, these parties together with the SECV completed a *"Loy Yang Complex Agreement"* to address certain issues relating to the possible future development of additional generating units near the Loy Yang power station (referred to as the Bench), mutual access rights and the future of the Loy Yang mine after the Loy Yang A power station is decommissioned.

4.43 The key terms of the Loy Yang Complex Agreement are summarised as follows:

- In the event that a power station is constructed on the Bench, Loy Yang Power Ltd and the SECV are required to negotiate the terms on which Loy Yang Power Ltd will supply coal and services to the Bench, provided there will be at least 50 years supply of coal from 1997 for both Loy Yang A and B power stations. The capital costs of the expansion associated with the supply of coal will be met by the SECV and the coal procurement and infrastructure services agreements would be appropriately amended to take account of this development;
- If, after December 2024, Loy Yang Power Ltd decides to cease operation of the Loy Yang A Power station, it will be required to give notice to EME. In turn, EME may require Loy Yang Power Ltd to transfer to it the mine and infrastructure assets. In the event that EME does not require any or all of the assets, Loy Yang Power Ltd may terminate the coal supply and infrastructure services agreements and the assets may be transferred to the SECV or any third party; and
- The party which owns the Loy Yang mine, ash pond and other infrastructure assets when they are shut down is responsible for rehabilitation. A trust fund is to be established as from 2023 for the purpose of accumulating moneys to meet rehabilitation expenses, which are shared according to tonnages delivered from the mine.

Loy Yang B power station

4.44 The Loy Yang B power station forms a part of the Loy Yang Complex located in the Latrobe Valley and consists of two 500 megawatt units, the first of which was completed in 1993 and the second commenced operations in January 1996.

Loy Yang B power station.

4.45 In December 1992, during the construction of the power station, the SECV sold a 51 per cent interest in Loy Yang B to a private sector operator, Mission Energy Australia Pty Ltd. This company was affiliated with Mission Energy, a North American company linked to its holding company, Southern California Edison Corporation. Mission Energy's share in Loy Yang B was held through a group of wholly-owned subsidiaries, collectively referred to as the Latrobe Power Partnership.

4.46 The SECV's remaining 49 per cent interest in Loy Yang B was purchased by a State-owned company, Loy Yang B Power Station Pty Ltd (LYBCO), which became a wholly-owned subsidiary of Power Net Victoria following the disaggregation of the SECV.

4.47 A comprehensive analysis of the Loy Yang B sale was included in my May 1994 *Report on Ministerial Portfolios*. Under the sale arrangements, the State received an amount of $518 million from Mission Energy for the sale of the 51 per cent interest in Loy Yang B.

4.48 In conjunction with the sale arrangements, the State also entered into a State Support Agreement, under which the State undertook to ensure the performance of the SECV's obligations under certain project contracts with Mission Energy and LYBCO. The key project agreements included:

- *Completion of Construction Contract*, under which the SECV assumed the role of head contractor for the completion of Loy Yang B on the basis of a fixed price, fixed completion date contract, for approximately $800 million. In the event that the final construction costs exceeded the contract amount, the SECV was responsible for any cost overruns; and
- *Power Supply Agreement*, under which the SECV was committed to a take-or-pay contract for a period of 33 years to purchase energy from the Loy Yang B power station. The price paid for power under this contract was based on the fixed costs of operating the power station, including debt servicing costs and a return on equity, and a variable charge for the costs of generating energy, such as the cost of coal and water used. Under the established terms, the SECV was required to meet the fixed costs charged, irrespective of the actual power taken.

4.49 Furthermore, under the State Support Agreement, the State assured Mission Energy and its financiers that in the event of any split up or privatisation of the SECV, the State would continue to provide sufficient funds to purchase the Loy Yang B power station's output for the remaining term of the agreement.

4.50 An assessment of these arrangements, from the State's perspective, was included in my May 1994 *Report on Ministerial Portfolios*, which indicated that:

- The sale proceeds were substantially less than the percentage of the construction costs relating to the sale which were incurred by the SECV up to the agreed date of valuation;
- The book value of the assets sold equalled the purchase price paid by Mission Energy and LYBCO. However, the book value of the power station had been devalued prior to its sale;
- The SECV had locked itself into a long-term *take or pay* contract for the power generated by Loy Yang B which, in audit opinion, effectively eroded the anticipated benefits from the introduction of competition; and
- The State entered into agreements under which it was exposed to a number of substantial risks that may have been transferred to the private sector if the electricity generation industry was structured in a more competitive and open basis.

Proposal to divest the power station

4.51 In December 1996, Edison Mission Energy Holdings Pty Ltd (EME), which was formerly known as Mission Energy Australia Pty Ltd, approached the State with an offer to acquire the State's remaining 49 per cent interest in Loy Yang B through the purchase of the shares or the assets of LYBCO. Consequently, in January 1997, the Department of Treasury and Finance requested its financial, accounting and legal advisers to jointly prepare an analysis of the offer made by EME and to restructure the coal and miscellaneous services supply arrangements associated with the operation of the power station.

4.52 Following an analysis of the EME proposal by the Department's advisers, in March 1997 the Department approached this Office to provide a high level assessment of the proposal. Subsequently, **I advised the Department that the proposal did not appear to provide any substantial benefit to the State,** in that, while the proposed deal acted to change the nature of the associated risks, the net financial impact of the deal was that the State's exposures remained substantially unchanged.

4.53 **A further proposal was forwarded by EME following the above advice, which involved an up-front payment to the State of $84 million.**

4.54 In April 1997, the Department's advisers provided their analysis of EME's final proposal. At the outset, the financial and accounting advisers identified that their firms were likely to receive higher fees in the event that the transaction proceeded. As such, neither firm would qualify as an independent expert under the guidelines for independent expert reports in the relevant Australian Securities Commission practice note. However, notwithstanding this, neither of these advisers believed that their ability to provide an unbiased report to the State was compromised.

4.55 **The analysis provided by the advisers on the transaction was based on a large number of assumptions which were subject to significant uncertainties and contingencies, many of which were outside the control of the State or the electricity businesses. As a result, the advisers emphasised that it was possible that some of the assumptions underlying their projections may not materialise.** In particular, the financial analysis contained assumptions in respect of the Government's exposures and cost savings associated with the elimination of the existing arrangements and included a number of other benefits that by their nature were difficult to quantify.

4.56 Specifically, the advisers estimated that the valuation of the State's obligations and benefits under the existing arrangements equated to a net cost to the State of around $1.1 billion in present value terms. Table 4D shows the major components of this valuation.

TABLE 4D
ESTIMATED NET COST TO STATE UNDER EXISTING ARRANGEMENTS
($million)

Item	*(a) Amount*
Valuation of LYBCO (*b*)	1 567
LYB Trader losses (*c*)	(1 358)
Profit on coal and miscellaneous services agreements (*d*)	680
SECV Smelter Trader losses (*e*)	(1 958)
Net cost to the State	**(1 069)**

(*a*) Represents estimated net present value, based on a discount rate of 12 per cent which was considered to be broadly consistent with the rate applied by bidders in the previous privatisations of generators.

(*b*) Represents the valuation of the State's 49 per cent interest in the power station.

(*c*) Under the take or pay contract the price of energy sold to the SECV is significantly higher than current vesting contracts or pool prices. Consequently, a significant loss is incurred by the SECV's Loy Yang B Trader when this energy is sold into the pool. The amount included in the table represents the estimated losses over the remaining term of the contract.

(*d*) The SECV supplies coal and miscellaneous services to Loy Yang B power station under specified contracts which generate profits.

(*e*) The losses on the SECV Smelter Trader reflect the difference between the price of energy purchased from the pool of around $25 per megawatt and the price received from aluminium producers under existing arrangements.

4.57 Under the proposal put to the State, EME would acquire the State's 49 per cent interest in Loy Yang B power station and the vesting contracts currently held by the SECV's Loy Yang B Trader, and enter into new coal and infrastructure services supply agreements with Loy Yang Power Ltd. In return, EME would make an up-front payment to the State of $84 million, agree to cancel certain contracts with the SECV and enter into a new contract with the State to hedge the cost of energy for a load equivalent to that supplied by the SECV to aluminium producers from the year 2001 to 2016, at $23.95 per megawatt hour, indexed to movements in the consumer price index. In addition, the State provided a hedge for the difference between the energy volume under the vesting contracts and 920 megawatts at $23.95 per megawatt hour for the period May 1997 to December 2000.

4.58 **The Government advisers concluded that, based on their analysis of the proposal, the risk adjusted impact on the State from proceeding with the proposed transaction ranged from being cost-neutral to benefiting the State by $162 million**. This result is detailed in Table 4E.

TABLE 4E
ESTIMATED IMPACT OF EME PROPOSAL ON THE STATE (*a*)
($million)

Item	*Low case*	*High case*
Divestment of State's 49 per cent interest in the power station	(1 567)	(1 567)
Profit forgone on coal and miscellaneous services agreements	(680)	(680)
Cost of unwinding swap affiliated with take-or-pay power supply agreement	(58)	(58)
Benefit of terminating take-or-pay power supply agreement	1 358	1 724
Benefit of new State hedge on Smelter position	643	401
Benefit from residual trading of energy to the year 2000	110	56
EME up-front payment to the State	84	84
Potential benefit sharing *(b)*	31	58
Increased Loy Yang Power Ltd value due to higher profits under coal and infrastructure services agreements *(c)*	18	18
Other benefits (*d*)	61	126
Net impact on State	**nil**	**162**

(*a*) Based on net present value terms, using a discount rate of 12 per cent.

(b) Under the proposal, the State was entitled to participate in any benefits derived from pool prices for energy exceeding the forecasts adopted by EME and capability enhancements in excess of 15 megawatts over the existing generating capacity of the power station.

(*c*) Planned agreements between Loy Yang Power Ltd and EME were estimated to result in an $18 million increase in the value of Loy Yang Power Ltd due to increased profitability.

(*d*) Other benefits to the State under the proposal included the elimination of warranties provided by the SECV to EME in respect of the construction of the Loy Yang B power station and savings associated with the administration of the relevant agreements.

4.59 To gain additional confidence in the above financial analysis, the Department of Treasury and Finance also requested a further financial adviser to review the analysis. Based on a draft version of the above analysis, the adviser concluded that the financial model used to assess the arrangements was accurate and the value placed on the components of the evaluation of the proposed arrangements was considered to be reasonable.

4.60 **Subsequently, in April 1997, the Government announced the sale of the State's 49 per cent interest in the Loy Yang B power station to EME and the re-structuring of associated financial arrangements.**

Key elements of the agreed arrangements

4.61 The arrangements associated with the divestment of the State's remaining 49 per cent interest in the Loy Yang B power station, between the State, EME and Loy Yang Power Ltd, initially involved the following elements:

- the establishment of a new subsidiary, named Leanne Power Pty Ltd (Leanne), by the SECV and the provision by the SECV to the company of an initial capital contribution of $65 million, which was subsequently used by the company to pay stamp duty associated with the arrangements;
- the sale by the SECV of its shares in Leanne to Mission Energy Development Australia Pty Ltd, for a nominal sum;

- in consideration of a payment of $590 million by the SECV to EME, the parties agreed to terminate the power supply, coal supply and miscellaneous services agreements dated December 1992, between the SECV, LYBCO and Latrobe Power Partnership (now referred to as EME); and
- the receipt by LYBCO of $674 million from Leanne for the acquisition of the assets of the business, and a further amount of $65 million from Leanne to reimburse the cost of stamp duty, initially met by the State, associated with these arrangements.

4.62 **In substance, the above arrangements resulted in the sale of the State's interest in the Loy Yang B power station to EME, in return for the receipt of an up-front payment of $84 million, the termination of the power supply agreement which exposed the State to substantial future financial obligations, the establishment of a hedge contract to cover the SECV's aluminium smelter obligations and the termination of the coal supply and miscellaneous services agreements which were associated with the operations of the power station.**

4.63 Other key elements of the arrangements between the parties, also impacting on the State's future financial rights and obligations, included:

- Allocation to Leanne of the vesting contracts between the SECV and all the electricity distribution businesses. These contracts expire in December 2000;
- Establishment of a *Loy Yang Complex Agreement* (referred to previously under the Loy Yang A power station sale) between the SECV, EME and Loy Yang Power Ltd, to address certain issues such as the supply of coal for future generation units , mutual coal access rights and the future of the Loy Yang mine;
- Termination by the parties of any existing or future rights and privileges against each other under the former sale of assets agreement between the SECV, LYBCO and EME. In addition, the parties agreed that the SECV had satisfactorily performed its construction period and production period obligations and therefore the State had no ongoing liability with respect to these obligations;
- Termination and hence waiving by the parties of any rights or obligations emanating from the completion of construction agreement. In particular, EME released the SECV from all claims it may have in connection with the construction of the Loy Yang B power station, other than any loss associated with any personal injury, occupier's liability or occupational health and safety claim which is not recoverable by EME under the construction contracts;
- EME and the State to share the benefits of any physical modifications to the Loy Yang B power station which result in increases in its output, under certain prescribed conditions;
- EME not to transfer a controlling interest in the Loy Yang B power station within 12 months of settlement. However, the State has agreed to permit EME to transfer up to 30 per cent of its interest in the power station through a public float;
- EME to provide as security the Loy Yang B power station in favour of the SECV to support EME's obligations under the hedge arrangements; and
- EME to participate directly in the competitive national electricity market.

Overall assessment of the arrangements

4.64 **In summary, under the arrangements established by the Government in relation to the disposal of the State's remaining 49 per cent interest in the Loy Yang B power station, the State received an up-front payment of $84 million for the disposal of an asset which was valued at around $1.6 billion and agreed to terminate or restructure certain unfavourable arrangements associated with the Loy Yang B power station, in particular the power supply agreements which were established in the 1980s which gave rise to substantial future financial obligations on the State.**

4.65 **Based on a financial analysis undertaken by the Government's financial and legal advisers which, due to the term and nature of the relevant agreements, was subject to substantial assumptions and uncertainties, the arrangements were estimated, at worst, to maintain the State's pre-existing financial position and, at best, achieve estimated savings in present value terms of $162 million.**

United Energy Limited - Franchise fee indemnity

4.66 My October 1996 *Report on the Statement of Financial Operations* commented on an indemnity provided by the State to the purchaser of United Energy Limited, an electricity distribution company, concerning the deductibility of franchise fees for taxation purposes. Under this indemnity, the State will be required 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 3 years of the date of sale of the United Energy business.

4.67 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. Subsequently, in October 1995, the Government lodged an objection to the ATO ruling, however, a further private tax ruling was issued by the ATO in August 1996 which confirmed that the franchise fees were not deductible for taxation purposes.

4.68 The Government subsequently appealed the ATO decision in the full Federal Court. However, in August 1997 the Court dismissed the appeal and confirmed that the franchise fees were not deductible for tax purposes. Audit was advised that **the State has subsequently lodged an application seeking special leave to appeal to the High Court the decision of the full Federal Court. The potential indemnity payment of $85 million has been recognised as a liability in the Government's Annual Financial Statement as at 30 June 1997.**

HRL Limited

4.69 HRL Limited was established in 1993 to acquire the business of the former research and development arm of Generation Victoria, operating from the Herman Research Laboratory in Mulgrave, Melbourne. As at March 1995, the SECV held a 40 per cent interest in the company, with the remaining shareholding held by private sector investors following a partial sale. Since March 1995, the SECV held an option to convert unsecured convertible notes in the company of $1.2 million to shares by March 1997.

4.70 In March 1995, the SECV finalised arrangements which had been commenced by Generation Victoria in 1994 for the establishment of a syndicate to finance research and development relating to a method of generating electricity from brown coal, referred to as the *Integrated Drying Gasification Combined Cycle Process*. This project, which the syndicate contracted the company to undertake, represented the company's core activity, however, the company also performed research into the commercialisation of new products from brown coal and carried out other consulting tasks. As part of the arrangements, the Government indicated that it would use its *"... best endeavours to ensure funding after December 1997 of approximately $5 million per annum for longer-term strategic research in respect of brown coal technology"*.

4.71 **The SECV had acquired a minor shareholding interest in the research and development syndicate of 0.18 per cent and licensed certain technology to the syndicate in return for the rights to licence fees, which are secured by a debenture over the rights and entitlements of other investors in the syndicate. The SECV also provided interest-free loans to the company totalling $8.5 million which are due for repayment in 2002 and 2003**. At that time, syndicate members will be required to make a decision on the commercial success or otherwise of this technology, which will determine whether the SECV will receive licence fees in accordance with the above arrangements.

4.72 The interest-free loans were not recognised in the financial statements of the SECV as their recovery was considered to be uncertain. The value of the SECV's equity interest in the syndicate was also not recognised in its financial statements as it could not be reliably measured. However, as at 30 June 1997, the SECV recorded in its financial statements a contingent asset, relating to its rights to licence fees from the syndicate, the realisation of which is dependent upon the commercial success of the technology, which could take many years to achieve.

4.73 In December 1995, HRL Limited acquired the Energy Business Centre Pty Ltd, a business that provided energy advisory services to the electricity distribution businesses and energy users. In August 1996, the company also acquired a 90 per cent interest in Energy Brix Australia Corporation Ltd, which was formerly owned by the SECV.

4.74 Financial and legal consultants engaged by the SECV in September 1996 recommended that the SECV should negotiate the redemption of the $1.2 million of convertible notes by March 1997 and the early repayment of the 2 interest-free loans. The SECV subsequently resolved to adopt this recommendation.

4.75 Following negotiations between the parties, in November 1996 the company offered a nominal amount for the full settlement of the SECV loans. This offer was considered unacceptable and therefore the SECV decided to allow the loans to run their full term, expiring in years 2002 and 2003.

4.76 In January 1997, the SECV's legal consultants advised that, due to a restriction in the company's Articles of Association, the SECV's shareholding in the company could only be sold to a party approved by the shareholders or back to the company. Subsequently, in February 1997 the SECV received a preliminary offer from the company for the buy-back of its equity interest at a price of $2.21 per share. The SECV engaged a firm of chartered accountants in February 1997 to evaluate this offer and, in March 1997, the firm concluded that the offer which equated to a value of approximately $2.6 million after conversion of the convertible notes to shares, was fair and reasonable. In addition, the company would still be responsible for the repayment of the outstanding loans.

4.77 Furthermore, from the SECV's perspective, the offer was considered attractive as it:

- completed the privatisation process of the company in a manner which had the support of the remaining shareholders;
- occurred at a time when the company was profitable; and
- removed the possibility of the SECV having to fund any shortfall of net assets if the business should fail in the future.

4.78 In March 1997, the SECV converted its holding of convertible notes of $1.2 million into shares, and received $195 000 in relation to interest payable on the conversion of the notes.

4.79 Subsequently, in June 1997, the SECV proceeded with the disposal of the State's shareholding in the company, via a share buy-back arrangement. **A competitive process was not established for the disposal of the State's interest in the company as, according to SECV management, the disposal was complicated by the pre-emptive rights to the shares of the other shareholders, which made it difficult to sell the shares to parties other than the company or a buyer approved by the other shareholders.** In addition, the disposal was viewed as an opportunity to reduce the level of risk associated with the State's interest rather than seeking maximum value for the company, and allowed the State to retain the right to benefit from any upside in the research and development syndicate, through the potential future realisation of licence fees.

4.80 Consistent with the terms of the share buy-back agreement, in June 1997, the SECV received $2.65 million from the company for its shareholding. The costs incurred by the SECV associated with the sale of the shares amounted to approximately $100 000.

Assessment of sale

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

- **the net sale proceeds of $2.5 million for the SECV's remaining interest in the company were higher than its estimated share of the book value of the company's net assets of $2 million;**
- **the SECV considers that there is substantial uncertainty concerning the recovery of $8.5 million of interest-free loans provided to the company, which are due for repayment in the years 2002 and 2003; and**
- **the State has retained the right to benefit from any upside in the research and development syndicate, if there are any receipts from future licence fees.**

Sale of port-related assets

4.82 My previous Reports to the Parliament have commented on the status of the Government's reform program of Victorian commercial ports which was introduced in 1995 to improve the efficiency and effectiveness of port services, reduce port costs to importers and exporters, and achieve a reasonable return on port assets sales.

4.83 As part of the implementation of this reform program, the Government had secured the following key outcomes as at the date of preparation of this Report:

- disaggregation of the business and service functions of the Port of Melbourne Authority (PMA) into 3 new entities, namely, the Melbourne Port Corporation (MPC), Melbourne Port Services Pty Ltd (MPS) and the Victorian Channels Authority (VCA);
- transfer of certain non-commercial port assets, mainly to municipal councils;
- sale of the World Trade Centre and the port-related assets previously under the management of the Port of Portland Authority and Port of Geelong Authority (a comprehensive analysis of these asset sales was provided in my October 1996 *Report on the Statement of Financial Operations)*;
- sale of the Melbourne Port Services Pty Ltd in May 1997; and
- sale of the management and operating rights of the Port of Hastings in July 1997.

4.84 In this Report, I have provided a detailed analysis of the major developments during the 1996-97 financial year in relation to the port reform program, namely, the sales by the Government of the Melbourne Port Services Pty Ltd and the management and operating rights associated with the Port of Hastings.

Melbourne Port Services Pty Ltd

4.85 Melbourne Port Services Pty Ltd (MPS) was established in February 1996 and commenced providing port services to the Melbourne Port Corporation (MPC) and the Victorian Channels Authority (VCA) in March 1996. The major services provided by MPS included docking, security and port surveillance, first aid, cleaning, maintenance and dredging services.

4.86 Given that MPC was the sole shareholder and major client of MPS, a statutory restriction was imposed under the *Port Services Act* 1995 to ensure that neither entity was able to provide a financial benefit to the other, except on an arm's length basis.

4.87 In December 1995, prior to the establishment of MPS, the Government entered into an Memorandum of Understanding with 5 maritime unions to facilitate the introduction of a process of competitive tendering for port services, in exchange for a Government commitment to retain MPS in public ownership. In particular, the Memorandum provided that MPS should adopt a competitive tendering process so that services were delivered by the most cost-effective provider and that the market for such services would be truly contestable. However, the Memorandum provided a general moratorium for the introduction of competitive tendering until September 1996 in order to give MPS the opportunity to strengthen its commercial viability. Accordingly, MPS entered into exclusive service contracts with MPC and VCA, covering this transitional period.

4.88 The Memorandum specifically provided that wharf carpentry services and plumbing functions would not be subject to competitive tendering until December 1998. Consistent with the terms of the Memorandum, it was also agreed that MPS would be the sole provider of dredging services to VCA until June 2000. As part of this arrangement, VCA provided an indemnity to MPS against any costs or liabilities, including environmental liabilities, arising as a result of compliance with any direction given by VCA in relation to work performed, unless caused by the negligence of MPS or its employees.

Sale process

4.89 Following an expression of interest by a third party in September 1996 for the acquisition of MPS, the Government commenced negotiations with the unions for the potential sale of this entity. These negotiations culminated in the signing of an agreement by the parties which provided for:

- The sale of MPS through an open and competitive process;
- An extension of the moratorium for the introduction of competitive tendering of all services provided by MPS to MPC until July 1997. In addition, as previously mentioned, the introduction of competitive tendering for dredging services to VCA was also deferred until June 2000; and
- The termination of the sale process in the event that an agreement could not be reached by the parties for the joint determination of a shortlist of bidders. In the event that the sale process was terminated, MPS would be retained in State ownership and would adopt competitive tendering practices, as originally envisaged by the parties.

4.90 Subsequently, in October 1996, the Treasurer announced that the Government would seek the submission of expressions of interest for the sale of MPS by January 1997. A firm of chartered accountants was also appointed by the Department of Treasury and Finance in December 1996 to act as advisers on the sale.

4.91 In January 1997, the Department received 9 expressions of interest for the acquisition of MPS, from which 6 bids were shortlisted following consultation with the unions. The shortlisted parties were subsequently provided with an Information Memorandum dated February 1997 which, inter-alia, outlined the following:

- The net asset position of MPS, which was in fact $980 000 greater than the book value of the assets of $10 million as at February 1996. This result included a value assigned to the shipping vessel the *AM Vella* of $2.5 million, which represented an increase of $2 million from its book value of $583 000 at that time. The increase in the net asset position was brought about by a revaluation of fixed assets conducted by an independent valuer, based on the existing use/deprival value methodology;
- the criteria against which the bids would be assessed, comprising:
  - the value and certainty of the purchase price;
  - bidders' outlook on port management issues and practices, and their general experience and proven abilities;
  - strategies for dealing with transitional industrial relations matters; and
  - conditions of the bid, specifically, any residual risk and requirement for government investment.

4.92 The Information Memorandum did not provide any projected cashflows or earnings for the company due to uncertainties associated with the commencement of competitive tendering arrangements.

4.93 Following the completion of due diligence inquiries by 4 bidders, in March 1997, 3 of the bidders who had previously expressed an interest in the sale withdrew from the process primarily due to the uncertainty associated with the future revenue base of MPS. Accordingly, the Government only received a binding offer from one shortlisted party, which was the party that made the original bid to purchase MPS in October 1996. Consequently, in March 1997, the Department of Treasury and Finance nominated Skilled Engineering Limited as the preferred bidder.

4.94 A key condition of the offer presented by the preferred bidder was a requirement for the State to defer compulsory competitive tendering for a period of not less than 12 months from the date of purchase. Following consideration of this matter, **the Treasurer instructed the Department to delay the introduction of competitive tendering by 12 months to June 1998 and that all bidders be advised of the changed circumstances. Consequently, the direction to extend the period of the exclusive service contracts to June 1998 was advised to the shortlisted bidders in April 1997.**

4.95 The preferred bidder was the only shortlisted party to resubmit a firm offer to purchase MPS by late April 1997. Consequently, on the basis that MPS was unlikely to remain competitive once the term of the exclusive contracts had expired, in May 1997 the Department requested its sale advisers to prepare an analysis of the offer submitted by the bidder and the estimated level of proceeds that could be derived from the liquidation of the business. This analysis revealed that a sale of MPS to the preferred bidder represented the best result for the State as it would provide additional estimated proceeds of $600 000 when compared with the liquidation of the business.

4.96 Consistent with the results of the above analysis, in May 1997, the Treasurer was advised by the Department to proceed with the sale of the business. It was also considered that through the sale the State would be able to transfer the risks associated with the continued viability of the business and industrial relations issues to the purchaser. Based on this advice and following extensive negotiations with union representatives, **the Government proceeded with the sale of the business to Skilled Engineering Limited in May 1997, for a price of $7.7 million**.

4.97 An independent accounting firm, appointed in March 1997 by the Department as the process auditor in relation to the sale, concluded that all bidders had been accorded fair and equitable treatment.

Sale arrangements

4.98 While the business was sold for a price of $7.7 million, the sale price was subject to adjustment, based on the final value of the net assets acquired as at May 1997. Other key provisions of the sale agreement between the State and the purchaser included:

- **A requirement by the purchaser to pay an additional $900 000 to MPC**, representing the State's entitlement to 50 per cent of the purchaser's profit on sale of the shipping vessel based on an assigned value of $400 000 for the vessel at March 1997 and adjusted for the costs incurred by the purchaser incidental to its subsequent disposal, including any tax payable in respect of any profit made by the purchaser. This amount was paid in August 1997;
- The provision by the State of various general warranties and indemnities to the purchaser, under which the State's maximum exposure is $7.7 million in the event that the purchaser lodges any claims within 12 months from the completion of the sale. However, the State will not be held liable for a claim where:
  - the claim is in respect of matters against which the purchaser is insured for loss or damage;
  - the purchaser has sold its interest in MPS; and
  - the claim is the result of any act, matter, omission or arrangement caused by the purchaser or a change in legislation, including the imposition of any new taxes;

- A requirement by the PMA to offer and fund redundancy packages to all MPS employees and PMA employees seconded to MPS. The estimated cost of this commitment to the State is $6.4 million, of which $5.1 million related to PMA employees seconded to the MPS as casual labour. In turn, the purchaser has agreed not to employ or contract with any employee made redundant in connection with any existing core business of MPS on a full-time permanent basis prior to May 1999, otherwise the purchaser will be required to repay an amount equal to the redundancy package to the PMA;
- The provision by the PMA of an indemnity to the purchaser for any unfunded superannuation liability relating to staff re-employed by the purchaser who did not accept a redundancy package. As at the date of preparation of this Report, the PMA had paid $7.2 million to public sector superannuation funds to finance the unfunded superannuation liability relating to PMA staff seconded to MPS; and
- A requirement by the PMA to fund 64 per cent of the value of accrued annual and long service leave entitlements of each PMA employee seconded to MPS and re-employed by the purchaser, at an estimated cost of $100 000.

4.99 **Following the final determination of the value of net assets sold, a further $200 000 was received from the purchaser by the State**.

Application of sale proceeds

4.100 In June 1997, MPC received the initial sale proceeds of $7.7 million, consistent with the terms of the sale agreement. While it was expected that MPC would forward these proceeds in full to the Consolidated Fund, due to the uncertainty surrounding the final proceeds to be received for MPS, the Treasurer requested MPC to pay a dividend to the Consolidated Fund in June 1997 of $7 million and to retain the balance of $700 000, pending the impact of any adjustment to the final sale price.

4.101 In addition, the Treasurer notified MPC that it was intended that a dividend determination would be made for the remittance to the Consolidated Fund of an amount equivalent to the State's share of the net proceeds from the profit on the sale of the shipping vessel, once the moneys were received by MPC.

Assessment of sale result

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

- **while the estimated proceeds to be received by the State from the sale total $8.8 million, the State has incurred costs associated with the port reform process related to the sale of $14 million, mainly relating to the funding of redundancy packages and leave entitlements ($6.5 million), unfunded superannuation liabilities ($7.2 million) and other costs of sale ($300 000), giving an overall negative cashflow of $5.2 million to the date of preparation of this Report;**
- **the sale proceeds were $2.7 million less than the net assets of MPS which had a book value of $11.5 million at May 1997; and**
- **the purchaser has acquired the rights to exclusive contracts for the provision of services to MPC and VCA until 30 June 1998 and 30 June 2000, respectively.**

Port of Hastings

4.103 The Port of Hastings is located approximately 60 kilometres south-east of Melbourne and was originally established in 1966 to provide port facilities to shipping vessels servicing a petroleum refinery located at Crib Point, Hastings, and operated by British Petroleum Refinery (Westernport) Pty Ltd. The Port of Hastings is one of 3 major regional ports in Victoria and consists of 5 commercial berths, a depot and a jetty, situated at 4 locations, namely, Crib Point, Stony Point, Long Island Point and the Steel Industry Wharves. The facilities situated at the Steel Industry Wharves are owned by BHP Steel (JLA) Pty Ltd.

Port of Hastings.

4.104 The port has an annual trade of about 5 million tonnes, comprising entirely of petroleum, gas and steel trades. Revenue is mainly derived from the following 2 charges which are levied on port facility users:

- *wharfage charges,* which are based on the volume of trade passing through the port and aimed at providing a reasonable rate of return on the port's dredging investment and on-shore based services; and
- *channel usage charges,* which are time-based fees designed to cover the cost of off-shore services such as harbour control, maintenance dredging and the up-keep of navigational aids.

4.105 Despite adequate road and water access to the port, its operations have largely been centred around the provision of services to 2 major users, namely, Esso Exploration and Production Australia Incorporated (Esso) and BHP. Consequently, the majority of the port's revenue is derived from these users. Furthermore, in recent years, there has been a significant reduction in the volume of trade passing through the port.

State agreements

4.106 The terms for the provision of port services to BHP and Esso are governed by certain agreements which were ratified by the *Westernport Development Act* 1970 and the *Western Port (Steel Works) Development Act* 1967. These agreements have a perpetual life, unless amended by legislation with the mutual consent of all parties.

4.107 In particular, the *Westernport Development Act* 1970 facilitated the establishment of Esso's refinery plant at Long Island Point, requiring the company to:

- construct, operate and use the plant;
- design and erect a jetty, which remains the property of the State;
- pay wharfage charges to the State;
- create a navagatable channel; and
- maintain and repair the jetty, the cost of which is to be reimbursed by the State.

4.108 In turn, the legislation obligates the State to:

- maintain the dredging of the channel;
- maintain adequate navigational aids for day and night navigation;
- provide normal harbour services; and
- ensure an adequate pilot service is provided at all times.

4.109 The *Western Port (Steel Works) Development Act* 1967 provided for the construction and operation of BHP's wharves to service its steel works. The obligations of the company under the legislation include:

- construction, operation and maintenance of a steel reduction mill and associated facilities;
- reclamation of a specified area at the company's expense;
- maintenance of wharves; and
- payment of relevant port charges, where necessary.

4.110 Under the legislation, BHP retains ownership and control of the wharves, and has the exclusive right of their use. However, the State retains responsibility for the maintenance of the channels, berthing and vessel turning areas, and navigational aids.

Proposed privatisation

4.111 As part of the Government's Port Reform Policy of January 1995, it was envisaged that the port's on-shore assets would be sold and the channel operations outsourced to a prospective purchaser. In particular, it was intended that, as a first step, Esso would be given the first right of refusal to purchase the dedicated berth associated with its operations, located at Long Island Point.

4.112 Subsequently, in February 1995, the Department of Treasury and Finance engaged corporate advisers to conduct a review of the State's obligations to Esso and BHP, in order to determine the associated implications on the proposed privatisation process. The Department was later advised that the obligations of the State to these companies may be carried out by a third party, however, it was considered unlikely that the companies would allow a private sector party to assume responsibility of the State's obligations without a guarantee.

4.113 In May 1995, a range of business valuations were obtained by the Department from the Government's financial advisers to assist in the further consideration of the available options. The valuations were based on the estimated discounted net cashflows of the business and certain assumptions in respect of wages and labour productivity growth rates, and future shipping revenue rates. The valuations were provided for differing trade volume scenarios, as follows:

- Negative cash flows of *$1.5 million*, if there was low growth in trade volumes, resulting mainly from a cessation of trade in petroleum products from the year 2000;
- Positive cash flows of *$18 million*, if current trade levels were maintained in perpetuity and no investment was made to upgrade port facilities;
- Positive cash flows of *$14.8 million*, if there was intermediate trade growth, reflecting a more gradual decline in petroleum exports, a higher steel trade and a strong growth in other trade. In addition, under this scenario, a high level of capital expenditure was assumed in the first 4 years to upgrade port facilities; and
- Positive cash flows of *$24.8 million*, if there was high trade growth and a high capital expenditure investment to upgrade the port facilities.

4.114 The Department, in October 1995, sought a specific valuation for the Long Island Point pier utilised by Esso. An independent valuer subsequently submitted a valuation of $4.3 million, however, a further valuation carried out in November 1995 by the Valuer-General estimated a value of $6 million for the pier. Consequently, the Department held a valuers' conference in December 1995, which resulted in the Valuer-General reducing his valuation to $5.4 million, after concurring on certain issues with the private valuer.

4.115 In December 1995, informal discussions were held between the Department's advisers, and Esso and BHP Petroleum (North West Shelf) Pty Ltd, Esso's joint venture partner, regarding the future options for the port. As a result of these discussions, the Department was briefed by its advisers that it could consider the possibility of allowing Esso to purchase its berth and for a company affiliated with BHP to be awarded a management contract over the whole of the port. However, subsequently, the Treasurer was advised that it would be difficult to dispose of the port as a whole, given the level of uncertainty associated with future trading volumes, the existing obligations under the State agreements and the port's specialised nature of trade.

4.116 In June 1996, the Department resolved that the negotiation of a port management agreement rather than the privatisation of the port would have the advantage of preserving the option for full privatisation of the port when future trade prospects become clearer.

4.117 However, in anticipation of an expected announcement for the sale of the port, 2 expressions of interest to purchase the port were received by the Department in April and July 1996. Nevertheless, given the above stated considerations, the Department decided not to pursue these expressions of interest.

4.118 In August 1996, the Treasurer agreed to contract-out the management of the port operations, including the responsibility for all associated outlays and revenues, and to offer the sale of the Long Island Point jetty to Esso in return for assumption of the related State obligations by Esso.

4.119 In early October 1996, the Department's financial advisers examined certain port pricing options and concluded that the net present value of the future cash flows of the business under the existing wharfage pricing and a proposed tonnage pricing regime was around $1.4 million. In regard to the future options for the port, the advisers considered that:

- While the port's size and isolation were disadvantages that eliminated the opportunities to benefit from economies of scale and scope, the self-sufficient nature of its large clients was a significant advantage that minimised the necessary size and expense of its operations; and
- The above advantages and disadvantages were likely to cancel each other out, allowing the port to achieve an operating margin of 50 per cent. Under these circumstances and assuming capital expenditure was managed properly, the value of the port would be around $5.4 million. However, the only way to confirm that this would be the case would be to transfer the port into the hands of a profit maximising entity, either directly through privatisation or indirectly through a management contract.

4.120 Subsequently, **in January 1997, Cabinet approved the contracting-out of the management rights for the Port of Hastings.**

Outsourcing of port management

4.121 Following the Cabinet decision, the Government sought expressions of interest from external parties to outsource the management of the port and subsequently received registrations of interest from 20 parties.

4.122 The key selection criteria for proponents who had submitted an expression of interest were:

- financial capacity,
- prior experience in port management operations;
- prior experience in relevant facility management and operations; and
- evidence of involvement in Hastings' regional development.

4.123 In March 1997, the Department, together with its legal and financial advisers, shortlisted 16 interested bidders who had satisfied sufficient criteria to proceed to the due diligence stage and these bidders were requested to submit proposals for the management of the port.

4.124 The Government subsequently received 7 proposals for the management of the port in April 1997 and these proposals were ranked according the net present value of payments receivable by the State under a number of alternative trade scenarios. However, in May 1997, subsequent to negotiations between the State and the bidding parties, 3 interested parties withdrew from the selection process.

4.125 The remaining 4 parties submitted their final bids in June 1997 and each final bid was evaluated against the following criteria:

- the revised net present value of payments to the State under the alternative trade scenarios;
- the level of protection provided to the State by the bidder against non-performance of the State obligations;
- capacity of the bidder to manage environmental responsibilities at the port;
- experience and demonstrated proficiency of the bidder; and
- financial consideration and certainty.

4.126 However, audit noted that **the Department had not undertaken an independent assessment of the fair value of payments that should be received by the State, based on various management scenarios, in order to benchmark the bids received.**

4.127 In June 1997, the Government announced that the contract to manage the port was awarded to TNT Australia Pty Ltd (TNT), the current owner of the Port of Geelong. The bid provided by this operator was estimated to provide the highest value to the State, with the present value of payments receivable by the State over the term of the arrangements ranging from $1.3 million to $7.3 million, depending on the trade scenarios. In addition, TNT was prepared to assume the relevant State obligations in relation to the port regardless of the volume of trade passing through the port.

4.128 An independent accounting firm appointed in October 1995 by the Department as the process auditor in relation to the selection and evaluation process concluded that the outsourcing of the management of the port was conducted in a manner which ensured procedural integrity.

Port Management Agreement

4.129 In July 1997, the State and TNT (the operator) entered into the Port Management Agreement under which the operator will perform certain existing obligations of the State associated with the port, consistent with the State agreements. The key provisions of the agreement between the State and the operator included:

- A contract term of 10 years, expiring in July 2007, with the operator having the option to extend this period for 2 further terms of 5 years upon the same terms and conditions as the existing agreement. In addition, after the sixth year of the first term of the contract, the parties may consult in relation to the terms and conditions of the agreement with a view to establishing whether there is consensus on the need for any variations due to altered circumstances;
- The receipt by the State of an annual fee from the operator, based on 40 per cent of specified revenue generated each year in excess of $2 million, with this threshold indexed annually for movements in the consumer price index. However, if the operator is unable to generate revenue in excess of $2 million, the State will not receive an annual fee. Furthermore, the annual fee will be reduced by an amount equal to 64 per cent of wages, annual leave and long service leave entitlements accrued as at July 1997 and paid to Port of Hastings staff re-employed by the operator during the term of the agreement; and
- In the event of a default, the non-defaulting party may issue a notice of intention to terminate the agreement. Upon receipt of such a notice, the defaulting party must commence to overcome the default. In addition, the defaulting party indemnifies the innocent party against any related costs.

4.130 In addition, under the agreement, the operator agreed to undertake the management of the port and assume the following obligations:

- provide port services as required under the State agreements, including tug services, mooring services, dredging, compliance with Marine Board requirements, provision of a licensed Harbour Master and the maintenance of navigation aids;
- maintain oil spill response equipment and promptly respond to oil spills in port waters, when required;
- seek the consent of the Port of Melbourne Authority in cases where contracts are entered into with third parties, with the Authority entitled to withhold such consent if a contract imposes an obligation or liability on the Authority;
- bear responsibility for procuring shipping indemnities in connection with the port as from October 1997, however, the operator shall have the benefit of shipping indemnities given in favour of the Authority in respect of any incident occurring prior to that date;

- provide an indemnity to the State for any loss or liability incurred in connection with any act or omission of the operator or its employees, other than to the extent that such a liability or loss was caused by the State; and
- in the event the agreement is terminated, to surrender licences, permits and records to the State, assign all contracts and leases to the State and forfeit the use of plant and equipment.

Key obligations of the State

4.131 Under the agreement, the State has retained the following specific obligations:

- Provide various general warranties, giving rise to a maximum exposure to the State of $500 000, in the event that the operator lodges a claim before July 1999. However, the operator is unable to lodge a claim if the total value of losses on the port's operations are less than $100 000;
- Grant to the operator a 10 year seabed lease and a further 10 year lease of the facilities at Stony Point, both for a nominal rental;
- Provide an indemnity to the operator for any liability associated with those employees who have rejected the operator's offer for re-employment; and
- Assume responsibility for the cost of any environmental remediation which is required as a result of a clean-up notice being issued by the Environment Protection Authority, attributable to the State occupation of the site prior to July 1997. In addition, the State has agreed to fund an environmental assessment of the relevant land, which is to be undertaken by July 1998.

Channel operations

4.132 Consistent with the terms of the management agreement outlined above, the operator has entered into a separate Channel Operating Agreement for the assumption of the State's existing obligations in relation to channel operations, which come under the statutory responsibility of the Victorian Channels Authority. The key provisions of this agreement include:

- a contract term, and options to extend this term, which are consistent with the port management agreement;
- a requirement for the operator to dredge and maintain the port's channels, maintain navigation aids and direct vessels in the port;
- an agreement by the operator to perform all the State's obligations under the State agreements and to provide an indemnity to the State against any liability incurred under the agreement in connection with any act or omission of the operator;
- a requirement for the operator to bear the cost of any development and associated maintenance of new channels;
- a right for the operator to impose a channel usage charge on each vessel arriving in the port;

- a requirement for the operator to maintain adequate insurance cover against port blockage, pollution, property damage, public liability and marine hull damage; and
- a right for the State to terminate the agreement, if certain events of default are not addressed within agreed timeframes.

Overall audit assessment

4.133 **While the Government initially envisaged privatising the Port of Hastings, a subsequent analysis of the risks associated with State obligations and uncertainties relating to future trade volumes led to a re-assessment of this position. Consequently, the Government proceeded with the outsourcing of the management of the port to a private sector operator, which has enabled the State to:**

- **assign certain of its responsibilities and obligations to the operator;**
- **receive annual management fees, ranging between $1.3 million and $7.3 million, based on the revenue levels achieved by the operator; and**
- **retain the option to sell the port at a later time, when the prospects of achieving higher returns arise.**

❑ ***RESPONSE*** *provided by the Secretary, Department of Treasury and Finance*

The request for tenders sought innovative management arrangements from bidders while establishing several key terms as non-negotiable. It was therefore, impossible to identify or value a single management arrangement which could usefully be considered a benchmark.

AMRAD Corporation Limited shareholding

4.134 AMRAD Corporation Limited, a public company incorporated in Victoria, was established in 1986 as a joint venture between the former Victorian Economic Development Corporation and 4 Melbourne-based medical research institutions, with the objective to identify, protect and develop medical technology from these institutions. The company is mainly engaged in research and development relating to pharmaceutical, therapeutic, diagnostic and molecular biological products, but also supplies and distributes pharmaceutical and related products. The company has established formal arrangements with various Australian medical and scientific research institutions for access to certain inventions and technology which may be of commercial value in the development of new pharmaceuticals.

4.135 On formation of the company, the State subscribed to 14 million $1.00 fully paid shares and, in July 1989, acquired a further one million $1.00 fully paid shares. The State's shareholding at this time of 57 per cent of the issued capital in the company was held by the State Trustees Limited.

4.136 In October and November 1993, the company privately raised capital of $45 million, thereby reducing the State's investment in the company to 35 per cent. The other shareholdings in the company at that time comprised private investors (40 per cent), member research institutions (10 per cent) and pharmaceutical industry participants (15 per cent).

4.137 Subsequently, in August 1994, the company entered into an agreement with the State under which:

- the State agreed to restrict the voting rights of its shareholding to 24.9 per cent, except in the case of special resolutions concerning takeover offers for the company or in cases where another shareholder had voting rights of more than 19.9 per cent, and agreed to consult with the company prior to any sale or transfer of its shareholding;
- in consideration of the above, the company agreed to comply with the Australian Stock Exchange Listing (ASX) rules as if the company was listed on the ASX and to use its best endeavours to arrange for the introduction to the State Trustees Limited of prospective purchasers for the State's shares; and
- the above agreement would cease to be operative as from the time the company's shares were listed on the ASX.

4.138 In August 1996, the company advised the Government that it proposed to undertake a public capital raising, preferably through the listing of the company on the ASX. Subsequently, in September 1996, the Government indicated its support of the proposal and advised that it would pursue the opportunity to recoup its initial investment in the company. In particular, the Government requested that, as part of the proposal, the State should receive an amount of $22.1 million for the disposal of its shareholding, representing the inflation adjusted value of its initial investment. It was considered that such an amount would not jeopardise either the company or the float and was consistent with the State's obligation to seek an appropriate return on its funds while recognising that, in this instance, the State should not be considered a commercial investor seeking to attract a commercial return greater than inflation.

4.139 Subsequently, the State agreed to a company request to limit the Government's recoupment of its initial investment to $20 million compared with the requested amount of $22.1 million, as it was considered that it would be more practical to promote the proposed $70 million capital raising to potential investors on the basis of a split of $50 million to the company and $20 million to the State. In addition, the State agreed to a buy-back by the company of an agreed portion of its shareholding rather than to dispose of the State's share directly via the public listing.

4.140 In preparation for the public listing, the company's Board of Directors in October 1996 resolved to amend the Articles of Association to permit the individual issued and unissued shares, which had a par value of $1.00, to be reclassified into 2 shares with a par value of 50 cents each. In addition, the Board approved an agreement for the **buy-back of 10 256 411 shares of the State's existing holding of 30 million shares with a par value of 50 cents, in consideration for the payment of $20 million to the State Trustees Limited.**

4.141 A prospectus was subsequently lodged by the company with the Australian Securities Commission, offering 35 897 436 shares with a par value of 50 cents each for a subscription price of $1.95. Potential applicants were advised that the total funds to be raised of $70 million would finance research and development projects ($45 million), allow the buy-back of a portion of the shares owned by the State ($20 million) and meet share issue and administration expenses including an underwriting fee ($5 million).

4.142 In November 1996, the Treasurer directed State Trustees Limited to execute the buy-back arrangements and to pay the purchase price of $20 million to the State at the completion of the share sale. AMRAD successfully allotted all the shares under the public offer and, consequently, **$20 million of the proceeds from the share sale were paid to the Consolidated Fund in late November 1996, immediately prior to the listing of the company on the ASX**.

4.143 As at the date of preparation of this Report, the State's remaining holding in the company was represented by 19 743 593 shares with a par value of 50 cents each and a market price of approximately $2.80 each.

Assessment of sale result

4.144 **Despite the high risk profile associated with the research-based pharmaceutical industry, the nature of the company's business and the fact that the State's accumulated investment of $15 million in the company would have been considered as highly speculative when it was made, the State has received $20 million in December 1996 from the part sale of its shareholding and retained an investment in the company worth around $55.3 million, based on an approximate current market share price of $2.80 as at the date of preparation of this Report.**

Health Computing Services

4.145 In 1967, the former Alfred Hospital established a bureau to provide computer-related services primarily to the public health sector. In June 1982, the assets and liabilities of the bureau were gifted for nil consideration to Health Computing Services Victoria Limited (HCS), a company limited by guarantee and controlled by the former Department of Health (now known as the Department of Human Services).

4.146 The company's principal activities included the provision of computer-related services including data processing, systems development, support and maintenance, consultancy and training to the Department, hospitals and other public sector organisations within Victoria. However, some additional business was generated from other Australian States and New Zealand.

4.147 In early 1995, the Department engaged a chartered accounting firm, to undertake a strategic review of the ownership and control of the company. The firm advised that there were no impediments to the sale of the company and, therefore, it should be sold in accordance with government policy which encouraged the outsourcing of information technology services. The firm also recommended the sale of the company by way of a trade sale, as a float was considered inappropriate given the size of the company.

4.148 In September 1996, the Minister for Health approved the sale of the company or its assets.

Sale process

4.149 In November 1996, an adviser was appointed to facilitate the sale process on behalf of the Department. In addition, a chartered accountant was engaged by the Department in December 1996 to act as the probity auditor.

4.150 In February 1997, a committee comprising of representatives from the Departments of Human Services and Treasury and Finance was established to manage the sale, and called for expressions of interest for the purchase of the company or its assets. Following the calling of expressions of interest, the committee received 17 submissions which were considered suitable to receive an Information Memorandum prepared by the Department's adviser for the sale of the business. The Information Memorandum advised the bidders that surplus cash generated by the business, estimated at $4 million as at December 1996, would not be included in the sale.

4.151 In March 1997, the adviser provided an estimate of the potential sale price of the company of between $7.2 million and $8.3 million, based on the future cash flows of the business and indicated that the estimate did not purport to be a formal valuation but could be used as a guide for evaluation of the prospective offers.

4.152 The committee subsequently received 8 indicative purchase offers in March 1997, with bids ranging between $5 million to $10 million and including varying terms and conditions. Following an analysis of these bids against pre-determined selection criteria, 6 tenderers were permitted to conduct due diligence inquiries into the company's affairs. Subsequently, 2 bidders withdrew and the remaining bidders lodged final offers in June 1997.

4.153 After due consideration of these offers against the selection criteria, the committee recommended a preferred purchaser to the Minister for Health. Following the Minister's acceptance of the committee's recommendation, **the company entered into an agreement with Maledict Pty Ltd, a wholly-owned subsidiary of a private sector investment group in the information technology industry, in relation to the sale of its assets, with the company remaining under State control.**

Key terms of sale

4.154 Under the terms of the sale arrangements, HCS received $10.2 million from Maledict Pty Ltd, mainly in July 1997, comprising $3.7 million for a property HCS owned in Clayton and $6.5 million for the sale of HCS's other net assets sold, which overall had an estimated combined book value of $3.4 million as at 30 June 1996. Other key terms of the sale arrangements included:

- Warranties and indemnities to the purchaser, giving rise to a maximum exposure to the State of an amount not exceeding the purchase price, in the event that the purchaser lodges claims by June 1998;
- The purchaser to offer to re-employ all existing HCS employees;
- HCS to retain the right to the collection of certain debtor balances estimated at $2.5 million as at the date of sale;
- HCS agreeing to novate to the purchaser software licences and all other contracts with public sector agencies, mainly comprising public hospitals throughout the State. However, the purchaser agreed to refrain from increasing charges under the various public sector customer service contracts at a rate greater than movements in the consumer price index for a period of 2 years; and
- The purchaser to refrain from transferring or selling any part of the business without the prior written consent of the State, until July 1998.

4.155 The Department of Human Services advised that the HCS shell will repatriate proceeds from the sale of its assets to the Consolidated Fund later in the 1997 calendar year. However, a decision by the Australian Taxation Office to withdraw the company's rebatable status for fringe benefits tax purposes, retrospectively as from July 1994, has resulted in a potential liability with an estimated value of $511 000 to be met by the HCS shell, which could impact on the level of funds ultimately received by the State.

Assessment of sale result

4.156 **An analysis of the sale result indicates that:**

- **the sale proceeds of $10.2 million were greater than the informally estimated valuation, which ranged between $7.2 million to $8.3 million, provided by the Department's adviser in March 1997;**
- **the sale proceeds were substantially greater than the estimated book value of the net assets of the business sold; and**
- **the estimated costs of the sale were $800 000.**

Country Fire Authority vehicle manufacturing business

4.157 The Victorian Country Fire Authority (CFA), established under the *Country Fire Authority Act* 1958, is one of the world's largest volunteer and community-based emergency services, responding to a wide range of emergencies including fires, road and work accidents, hazardous accidents and other similar dangers facing the community.

4.158 Since 1951, the vehicle manufacturing business, a division of the CFA, has been building fire and emergency appliances and related equipment from a manufacturing facility and administration office in Ballarat, north-west of Melbourne. Historically, the manufacturing division has provided appliances almost exclusively for fire fighting services in Victoria. The business employs approximately 60 professional trades people and support staff.

Vehicle produced by CFA manufacturing business.

4.159 In December 1994, the Treasurer notified the then Minister for Police and Emergency Services of a preference for the sale of the CFA's vehicle manufacturing division. However, the Treasurer indicated that, in the event of a partial privatisation of the business, it would be critical that the partially privatised entity did not enjoy any preferential access to the business of the CFA.

4.160 The Board of the CFA supported the establishment of a joint venture with the private sector to operate the business, which was also subsequently accepted by the Treasurer and the responsible Minister.

4.161 In February 1995, the CFA announced its intention to enter into a joint venture with a private enterprise partner and to retain a minority interest of between 10 per cent to 20 per cent in the manufacturing division. The decision to retain a strategic interest in the business mainly reflected a desire to:

- capitalise on the opportunity for the CFA to rationalise operations and concentrate on its core business;
- have an involvement in the future direction of the business without retaining the highest level of commercial responsibility;
- assist in the maximisation of the potential of the business given the level of expertise, knowledge and systems developed over many years; and
- aid in ensuring market access to vehicles that meet the CFA's specifications and quality.

4.162 In order to prepare the business to operate as a joint venture, certain critical milestones were achieved by July 1995, including:

- establishment of the division as a stand-alone business unit;
- preparation of a detailed business plan and a financial budget;
- appointment of a new board and management structure; and
- establishment of new reporting and accounting systems.

Selection process for preferred joint venture partner

4.163 In April 1996, the CFA confirmed its commitment to proceed with the joint venture arrangement and advised the Minister for Police and Emergency Services of its intention to call for expressions of interest from potential joint venture partners.

4.164 The CFA subsequently sought expressions of interest from parties interested in purchasing a share of the business. Resulting from this process, 9 parties submitted an expression an interest, with 6 of these parties invited to participate in a due diligence process. A preliminary information memorandum was also distributed in August 1996 to the relevant parties, however, prior to the submission of the bids, 4 parties withdrew from the process.

4.165 In September 1996, the Department of Treasury and Finance requested consultants to provide an independent valuation of the business which could provide a benchmark to enable the CFA to evaluate the tenders provided by prospective joint venture partners. Subsequently, the consultants estimated the value of the business at between $2 million and $2.3 million, before any adjustment was made for future superannuation liabilities. During this period, a further detailed Information Memorandum to participate in the joint venture arrangement was issued, culminating in the receipt of 2 submissions from interested parties in October 1996.

4.166 Following the assessment of the 2 submissions, the Board of the CFA approved the commencement of detailed negotiations with the preferred party, Skilled Engineering Ltd, to enter into a joint venture arrangement, involving the sale of 90 per cent of the CFA’s vehicle manufacturing operations.

4.167 A process auditor engaged by the CFA concluded that the process of selecting the joint venture partner had been carried out in the best interests of the Authority and with fairness to all parties concerned.

Sale and joint venture arrangements

4.168 In November 1996, following approval by the Treasurer, a heads of agreement was executed between Skilled Engineering Ltd and the CFA. This agreement, together with a subsequent joint venture agreement dated December 1996, set out the key terms of the joint venture which included:

- the establishment of company, Skilled EM Pty Ltd, to act as trustee of the unit trust, Skilled EM Unit Trust, established to operate the joint venture;
- the unit holders in the trust to comprise the purchaser (90 per cent) and the CFA (10 per cent);
- the trustee to be unable to transfer units of the trust without the prior consent of the purchaser and the CFA;

- the Board of the joint venture to comprise one representative of the CFA and 3 representatives of the purchaser; and
- the effective date of the sale of the business to be December 1996, as outlined in a subsequent agreement.

4.169 Under the terms of the arrangements, the business was sold to the joint venture for $2.9 million, which was to be funded through the subscription for units in the trust by the purchaser and the CFA, in proportions of 90 per cent and 10 per cent, respectively. Consequently, **the CFA received net cash proceeds of $2.6 million from the purchaser for its share in the joint venture arrangement**.

4.170 Under the sale and joint venture arrangements, the CFA provided certain undertakings and indemnities to the purchaser and the unit trust which may give rise to future financial obligations, including:

- **An undertaking that most of its vehicle requirements would be met by the business for the first 2 years of the joint venture, including the confirmation of an existing order of 120 units at an estimated cost of $6.8 million, representing a significant volume of work for the business during this period. Accordingly, the CFA will continue to be an important partner and a major customer of the joint venture and will significantly contribute to the profitability of the business, for at least 2 years;**
- An indemnity against any liabilities of the business arising prior to December 1996 which were not included in the completion accounts, including any ongoing workers compensation claims, and any liabilities such as warranty claims and environmental claims on freehold property;
- An indemnity against any superannuation liability relating to employees participating in a defined benefit scheme, which is over and above normal occupational superannuation entitlements;
- A requirement to fund redundancies payments of 5 employees who were not re-employed by the joint venture;
- An undertaking not to directly or indirectly become involved in a business within Australia that is similar to the vehicle manufacturing business prior to December 1998, except as a customer; and
- A requirement to meet the cost of any works required to existing buildings after a final inspection by the responsible local government authority.

4.171 An option was provided under the joint venture arrangements under which either party may initiate action to acquire a 100 per cent interest in the trust. This option may only be exercised during the period commencing December 1998 and ending May 1999.

4.172 In establishing the joint venture, the CFA incurred costs of approximately $400 000, mainly including consultant fees, legal fees, employee separation costs and additional superannuation payments for employees resigning from the Emergency Services Superannuation Fund.

4.173 In February 1997, the Board of the CFA resolved that $2.2 million of the net cash proceeds from the sale of the business would be utilised to reduce long-term loans and/or offset the need for further long-term borrowings in proceeding years.

Assessment of sale result

4.174 **The audit analysis of the sale result and the joint venture arrangements indicated that:**

- **the net cash proceeds to the CFA from the sale, after taking account of the costs incurred with the establishment of the joint venture, were $2.2 million;**
- **the aggregate sale proceeds of $2.9 million were equal to the book value of the assets as at the date of sale;**
- **the aggregate sale proceeds were in excess of a valuation provided in September 1996, which indicated a business value within the range of $2 million and $2.3 million; and**
- **as part of the arrangements, the joint venture has acquired the rights to supply the majority of the CFA's vehicle needs, valued at $6.8 million, for the next 2 years.**

Grain Elevators Board

4.175 My previous *Reports on the Statement of Financial Operations* commented on the sale by the Government of the former Grain Elevators Board (GEB) business in May 1995 to a consortium headed by the Victorian Farmers Federation.

4.176 Under the terms of the sale agreement, the State was entitled to receive total estimated proceeds of $52.4 million. However, of this amount, $5 million was only receivable if, among other things, the purchaser obtained a favourable tax ruling in relation to fixed asset depreciation deductions, with a further estimated amount of $800 000 receivable subject to the receipt from marketers of amounts in respect of grain received but not distributed by the former Board at the time of sale.

Depreciation price adjustment

4.177 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 my October 1996 Report, the Department of Treasury and Finance on behalf of the purchaser had commenced action to obtain an advance tax opinion on this issue from the Australian Taxation Office (ATO).

4.178 In April 1995, the Deputy Commissioner of Taxation provided a favourable opinion to the Department on the deductibility of fixed asset depreciation based on the written-down value of the assets at the date of sale. Subsequently, the purchaser's tax advisers in June 1997 requested the Deputy Commissioner of Taxation to provide a private ruling on the issue. However, **as at the date of preparation of this Report, a private ruling had not been received from the Deputy Commissioner of Taxation**.

4.179 Nevertheless, an announcement by the Commonwealth Government in August 1997, following its May 1997 Budget, reinforced the likelihood of the $5 million receivable being paid to the State.

Non-distributed grain price adjustment

4.180 In relation to the estimated $800 000 receivable by the State on account of receipts from marketers of amounts in respect of grain received but not distributed by the GEB at the time of sale, an initial payment $435 000 was received by the Consolidated Fund in December 1996. The State expects to receive a further amount in relation to the above entitlement by early 1998.

State indemnity for workers compensation claims

4.181 Under the terms of a *letter of waiver and acknowledgment*, the State 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 former 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.

4.182 As at the date of preparation of this Report, the Department of Treasury and Finance advised that no claims have been made against the State in relation to this matter.

Sheraton Towers Southgate Hotel

4.183 The Sheraton Towers Southgate Hotel is a 5 star international hotel completed in 1992, comprising 386 guest rooms together with various food and beverage outlets, conference and function room facilities, a business centre and recreational facilities. The property is located within the Southgate complex in Melbourne and occupies a highly visible site facing the south bank of the Yarra River, which is in close proximity to Princess Bridge and the arts precinct of St Kilda Road.

4.184 In June 1994, the Transport Accident Commission purchased the Southgate complex, which includes the Hotel, a residential site and various other substantial commercial properties, for $310 million. The Commission's interest in the complex was held by Opalwood Pty Ltd, which was directly controlled by TAC Property Investment Pty Ltd, a wholly-owned company of the Commission with the principal activity of investing in property on behalf of the Commission.

4.185 As part of restructuring the Commission's investment strategy, in August 1995, its Board of Management resolved to dispose of its interest in the Southgate complex. Specifically, an analysis undertaken by the Commission of the nature and duration of its claim liabilities revealed that their investment strategy required re-alignment to facilitate the better matching of its asset and claim liabilities profiles.

4.186 As a consequence of the Commission's resolution, in August 1995 the residential site on the Southgate complex was sold by Opalwood to private sector property developers for around $7 million, after deducting costs incidental to the sale. The Southgate Arts and Leisure Centre, IBM Centre, HWT Tower and car park, excluding the Sheraton Towers Southgate Hotel, were subsequently sold by Opalwood in November 1995, which resulted in the Commission receiving around $253 million, after deducting the costs incidental to the sale.

Sheraton Towers Southgate Hotel.

Sale process

4.187 In March 1996, the Commission appointed a taskforce to facilitate the realisation of the remaining part of the complex, namely, the Sheraton Towers Southgate Hotel. A firm of property agents was also engaged to market the property internationally and to assist in its sale through a public tender process. Subsequently, in July 1996, an Information Memorandum for the property was circulated to all interested parties to facilitate the submission of offers for the property.

4.188 **Following the receipt and assessment of 3 binding offers, in November 1996 the Commission's Board approved the sale of the property to Great Eagle Holdings Ltd, a company affiliated with Hong Kong-based investors, for $119 million.**

4.189 An independent accounting firm, appointed in May 1996 by the Commission as the process auditor in relation to the sale, concluded that the sale process was consistent with the pre-determined protocol steps for the sale.

Property valuations

4.190 As part of the sale process, in June 1995 an independent valuer estimated the value of the hotel property at $92 million. However, the value of the property was subsequently re-assessed at $113.3 million in December 1995, with the increase in the value attributable to a significant improvement in the Hotel's trading results and financial projections.

4.191 The property was again re-assessed in June 1996 by an independent valuer, who estimated its value at $123.5 million. The valuer considered that the increase in the property's value was attributable to increased demand pressures for hotel accommodation to the year 2000 and the low future capital cost requirements associated with the property. The valuer further indicated that the current market value of the property for sale purposes was between $117.5 million and $132.5 million.

Key terms of the sale

4.192 Consistent with the terms of the sale agreements, the Commission received total sale proceeds of $119 million for the sale of the hotel property and all shares in the wholly-owned subsidiaries Southgate Hotel Management Pty Ltd (SHM) and TAC Property Investment Pty Ltd. Under the terms of the sale arrangements, the Commission retained the following ongoing key obligations and financial exposures:

- Obligations under general warranties and indemnities provided to the purchaser, with a maximum exposure of $20 million in the event that the purchaser lodges claims by April 1998;
- Responsibility for any costs or liabilities incurred in relation to certain public liability claims, demands and disputes which remained pending as at the time of sale;
- In the event that SHM is obliged to pay a management fee to Sheraton Pacific Hotels Pty Ltd, the Commission indemnified the purchaser for four-fifths of any such payment, however, the purchaser is required to notify the Commission of any claims by June 1998. The Commission does not anticipate any costs to be incurred under this indemnity; and
- An indemnity to the purchaser against any tax payable which was not provided for in the completion accounts at the sale completion date, with a maximum exposure of $20 million subject to the purchaser lodging claims by April 2000.

Legal claims

4.193 As previously mentioned, the Commission retained responsibility for any costs associated with the resolution of certain claims and demands relating to the property sold. Similarly, the Commission was in the process of resolving certain other claims associated with its previous ownership interest in the Southgate Arts and Leisure Centre, which was sold in November 1995.

4.194 At the time of preparation of this Report, the Commission had incurred total costs of $2.3 million in relation to the settlement of claims relating to the Southgate complex.

Assessment of sale result

4.195 **An analysis of the sale result indicates that:**

- **the net proceeds to the Transport Accident Commission from the sale of the Sheraton Towers Southgate Hotel, after taking account of $1.6 million costs incurred in relation to the sale, were $117.4 million; and**
- **the gross sale proceeds were at the lower end of a valuation range of $117.5 million to $132.5 million for the property provided by an independent valuer in June 1996.**

South East Water Moorabbin site

4.196 The disaggregation of Melbourne Water in early 1995 resulted in the establishment of 3 government-owned companies, namely , South East Water Ltd, City West Water Ltd and Yarra Valley Water Ltd, which now provide regionally-based retail water and sewerage, including trade waste services within the Melbourne metropolitan area. In addition, Melbourne Water now acts as a wholesale provider of water and sewerage services to these companies and retains responsibility for drainage services.

4.197 Prior to its disaggregation, Melbourne Water owned a site located at Warragul Road, Moorabbin which contained certain vacant land and a number of buildings that were principally utilised for office accommodation and depot purposes. The ownership of this site was transferred to South East Water as part of the disaggregation process. Part of the site was leased to a recently privatised electricity utility for a term of 15 years ending in the year 2008. In addition, a building on the site was leased to a private sector company which provides contract maintenance services to South East Water.

4.198 Given that the majority of the land on the site was vacant and not utilised, in April 1995, South East Water declared 50.4 hectares of the property as surplus to requirements and commenced action to facilitate its disposal. At that time, the company also owned and occupied an office building at Lawson Ave, Frankston and leased accommodation at Centre Road, Clayton.

Former South East Water Moorabbin site.

Sale process

4.199 In July 1995, the company appointed a firm of property advisers to market the site and act as a project manager. After completing a site assessment, the project manager advised the company that there was no impediment to the sale or future development of the site and, subsequently, in October 1995 a marketing campaign commenced which culminated in the receipt of 13 bids from interested parties.

4.200 Given that the bids submitted, with the exception of one of the proposals, were considered inadequate, in December 1995, the company requested all parties to revise their bids. As a result, 4 revised bids were received by the company in February 1996.

4.201 In the meantime, the company's Board of Management approved a proposal to rationalise office accommodation and establish either new or additional office space at the current Moorabbin site, given that the existing accommodation arrangements were deemed to be inefficient.

4.202 In February 1996, the company's Board proposed that a market price of $15 million be adopted for the sale of the site for negotiation purposes, in order to facilitate the narrowing of the difference between the value of bids previously received, which ranged from $7.5 million to $12 million. In addition, a reserve price of $12.3 million was set by the company for the sale.

4.203 Following an assessment of all bids received, in May 1996, the company was advised by the project manager of several potential issues that had arisen relating to the disposal of the site, including:

- requests by bidders that the sale terms be conditional upon the receipt of certain planning approvals concerning site re-zoning and site development densities;
- the financial viability and development potential of the site could be substantially enhanced if the company made a commitment to lease a new building on the site;
- the existing office building on the site was considered to be poorly located, which impeded the orderly development of the site and was not attractive to a long-term property investor; and
- due to planning issues and the property size, the development of the site would take a number of years and, accordingly, a staged settlement of between 2 years and 5 years was sought by each of the parties.

4.204 In June 1996, following the receipt of 2 additional bids, the company advised 3 of the 6 bidders that their submissions were no longer under consideration mainly due to conditions attached to the bids which were deemed to be unacceptable. However, in July 1996, 2 additional bids were received by the company and the remaining 5 interested parties were then requested to submit proposals on the basis of the following 3 development options which were considered capable of meeting the company's functional requirements:

- *Option 1* - the company to sell the site but continue to utilise the existing facilities which occupied around 5 hectares for its own purposes;
- *Option 2* - the purchaser to acquire 16.5 hectares of the site, with the company retaining the remaining site to undertake its own staged development; and
- *Option 3* - the company to sell the site, with the purchaser providing a new purpose-built facility to be leased or repurchased by the company.

4.205 At this stage of the process, 2 bidders withdrew their submissions and the remaining 3 bidders in September 1996 each provided proposals under each of the development options.

4.206 Following negotiations and consideration of the final proposals, in October 1996, the company's Board approved **the sale of the site to Sunmore Holdings Pty Ltd, a wholly-owned subsidiary of Pellicano Building Contractors, for a price of $15 million**.

Property valuations

4.207 As part of the process associated with the sale of the property, the company obtained a number of valuations. In October 1995, the Valuer-General and an independent valuer determined valuations of $8.5 million and $12.3 million, respectively, for the entire Moorabbin site. Given the difference between the valuations, in November 1995, a conference was held between the company and the valuers, which resulted in the Valuer-General increasing the estimated property valuation to $9.5 million on the grounds that the previous assessment of the value was based on a single stage site development rather than a multiple stage development as assumed by the independent valuer. The independent valuer re-confirmed his initial valuation of $12.3 million.

4.208 In August 1996, the company received additional indicative valuations from the Valuer-General and an independent valuer for the 3 development options, as indicated in Table 4F.

TABLE 4F
VALUATION OF DEVELOPMENT OPTIONS
($million)

Valuer	*Option 1*	*Option 2*	*Option 3*
Valuer-General	6.5	5.5	11.2
Independent valuer	8.4	6.6	13.0

4.209 The book value of the site and associated improvements subject to the sale arrangements, as at the date of sale, was $9.6 million.

Key terms of the sale

4.210 Under the sale arrangements, the total proceeds to the company for the sale of the site was $15 million, with a deposit of $750 000 paid in November 1996 and the balance payable as follows:

- $3 million payable in July 1997; and
- $11.25 million payable within 12 months following the successful re-zoning of the site, with this amount to be appropriately adjusted in the event of earlier settlement.

4.211 The sale agreement was conditional upon the purchaser obtaining a planning permit by June 1997 allowing the use and development of the site in accordance with the concept plans previously agreed to between the parties, or if the purchaser is required to defend appeal proceedings in respect of the permit application, no later than November 1997. Audit was advised that a planning permit was issued to the purchaser by the City of Kingston in July 1997 and that it is expected that the site will be appropriately re-zoned by December 1997.

4.212 A key term of the sale agreement was that the company would enter into leases relating to the existing premises and a lease for a new building, which would be constructed by the purchaser and would be ready for occupation by May 1998.

Lease for new building

4.213 Consistent with the terms of the sale agreement, the company entered into a lease for its existing office at Warrigal Road, Moorabbin, at a nominal rental, until the occupation of the new building which is to be constructed by the purchaser. The company also agreed to enter into a lease with the purchaser for the new building which is to be ready for occupation by May 1998. The key terms of the development agreement for the new building include:

- the design and construction of the premises to be undertaken in accordance with specified requirements and to be financed by the purchaser;
- the purchaser to be entitled to an extension of time for the completion of the works under certain specified circumstances;
- the purchaser cannot recover from the company any costs or expenses for any delay or disruption to the works other than where the delay is due to a breach by the company of the sale arrangement, including lease documentation, or the issue of a variation order initiated by the company;
- fit-out works to be conducted by the company at its expense; and
- the purchaser to provide 2 bank guarantees totalling $500 000 as security for performance of their obligations to the agreement.

4.214 Upon the completion of the works, the company has agreed to enter into a lease with the following terms and conditions:

- An annual rental of $1.2 million for a lease term of 8 years with the option of 2 further 8 year terms, however, the rental may be varied to incorporate the additional cost of any variations to the construction works requested by the company;
- An annual rental review for movements in the consumer price index and a market review of the rental after the expiration of 4 years from the commencement of the lease term;
- The company to reimburse the purchaser for operating costs incurred in relation to the leased premises including outgoings, land taxes, rates and other government agency charges, insurance, cleaning and preventative maintenance services, water and energy costs;
- The company to pay all stamp duty relating to the lease agreement;
- The company to have first right of refusal for the purchase of the property; and
- If the premises are destroyed or damaged causing a substantial part of the premises to be unfit for use during the lease term, the rental and other costs will abate until the premises are restored by the purchaser, or the lease may be terminated by the company if the purchaser fails to make good the restoration or both parties agree to terminate the lease. If the company defaults or its negligence has caused such significant damage, then the rent and operating costs will not abate and the lease cannot be terminated.

Assessment of the sale

4.215 **An analysis of the sale result indicated that:**

- **the net proceeds from the sale of the site, after taking account of costs of around $200 000 incurred in relation to the sale, were $14.8 million; and**
- **the sale proceeds were substantially higher than the property valuations obtained by the company and the book value of the site.**

4.216 As an integral element of the sale arrangements, South East Water agreed to lease a building which is to be constructed by the purchaser, over an initial period of 8 years, with further options to extend this initial lease period.

Chevron Hotel complex

4.217 The Chevron Hotel complex comprises a hotel, associated buildings and surrounding land, and is located on the corner of St Kilda and Commercial Roads, Melbourne. The complex was purchased by the former Alfred Group of Hospitals in 1976 for a consideration of $3.3 million. As part of the Government's public health reform program, in July 1996, the Group was incorporated into the Inner and Eastern Health Care Network.

4.218 Up until 1994, part of the complex was used to provide residential accommodation for nurses and associated hospital staff, with the balance of the complex leased to various parties for total annual rentals of approximately $365 000.

4.219 Given that the complex was assessed as surplus to the Network's requirements and that the rentals received from its leasing represented a low return on capital, in December 1996 the Board of Management of the Network approved the sale of the site and agreed that the proceeds of the sale would be directed to the refurbishment of existing buildings owned by the Network.

Sale process

4.220 In February 1997, an independent valuer assessed the market value of the property at $8.7 million, based on building height restrictions of 60 metres, which is equivalent to around 15 levels. The Network was advised that due to the existence of the nearby helipad, which was constructed over Commercial Road for the purposes of transferring patients to the Alfred Hospital Trauma Centre, the Civil Aviation Authority would discourage any development on the site which was higher than 4 levels, however, this would not be enforceable under any legislation.

4.221 A further private valuer, separately engaged by the Valuer-General in March 1997 to independently assess the current market value of the property for sale, estimated its value at $9.3 million, based on the existing height restrictions of 60 metres. However, the valuer considered that the imposition of lower height restrictions on the future development of the site, as recommended by the Civil Aviation Authority, would reduce the value of the property to $7.3 million.

4.222 In March 1997, the property was offered for sale by public tender which resulted in the receipt of 6 offers. Subsequently, in May 1997 Development Ventures Pty Ltd was recommended as the preferred tenderer, providing the highest bid price of $10 million for the property. The Network subsequently approved the sale of the property at this price.

Contract of sale

4.223 Under the terms of the sale agreement, the price of $10 million was payable to the Network as follows:

- a deposit of $1 million payable in May 1997;
- a further $1 million payable in August 1997; and
- the balance payable in June 1998.

4.224 Under the sale agreement, the Network has retained an entitlement to the receipt of lease payments from the current property leases until June 1998 and has been authorised by the purchaser to commence or continue legal proceedings subsequent to June 1998 against a tenant for a breach of lease, including any arrears of rent due to the Network by the tenant as at settlement date, in June 1998. In turn, the Network has provided an indemnity to the purchaser for all costs incurred as a result of steps taken or proceedings instituted by the Network in respect of this matter.

Assessment of sale

4.225 **An analysis of the sale indicated that:**

- **the sale proceeds of $10 million were $2.1 million above the estimated book value of these assets of $7.9 million at the date of sale; and**
- **the purchase price compared favourably with the available property valuations.**

Queen Victoria Market site

4.226 The Queen Victoria Market has been managed by the City of Melbourne since 1859 and is situated on a number of parcels of land permanently reserved for market purposes, located within the perimeters of Victoria, Peel, Franklin, Queen, Therry and Elizabeth Streets, West Melbourne. The operation of the market has been restricted through various provisions contained in the *Melbourne General Markets Act* 1877, the *Melbourne Lands Exchange Act* 1904, the *Melbourne General Markets Act* 1917 and other legislation since 1862. The City of Melbourne has financed the establishment, expansion and operation of the market, which has undergone significant improvements in recent years.

4.227 The land which comprises the Queen Victoria Market falls into 2 categories: the area occupied by the heritage buildings in which all the retail activities are undertaken and the area occupied by the car park. In November 1994, the Valuer-General estimated the value of the entire Queen Victoria Market site at $25 million, comprising $20 million for the retail area and $5 million for the car park under current usage or $10 million if there was an increase in its current usage.

Queen Victoria Market.

Corporatisation of the market

4.228 To facilitate the corporatisation of the market and, in particular, enable the transfer of its direct control from the Council to a wholly-owned company of the Council, in July 1994 the Council sought approval from the then Minister for Finance to amend the legislation governing the operation of the market in order to revoke the restrictive land-use reservations in place and to cancel the restrictive Crown grants over the parcels of land which comprise the market site. While the Council had successfully managed the market for over 130 years, it aimed to establish an appropriate arm's length relationship with its wholly-owned company to allow the market to be managed and developed independently of the broader local government objectives. While the corporatised structure would remove the Council from the direct control of the market, ultimate control would still remain with the Council by virtue of its ownership of the company.

Revocation of permanent reserve and transfer of market operations to company

4.229 In September 1995, the Minister for Finance approved the granting of the relevant Crown land parcels to the City of Melbourne for the operation of Queen Victoria Market, for nil consideration, reflecting the Government's limited interest in the site. In addition, the Minister agreed to grant to the City of Melbourne, at market value, the Crown land required for commercial car parking. Subsequently, in November 1996, the *Queen Victoria Market Lands Act* 1996 was passed by the Parliament which revoked the permanent reservations and Crown grants, and provided for the surrender of certain land in relation to the Queen Victoria Market site to the City of Melbourne.

4.230 Part of the market site is located on the site of the Old Melbourne Cemetery, a portion of which was an Aboriginal burial site. An agreement was executed in November 1996 between the Melbourne City Council, the Wurundjeri Tribe Land Compensation and Cultural Heritage Council and the Minister for Planning, which acknowledged the interests of the Wurundjeri Council and formalised arrangements for the future use and protection of that part of the market site.

4.231 In July 1997, a further agreement was executed between the City of Melbourne and its wholly-owned company, Queen Victoria Market Pty Ltd, for the lease by the company of the market site excluding the car park area for a period of 20 years at a nominal rental rate of $1 a year. Under the agreement, the company will be responsible for the payment of all rates and taxes assessable on the property. In turn, the company is to sub-lease and licence these areas to commercial tenants and stall holders.

Car parking facility

4.232 In August 1996, the Valuer-General estimated the value of the land utilised for the existing car park at $6.5 million. However, in February 1997, this valuation was revised to $5.95 million, in recognition of:

- restrictions placed on the use of the land, for only car parking and municipal purposes associated with the operation of the adjoining market;
- the impact of urban design guidelines which were likely to inhibit the development capacity of the site; and
- the heritage significance of the precinct which was expected to inhibit the development capacity of the car parking facility, resulting in substantial construction costs in the development of a multi-deck car park;

4.233 **Consistent with the previous approval of the Minister for Finance in relation to the car park site, in June 1997, an amount of $5.95 million was paid by the City of Melbourne into the Consolidated Fund, representing market value of the site.**

4.234 A management agreement was executed in July 1997 between the City of Melbourne and Queen Victoria Market Pty Ltd, in relation to the car park facility, which provided for:

- the company to manage or contract-out the management of the operation of the facility over a 20 year period; and
- the company to meet all costs and expenses relating to the operation and maintenance of the facility, including insurance.

Assessment of land transfer

4.235 The analysis of the results achieved by the State from the transfer of the Queen Victoria Market site to the Melbourne City Council indicated that:

- in recognition of the Government's limited interest in the site relating to that part dedicated to retail activities, the State received nil consideration for that part of the site which was valued by the Valuer-General in November 1994 at $20 million; and
- the proceeds of $5.95 million for the car park facility were consistent with the Valuer-General's valuation in February 1997, however, the proceeds were below the potential valuation of up to $10 million for the facility, provided by the Valuer-General in November 1994, based on increased utilisation of the facility.

Sale of South Melbourne property

4.236 In February 1988, a parcel of Crown land within an industrial sector adjacent to the Westgate Freeway, located at Montague Street in South Melbourne, was identified as surplus to government requirements and earmarked for disposal by public auction or tender.

4.237 In December 1988, the Valuer-General informally estimated the value of the property at $7.7 million and identified that up to $8.3 million could be realised if an adjacent property owned by the City of South Melbourne was also made available for sale. The Valuer-General considered that the improvements on the site did not add any value to the property.

4.238 Private selling agents were appointed by the former Department of Finance in April 1989 to facilitate the sale of the property. At that time, the Valuer-General estimated the unencumbered freehold value of the property at $9.2 million. This compared with a valuation provided by a private valuer at the same time, of $11.2 million which included the value of improvements. A further private valuer commissioned by the Department estimated the unencumbered freehold value of the property and related improvements at $10 million.

4.239 The property was offered for sale by public auction in May 1989 for a reserve price of $8.2 million. However, a sale did not result from this process and the property was subsequently offered for sale by public tender. In the meantime, the property was leased to a private sector company until December 1994.

4.240 A report issued by the selling agents in July 1989 which analysed the market status of the property, recommended that a sale by public auction should be pursued with a reserve price not exceeding $6.5 million, given that the estimated realisation value for the property was substantially below the existing reserve price of $8.2 million.

4.241 In November 1989, a private valuer commissioned by the Office of the Valuer-General to provide a valuation of the property on its behalf, estimated the fair market value of the unencumbered freehold land at $8.1 million. In December 1989, the private valuer previously commissioned by the Department also revised the previous estimate of $10 million for the property to $8.8 million. The valuation report indicated that the decline in the estimated property value was due to a deterioration in market conditions.

4.242 The disposal of the property was suspended until November 1995 as the Department was advised that the site would be significantly effected by the Melbourne City Link project. However, action was re-commenced at that time to sell the property, following advice received from the City Link Authority that the site was not required for the project.

Completion of sale

4.243 In November 1995, a private valuer estimated the value of the property at $3.5 million, with this valuation subsequently revised to $4 million in July 1996. These valuations were updated in July 1996 by the Valuer-General, who estimated the value of the property including the associated improvements at $3.8 million.

4.244 **The property was offered and sold at public auction in July 1996 for $4 million**. However, a decision was subsequently taken to attempt to abort the sale as the property was earmarked for use by the Melbourne Exhibition Centre Trust for the proposed construction of a convention centre and multi-level car park. However, this attempt was unsuccessful and the sale proceeded.

Assessment of sales result

4.245 A deposit of $403 000 was paid by the purchaser in July 1996, with the residual amount of $3.6 million paid in September 1996. **An analysis of the sale indicated that the sale price compared favourably with the estimated book value of the property at the time of sale and the Valuer-General's valuation in July 1996. However, the sale price was significantly less than earlier valuations of the property of $11.2 million and $9.2 million provided by an independent valuer and the Valuer-General in April 1989.**

Southern Cross Hotel site

4.246 My previous *Reports on the Statement of Financial Operations* have commented on the sale, in September 1994, of the former Southern Cross Hotel site located at the corner of Exhibition and Bourke Streets, Melbourne, to parties affiliated with the Republic of Nauru.

4.247 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. However, the settlement was not effected by the Nauru Government in accordance with the sale conditions.

4.248 **In July 1997, the settlement of this property sale was finally completed, some 16 months subsequent to the initially agreed date, with the balance of the purchase price of $9.5 million together with a further $1.9 million penalty interest paid into the Consolidated Fund.**

Educational properties

4.249 The disposal of surplus educational properties by the Directorate of School Education and the Department of Treasury and Finance in recent years has been a major component of the Government's asset sales program, with the sale proceeds earmarked for re-investment into the public school system for capital purposes. During the 1996-97 financial year, 110 surplus properties with an aggregate value of $57 million were sold. An amount of $39.5 million was paid into the Consolidated Fund during the year from the disposal of these surplus properties and settlements relating to the prior year property sales.

4.250 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.

4.251 **At 30 June 1997, 48 properties valued at approximately $16.9 million had been identified as surplus to present requirements and were awaiting sale.**

Identification of surplus property assets

4.252 As previously indicated in this Part of the Report, a key element of the Government's asset management program in recent years has been the disposal of surplus and underutilised property assets held within the budget sector. Since the commencement of the program in 1986-87, the Government has raised proceeds of around $1.2 billion from the sale of such properties. The major budget sector entities contributing to this outcome have included the Department of Treasury and Finance, Department of Natural Resources and Environment, Department of Education, Public Transport Corporation, VicRoads and the Office of Major Projects of the Department of Infrastructure.

4.253 **According to departmental records, at 30 June 1997, approximately 2 460 properties with an aggregate value of $149 million (30 June 1996, $136 million) had been identified as surplus to government requirements and were awaiting sale**. Table 4G shows the periods in which these assets were identified as surplus to requirements and approved for sale.

TABLE 4G
ASSETS AWAITING SALE,
AT 30 JUNE 1997
($million)

Year approved for sale	*Estimated value*
Prior to 1991-92	17.6
1991-92	13.7
1992-93	12.1
1993-94	11.5
1994-95	20.4
1995-96	16.7
1996-97	56.7
Total	**148.7**

4.254 According to the Department of Treasury and Finance, the key reasons for the delay in the sale of these assets include the extended time required to establish titles for certain properties, the need to resolve certain native title claims, the poor quality of assets within the portfolio and a low demand for these assets, particularly in regional areas.

4.255 The Government estimates that the disposal of certain of these surplus property assets in the 1997-98 financial year will generate revenue of $79 million to the Consolidated Fund.

PART 5

Revenue

VICTORIAN
AUDITOR-
GENERAL'S
OFFICE

Auditing in the Public Interest

Summary of State revenues

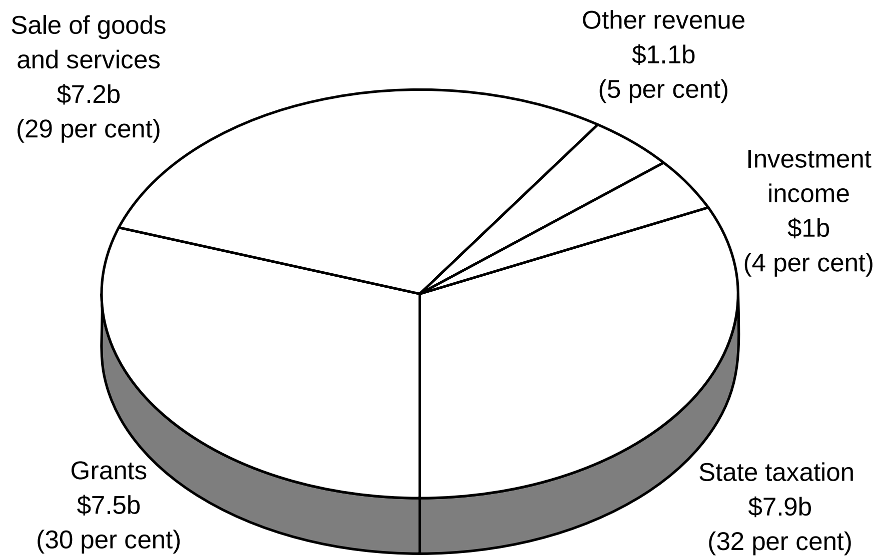
5.1 **During the 1996-97 financial year, the operating revenues of the State totalled $24.7 billion** and mainly comprised State taxation collections, grants from the Commonwealth Government, proceeds from the sale of goods and services, and investment income. Table 5A provides a summary of revenue collections for the year.

TABLE 5A
STATE REVENUES, 1996-97
($billion)

Item	*Amount*
State taxation	7.9
Sale of goods and services	7.2
Grants	7.5
Investment income	1.0
Other	1.1
Operating revenue before abnormal items	**24.7**

5.2 As further illustrated in Chart 5B, **collections from taxation, grants and the sale of goods and services in the 1996-97 financial year accounted for around 91 per cent of the State's operating revenues**.

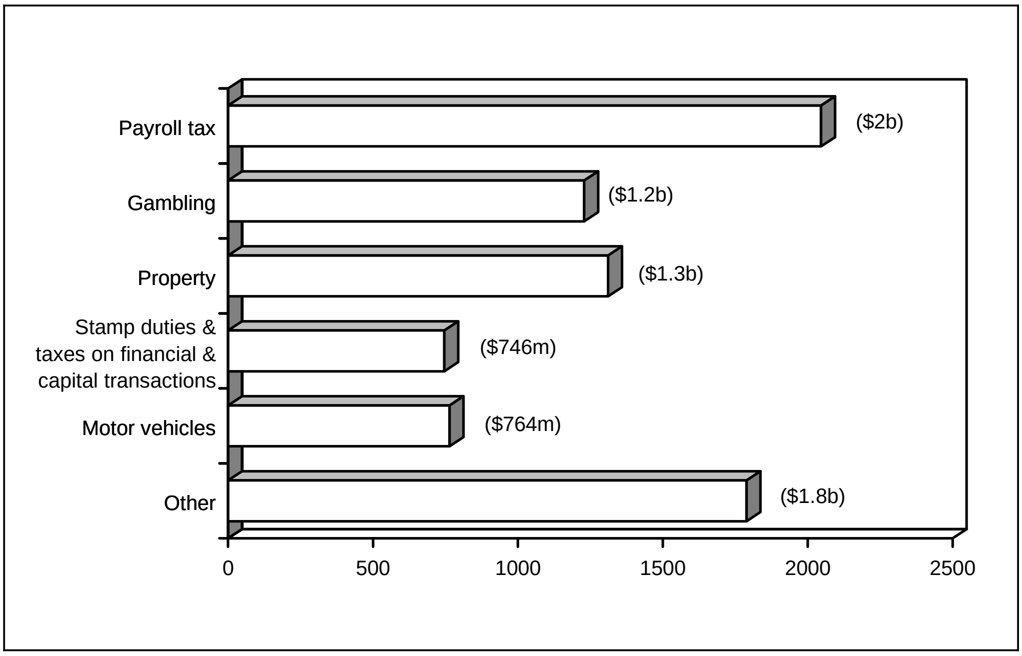
CHART 5B
MAJOR SOURCES OF STATE REVENUE, 1996-97
($billion)



Taxation revenues

5.3 Taxation represents the largest source of State revenues and principally comprises payroll tax, various stamp duties and taxes on financial and capital transactions, taxes on property holdings and gambling activities, motor vehicle fees, and other licences and levies. **In the 1996-97 financial year, taxation collections not including those associated with the sale of State assets totalled $7.9 billion, representing 32 per cent of total State revenues**. Chart 5C illustrates the key taxation categories.

CHART 5C
KEY TAXATION CATEGORIES
($million)



5.4 As highlighted in my previous Reports to the Parliament and in the Government's Budget Papers, in recognition of the higher level of taxation collections by Victoria compared with other large Australian States, and the associated impact on the competitiveness of the State, one of the Government's longer-term budget aims has been "*... to bring Victoria's overall tax effort into closer alignment with the average of the Australian States*".

5.5 To assist in the achievement of this aim, in previous years the Government introduced various tax reduction and expenditure management measures. 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 had been deferred. In particular, the 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. Notwithstanding the deferral of tax relief, the Government identified that, with some other States funding their contribution through increased taxes, the gap between Victoria and other States in the level of taxation collections had nevertheless narrowed.

5.6 With the continuing stabilisation of the State’s finances, in the *1997-98 Budget Papers*, the Government announced a number of tax relief measures, including reductions in payroll tax rates. In particular, the Budget Papers identify that, based on the 1997 Commonwealth Grants Commission assessment of Victoria’s relative revenue-raising effort, alignment with the average tax effort of all State’s would require further tax cuts estimated at around $500 million.

Impact of High Court decision on franchise fee revenues

5.7 As highlighted in the notes to the Government’s Annual Financial Statement, in August 1997, the High Court of Australia ruled that the New South Wales tobacco franchise fee legislation was unconstitutional. As a result, the *Business Franchise (Tobacco) Act* 1974, administered by the Victorian Government, has also been deemed by the Victorian Government to be unsustainable, and questions have been raised about the validity of similar legislation in respect of petroleum and liquor fees.

5.8 Subsequent to the court decision, the Victorian Government, together with all other State Governments, agreed to stop collecting in their current form business franchise fees on tobacco, petroleum and liquor.

5.9 The impact of the decision on Victoria was significant as the State generated in excess of $1.3 billion a year from these franchise fees. Consequently, Victoria together with the other State Governments has entered into an arrangement with the Commonwealth Government whereby the Commonwealth agreed to use its tax powers to collect revenue previously raised by business franchise fees on liquor, tobacco and petroleum. The Commonwealth Government has also introduced a 100 per cent “windfall tax” so that the States’ exposure to liabilities associated with possible claims for refunds of fees previously paid by licence holders is minimised.

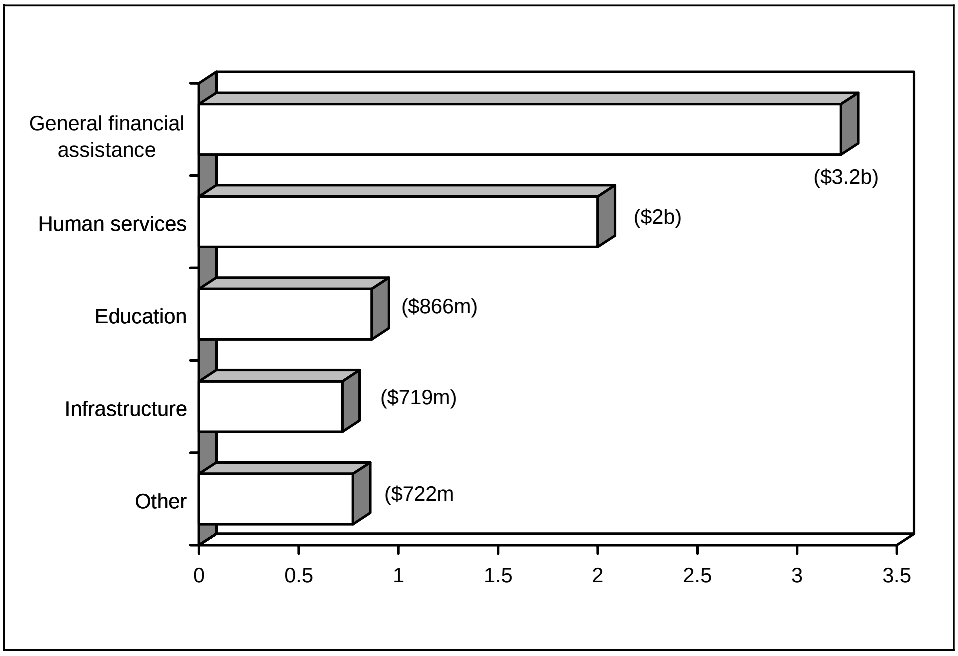
5.10 In recognition that the change in the tax regime for liquor from an annual pre-paid fee to regular wholesale sales tax payments would result in transitional cashflow difficulties for liquor retailers, the State Government agreed to reimburse licensees through ex-gratia payments to cover pre-paid franchise fees at an estimated cost to the State of $51 million. In addition, as the new tax arrangements imposed by the Commonwealth have caused an increase in the effective tax rates on certain liquor products and excise duties on petroleum, the State has further agreed to provide subsidies to the relevant wholesalers to avoid increases in prices for these products. However, the State in turn will receive funds from the Commonwealth Government to finance these subsidies.

5.11 The residual financial impact of the court decision on the State relates to the possible non-recovery of outstanding franchise fees estimated to be $3.2 million as at 30 June 1997.

Grants

5.12 Government grants represent the second largest source of State revenues and are mainly sourced from the Commonwealth Government. **During the 1996-97 financial year, grant revenues to the State totalled $7.5 billion and principally consisted of annual financial assistance grants from the Commonwealth, and other Commonwealth funding relating to human services, education and infrastructure programs**. Chart 5D outlines the major components of grant revenues.

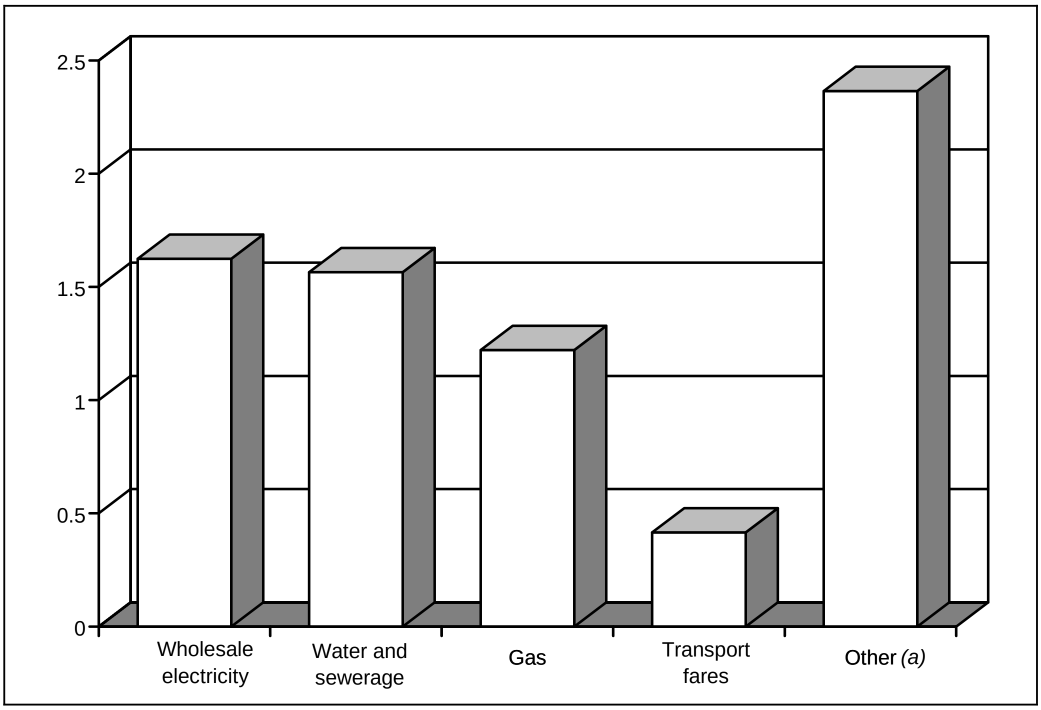
CHART 5D
GRANT REVENUES, 1996-97
($billion)



Sale of goods and services

5.13 Revenues from the sale of various goods and services by public sector bodies represents the third largest source of State revenues, accounting for around 29 per cent of its total operating revenues. **During the 1996-97 financial year, the revenue earnings of the State from the sale of goods and services totalled $7.2 billion**. The major components of this source of revenue were gas sales, transport fares, wholesale electricity charges mainly raised from private sector electricity distribution companies, and water and sewerage charges. Chart 5E illustrates the contribution of these components to the aggregate revenues derived from the sale of goods and services.

CHART 5E
REVENUE FROM THE SALE OF GOODS AND SERVICES
($billion)



(a) Mainly relates to transport accident charges, workers compensation premiums and health services charges.

Summary of Consolidated Fund transactions

5.14 As outlined earlier in this Report, 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. Accordingly, the receipts of the Consolidated Fund represent a key element of the State's financial operations and substantially influence the Government's capacity to finance present and future programs.

5.15 Given the continuing importance of revenues paid into the Consolidated Fund to finance government operations and the established parliamentary appropriation and accountability process, in this Part of my Report, I have provided an analysis of the year's Consolidated Fund receipts outcome compared with that budgeted.

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

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

Item	*1995-96 Actual (a)*	***1996-97 Actual***	*1996-97 Budget (b)*	***Variance from Budget***	***Variance from 1995-96 Actual***
Recurrent -					
Taxation	8 425	**9 000**	8 485	**515**	**575**
Commonwealth	5 239	**5 558**	5 661	**(103)**	**319**
Public authorities	1 395	**1 999**	1 273	**726**	**604**
Other	1 063	**1 022**	938	**84**	**(41)**
Total recurrent	16 122	**17 579**	16 357	**1 222**	**1 457**
Works and services -					
Commonwealth	495	**550**	505	**45**	**55**
Sale of assets	183	**143**	113	**30**	**(40)**
Other	3 945	**3 101**	1 857	**1 244**	**(844)**
Total works and services	4 623	**3 794**	2 475	**1 319**	**(829)**
Total receipts (excluding borrowings)	20 745	**21 373**	18 832	**2 541**	**628**

(a) 1995-96 comparatives have been adjusted to reflect the re-classification of certain items in 1996-97.
(b) Budget Estimates, *1995-96 Budget Paper No. 3.*

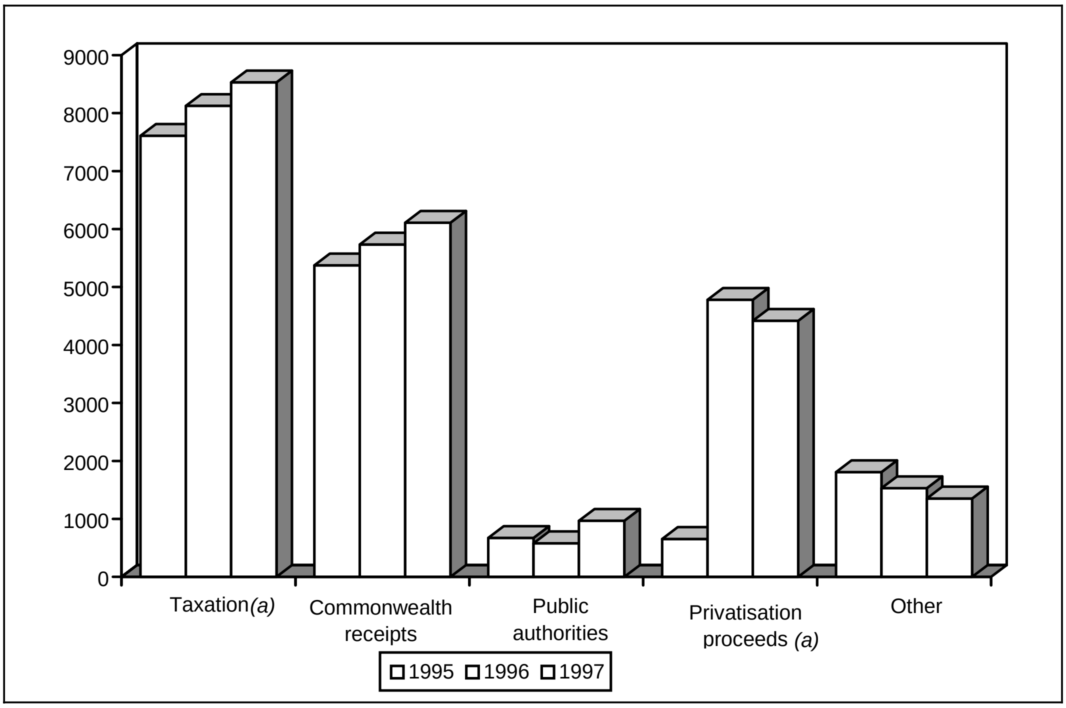
5.17 **The Consolidated Fund gross receipts for the year totalled $21.4 billion, which was $2.5 billion above budget expectations.** The major factor contributing to this positive outcome was the receipts from the sale of a number of substantial State-owned enterprises, especially the 3 electricity generation companies and the Port of Geelong, which were not fully provided for in the budget estimates.

5.18 **When the privatisation proceeds are excluded, the Consolidated Fund receipts were $390 million better than the budget estimates**. The key factors contributing to this favourable budgetary outcome were higher than expected taxation receipts ($179 million), increased receipts from public authorities ($180 million) and higher proceeds than expected from property and equipment sales ($30 million). However, these increased collections were to an extent offset by lower than expected grants from the Commonwealth Government ($58 million).

5.19 **The year's gross receipts, excluding the proceeds from privatisation, were $989 million higher than the level achieved in the previous year**. This result mainly reflects the impact of increased receipts from the Commonwealth Government ($374 million), higher taxation revenues ($407 million) and increased contributions from public authorities ($387 million), offset by reduced receipts from the sale of property and equipment assets ($40 million).

5.20 Chart 5G shows the contribution from each of the major sources of revenue to the Consolidated Fund over the past 3 years.

CHART 5G
MAJOR SOURCES OF CONSOLIDATED FUND RECEIPTS, 1994-95 TO 1996-97
($million)



(a) Privatisation proceeds for 1996-97 include $1.1 billion (1995-96, $816 million) of related public authority contributions and $466 million (1995-96, $301 million) of related taxation receipts.

Taxation receipts

5.21 As indicated in Table 4F, **taxation receipts in 1996-97 were $515 million above the budget estimate and $575 million higher than the previous year.** Table 5H details the major items contributing to this favourable outcome.

TABLE 5H
MAJOR TAXATION VARIANCES
($million)

Revenue sources	*1995-96 Actual*	**1996-97 Actual**	*1996-97 Budget*	***Variance from Budget***	***Variance from 1995-96 Actual***
Land transfers stamp duties	896	**1 153**	727	**426**	**257**
Other taxes on financial and capital transactions	164	**182**	143	**39**	**18**
Electronic gaming machines	509	**626**	589	**37**	**117**
Tobacco franchise fees	569	**634**	601	**33**	**65**
Land tax	393	**437**	407	**30**	**44**
Payroll tax	2 246	**2 386**	2 379	**7**	**140**

5.22 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 privatisation of State-owned electricity generation companies and a more buoyant property market in the year;
- *Other taxes on financial and capital transactions* - increased collections mainly due to mortgage stamp duties on the privatisation of State-owned electricity industry business enterprises;
- *Electronic gaming machines* - higher than expected average daily turnover combined with increased gaming licence fee payments from Tattersalls as a result of the organisation’s increased profitability;
- *Tobacco licences* - higher than expected sales and reduced evasion activity following a decision by the State Government of Queensland to raise the tobacco franchise fees in that State to a level equivalent to Victoria;
- *Land tax* - larger than expected increases in assessed property valuations and the finalisation of certain substantial disputed assessments in the year; and
- *Payroll tax* - higher than expected growth in wages and some employment growth.

Gambling fees and taxes

5.23 A significant component of Consolidated Fund revenues in recent years has been the various fees and taxes collected in relation to gambling activities conducted within the State. The major sources of such revenue include fees and taxes levied on electronic gaming machine operations, private lotteries, racing and casino operations. **During 1996-97, the total receipts of the Consolidated Fund from gambling activities totalled $1.2 billion, an increase of around $80 million since the previous year.**

Commonwealth receipts

5.24 As indicated in Table 5F, **Commonwealth receipts in 1996-97 were $58 million below budget expectations but $374 million higher than the previous year**.

5.25 There was a lower level of Commonwealth grants provided to Victoria compared with budget expectations due in part to a lower than expected inflation rate and variations to estimated population levels, which impacted on the grants received. In addition, there was a reduction in grants associated with the Medicare Bonus Pool due to penalties imposed by the Commonwealth Government relating to alleged cost shifting by the State to the Commonwealth, and delays in the receipt of funding from the Commonwealth Government in respect of Medicare mental health programs.

5.26 The increased Commonwealth receipts in the year compared with the previous year were mainly attributed to:

- higher financial assistance grants provided to the State;
- additional amounts provided to finance compensation payments and administrative costs associated with the national firearms buy-back program;
- additional funding to compensate for the greater number of drugs eligible for assistance under the High Cost Drugs Program;
- increased funding to assist in the construction of the Epping Hospital; and
- additional debt redemption assistance provided to compensate the State for the financing costs incurred as a result of the transfer of debt raising responsibilities from the Commonwealth to the State.

Public authority income

5.27 Public authority income mainly represent dividends and tax equivalent payments from various government business enterprises, which are collected under the authority of the *State Owned Enterprises Act* 1992 and other specific legislation, and by virtue of the State's interest in certain publicly-owned companies. **During 1996-97, the Consolidated Fund revenue from this source was $726 million greater than that budgeted for the year and $604 million higher than that received in the previous year.** Table 5I provides a summary of public authority payments received by the Consolidated Fund in the past 2 years.

TABLE 5*I*
RECEIPTS FROM PUBLIC AUTHORITIES, 1995-96 AND 1996-97
($million)

Business enterprises	*Actual 1995-96*	***Actual 1996-97***	*Budget 1996-97*	***Variance from Budget***	***Variance from 1995-96 actual***
Electricity sector	896	**1 290**	615	**675**	**394**
Transport Accident Commission	104	**156**	130	**26**	**52**
Water sector	132	**317**	250	**67**	**185**
Gas sector	152	**105**	159	**(54)**	**(47)**
Treasury Corporation of Victoria	38	**26**	25	**1**	**(12)**
Other	73	**105**	94	**11**	**32**
Total *(a)*	1 395	**1 999**	1 273	**726**	**604**

(a) Excludes a special dividend of $100 million from the Transport Accident Commission relating to the sale of its investment in Sheraton Towers, which is disclosed as part of works and services receipts, and franchise fees received from privatised electricity companies and statutory contributions relating to a share of natural gas revenues from Gas and Fuel, which are disclosed as taxation revenue.

5.28 **The substantial increase in public authority income in the year was mainly due to the receipt of additional tax equivalent payments arising from the sale of the State-owned electricity generation businesses.** In addition, the higher than budgeted collections related to the:

- State Electricity Commission of Victoria, which were sourced from surplus cash attributable to previous privatisations;
- Transport Accident Commission, due to increased profitability;

- Melbourne Water, due to a requirement to make dividend payments on a more commercial basis following the transfer of around $250 million of debt to the State during the year; and
- Port of Geelong, resulting from the liquidation of investments not included as part of the sale of port-associated assets.

5.29 However, these increased receipts were to an extent offset by lower than expected receipts from the gas sector resulting from the settlement arrangements relating to the petroleum rent resource tax dispute (further comment on this matter is provided in Part 8 of this Report).

Stamp duty on motor vehicles

5.30 Stamp duty is payable, subject to certain exemptions, on the initial registration and transfer of registration of motor vehicles pursuant to the *Stamps Act* 1958 (the Act) and the Stamps Regulations 1992.

5.31 The amount of stamp duty payable is based on the market value of a motor vehicle. The initial registration of vehicles attracts stamp duty on a sliding scale, ranging from $5 to $10 per $200 (or part thereof) of the vehicle's market value, while stamp duty payable on the transfer of ownership of a vehicle is set at a flat rate of $8 per $200 (or part thereof) of the vehicle's market value.

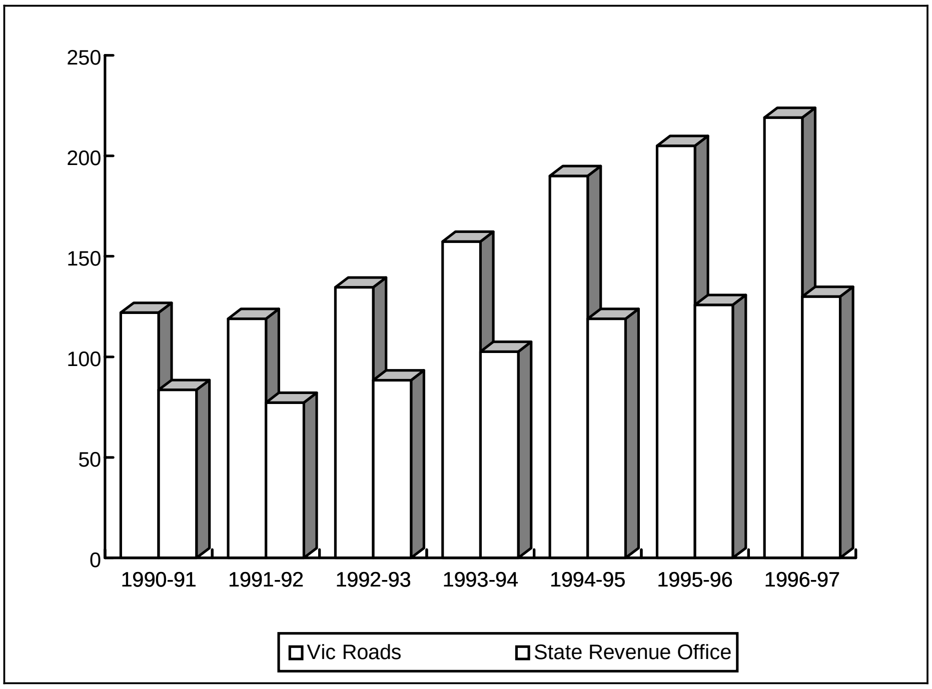
5.32 The person who applies for the initial registration or the person who acquires a motor vehicle in the case of a transfer of ownership is required to pay the stamp duty. However, both buyers and sellers of vehicles are obligated under the Act to declare the market value of the vehicle sold on the prescribed form.

5.33 The Act provides that the Comptroller of Stamps may impose certain penalties where stamp duty is not paid in accordance with the Act. In particular, the failure to pay the assessed duty within 14 days after the date of vehicle acquisition incurs a minimum penalty of $25, or 20 per cent of the amount outstanding. Further, where the payment of stamp duty is evaded the Act prescribes a penalty of 10 penalty units (currently $1 000) or double the amount of the duty evaded.

5.34 While the principal responsibility for the collection and administration of stamp duty on motor vehicles lies with the Comptroller within the State Revenue Office, the majority or approximately 60 per cent of such stamp duty is collected by the Roads Corporation (VicRoads) on behalf of the State Revenue Office. The total stamp duty collected in relation to motor vehicles during the 1996-97 financial year was in the order of $349 million, of which VicRoads collected $219 million.

5.35 The actual amount of motor vehicle stamp duty revenue collected in any one year is driven by the number, value and type of dutiable transactions. As illustrated in Chart 5J, since the 1990-91 financial year stamp duty revenues have increased by $143.3 million. This increase has been mainly due to the increase from 335 000 to 427 000 in the number of transactions subject to duty processed at VicRoads and the increase in the market value of vehicles. The average stamp duty payable per transaction increased over this period from $365 to $513.

CHART 5J
MOTOR VEHICLE STAMP DUTY COLLECTIONS BY VICROADS AND STATE REVENUE OFFICE, 1990-91 TO 1996-97
($million)



5.36 The October 1991 *Report on the Finance Statement* highlighted the following inefficiencies in the administration of motor vehicle stamp duty:

- the responsibilities and role of VicRoads had not been clearly defined;
- the costs of stamp duty collection functions performed at VicRoads had not been quantified;
- unclear definition of market value for the purposes of calculating motor vehicle stamp duty payable;
- ineffective evaluation of market values by VicRoads for the purposes of calculating stamp duty on motor vehicle transfers;
- inadequate information and management reporting systems at the former Stamp Duties Office; and
- low level of investigations at the former Stamp Duties Office.

5.37 It was against this background that audit undertook a follow-up review of the administration of motor vehicle stamp duty collections by VicRoads and the State Revenue Office.

Overall audit comment

5.38 The current **audit review concluded that the key inefficiencies in the administration of motor vehicle stamp duty identified by audit in 1991 continue to exist. The audit also established that as a result of the ongoing deficiencies up to $10.8 million in stamp duty could be forgone each year on private motor vehicle transfers alone.** This estimate excludes stamp duty payable on initial motor vehicle registrations and motor vehicle transfers by dealers. Accordingly, **there continues to be a need for action to ensure that all stamp duty revenues due to the State are collected.**

Identification of market value for stamp duty purposes

5.39 As previously mentioned, the present system for calculating stamp duty payable on motor vehicle transactions is based on the market value of each vehicle. The correct identification of the market value of vehicles which are transferred or registered is therefore critical to the proper assessment of stamp duty payable.

5.40 While the Act defines market value as *"... the greater of either the purchase price or the price which could be obtained for the motor vehicle in the open market at the date of transfer or initial registration"*, in practice the market valuation of a vehicle for the purposes of stamp duty calculation can be very subjective and specific to each individual vehicle. In particular, the market value can be influenced by the vehicle's condition (in the case of second hand vehicles), options fitted, specific model and which segment of the market is used as a reference point for valuation purposes. For example, market value can refer to the wholesale, retail, trade, fleet operator rates, private sale or auction values. Each of these values can be very different for the same vehicle.

5.41 **The State Revenue Office and VicRoads are therefore charged with the very difficult task of administrating the collection of stamp duty which is dependent upon the correct identification of market values that are subjective, variable and specific to each individual vehicle.** It should also be noted that during the 1996-97 financial year there were some 427 000 motor vehicle registrations and registration transfers subject to stamp duty collected by VicRoads. The difficulties associated with defining market values of vehicles is common to all Australian jurisdictions. In this regard, the 1991 audit review suggested that:

> *"... a simplified system of imposing duty, such as the use of broader bands for the calculation of the duty or fixed rates of duty for various categories of vehicles, would assist in the administration of the legislation especially in terms of identifying understatement of values. In developing such a system, consideration would also need to be given to protecting the existing tax base".*

5.42 Another administratively simpler basis for the calculation of motor vehicle stamp duty could be to strike stamp duty on the greater of either the purchase price or the vehicle value as set out in one of the industry dealer guides (as at the date of transfer or initial registration) assuming a vehicle of average condition. Industry dealer guides outline recommended motor vehicle values for individual vehicles which offer 3 different values analogous to the condition of each category of vehicle. The adoption of such a valuation basis provides an independent verifiable valuation basis but may also require provision for an appeal process where an assumption of average vehicle condition is inappropriate.

5.43 **Audit was advised that the State Revenue Office is continuing to consider alternative means by which a verifiable measure of market value can be ascertained.**

Service agreement

5.44 Stamp duty on all new and second hand motor vehicle registrations and vehicle transfers between private persons is paid directly to Vic Roads, in its capacity as agent for the State Revenue Office. However, stamp duty on purchases of used motor vehicles from motor car dealers is paid directly to the State Revenue Office.

5.45 The 1991 audit review found that *"Substantial revenue has been collected on behalf of the Comptroller* [of Stamps] *at the ... Roads Corporation. The rights, responsibilities and reporting requirements of each party in the arrangement have not been clearly defined. In addition, costs of the functions performed at the Roads Corporation ... on behalf of the Comptroller have not been quantified"*.

5.46 **The current review found that a service agreement still had not been developed between VicRoads and the State Revenue Office.** As a result, doubt continues to exist over the following:

- the role, rights and responsibilities of both the State Revenue Office, as principal, and VicRoads as its agent;
- agreed performance standards to be attained by VicRoads and the reporting framework under which performance is to be assessed; and
- the agreed cost for the collection of stamp duty by VicRoads on behalf of the State Revenue Office.

5.47 Furthermore, in the absence of such an agreement, the State Revenue Office is unable to assess the cost-efficiency and effectiveness of the existing assessment and collection arrangements. **While VicRoads has drafted a service agreement for its motor vehicle stamp duty collection activities, it is important that attention is given to its finalisation by both the State Revenue Office and VicRoads as a matter of priority.**

VicRoads

Performance management framework

5.48 VicRoads' annual strategic business plan sets out certain customer service, revenue and transaction targets relating to motor vehicle stamp duty processing and collections. Audit identified that while there was monthly reporting of actual collections against budget, there was no regular monthly monitoring and reporting of performance against all of the established targets.

5.49 **To enhance VicRoad's performance management, it is important that monthly management reports detail all appropriate performance indicators and targets to assess the effectiveness of motor vehicle stamp duty collections.**

Detection of understatement of stamp duty

5.50 VicRoads staff involved in processing private motor vehicle registration and transfer documents are responsible for ensuring that the market values declared within those documents, for the purpose of calculating stamp duty, are reasonable. To assist in this task, dealers' industry guides are available to staff, which are updated on a monthly basis. In addition, VicRoad's procedures, policies and business rules provide some assistance to staff in assessing, calculating and recording stamp duty payable on motor vehicles transactions.

5.51 Consistent with the previous audit findings it was evident that considerable reliance is placed on the judgement of VicRoads' staff to determine whether declared market values are reasonable.

5.52 Of a total of 194 000 motor vehicle transfers that were processed at VicRoads during the year ended 30 June 1997, audit observed from the available documentation that **on average only 1.8 per cent were queried for possible understatement of vehicle market values.** However, this does not take into account any verbal queries made by counter staff who process approximately 40 per cent of the transactions.

5.53 A factor which may impact on the low market value query rate is that some 60 per cent of all motor vehicle transfers are received by mail and are processed by an external contractor whose performance is linked to the number of transactions processed which may act against a more considered review of market values that have been declared.

5.54 **An audit examination of an extensive sample of stamp duty transfer documents processed at VicRoads revealed that 58 per cent of declared market values were below the values listed in the dealers' industry guides used by VicRoads, for a vehicle purchased by a dealer in average condition.**

5.55 **Existing procedures, policies and business rules of VicRoads need to be further developed to clearly articulate the definition of market value, as far as is currently possible given the existing legislative framework, and the procedures to be applied in assessing the reasonableness of such values. In addition, while dealers' industry guides provide a reference point against which staff can judge the reasonableness of declared market values, consideration could be given to automating the dealer's industry guides to enable more efficient and effective on-line matching by staff of declared market values to values prescribed by the guides.** This could be further supplemented by the generation of regular exception reports to identify potentially suspect declared market values for selected categories of vehicles based on industry guides. Audit notes in this regard that in light of the existing data limitations on VicRoads, systems such exception reports could only be expected to identify a small proportion of suspect market values but would nevertheless represent an efficient and cost-effective mechanism to identify suspect transactions.

Action taken on transactions deemed to have suspect market valuations

5.56 Where VicRoads staff identify a declared market value as unreasonable, a letter of notification, stating that the market value is considered unreasonable is automatically generated from the VicRoad's system and forwarded to the person requesting the transfer or registration. VicRoads receive a response to around 56 per cent of its notices of query, of which 63 per cent voluntarily amend upwards the market values of their vehicles. If a response is not received within 3 weeks of notification or if a response is deemed unsatisfactory, the details are submitted to the State Revenue Office for further investigation and the possible issue of a further letter, which includes an amended assessment of the stamp duty payable. The need for the State Revenue Office to be involved in this process is a result of VicRoads not having the legislative responsibility to issue assessments or impose penalties.

5.57 **The current separation of the above functions is not considered conducive to the efficient administration of motor vehicle stamp duty.**

5.58 Audit also observed that the letter issued by VicRoads only requires respondents to provide a revised market value without any supporting documentation which may substantiate, for example, a lower valuation due to the poor condition of a vehicle. Furthermore, where additional stamp duty amounts are received, **no further checks are undertaken by VicRoads to evaluate the adequacy of such amounts and no penalties are levied in respect of the initial understatement of market values as VicRoads does not have the legislative ability to do so and does not refer these cases to the State Revenue Office.**

Audit estimation of the extent of undervalued transactions

5.59 As previously mentioned, the audit examination of an extensive sample of stamp duty transfer documents processed at VicRoads revealed that in 58 per cent of cases, declared market values were below the values in the dealers' guides used by VicRoads, for a vehicle purchased by a dealer in average condition. The extent of understatement of market values was around $2 300 on average per vehicle, which equated to an understatement of stamp duty of $96 on average in each case. While this position represents an improvement on the findings of the previous audit review which estimated the understatement of stamp duty on average per private vehicle transfer at $121, the current level of understatement nevertheless, remains excessive.

5.60 Based on an extrapolation of the results of the current audit examination, it is **estimated that up to $10.8 million in stamp duty could be forgone each year on private motor vehicle transfers alone**. This estimate excludes initial motor vehicle registrations and motor vehicle transfers by dealers.

5.61 When undertaking the testing of transfer documents, audit also identified:

- a significant number of the transfer forms did not contain sufficient information of the model of the vehicle, to enable a proper assessment of the market value to be undertaken; and
- where market values were found to be below the values prescribed by the dealers' guide, there was no evidence to indicate that the values had been reviewed and accepted as appropriate.

State Revenue Office

Investigations of cases referred by VicRoads

5.62 VicRoads refers around 130 cases each month of suspect declared market values in relation to motor vehicle registrations and transfers between private persons to the State Revenue Office.

5.63 **Audit identified that the State Revenue Office did not investigate any of the cases referred by VicRoads for the period March 1996 to March 1997.** However, the cases referred by VicRoads for the period 1 April 1997 to 30 June 1997 were examined by the State Revenue Office, resulting in 22 of the largest cases of understatement being followed-up by requesting an amount of additional stamp duty. Of those 22 cases, 9 respondents made additional stamp duty payments. In view of the favourable outcome from this process, **serious consideration should be given to the follow-up of all referrals through the issue of further letters of request, to maximise stamp duty revenue collections.**

5.64 Furthermore, to improve the overall cost-efficiency of the collection process, consideration should also be given to assigning responsibility for these investigations to VicRoads.

Stamp duty payable by dealers

5.65 Registered used car dealers are charged with the responsibility of collecting stamp duty on motor vehicles sold by them and forwarding it directly to the State Revenue Office. The Act stipulates that the dealer shall, not later than 21 days of each calender month, furnish to the Comptroller of Stamps a statement in the prescribed form together with the amount payable. During the 1996-97 financial year, the State Revenue Office collected $130 million of stamp duty from registered used car dealers.

5.66 The audit review identified that the level of information provided to the State Revenue Office by dealers is limited to the total amount of stamp duty payable for the month and a certification by the dealers that the amount is true and correct. **The absence of detailed information on individual motor vehicle sales precludes any initial assessment by the State Revenue Office of declared market values and stamp duty paid by dealers, and consequently heightens the risk of underpayment by dealers.**

5.67 While the collection of stamp duty revenue from dealer transfers is undertaken by the State Revenue Office, individual transfer documents are nevertheless submitted to VicRoads for recording on its registration database. **Given this situation and while not restricting the conduct of investigations relating to the collection of stamp duty by the State Revenue Office, it is considered that it would be more efficient and effective for VicRoads to undertake the collection and assessment of stamp duty revenue relating to dealer transactions.**

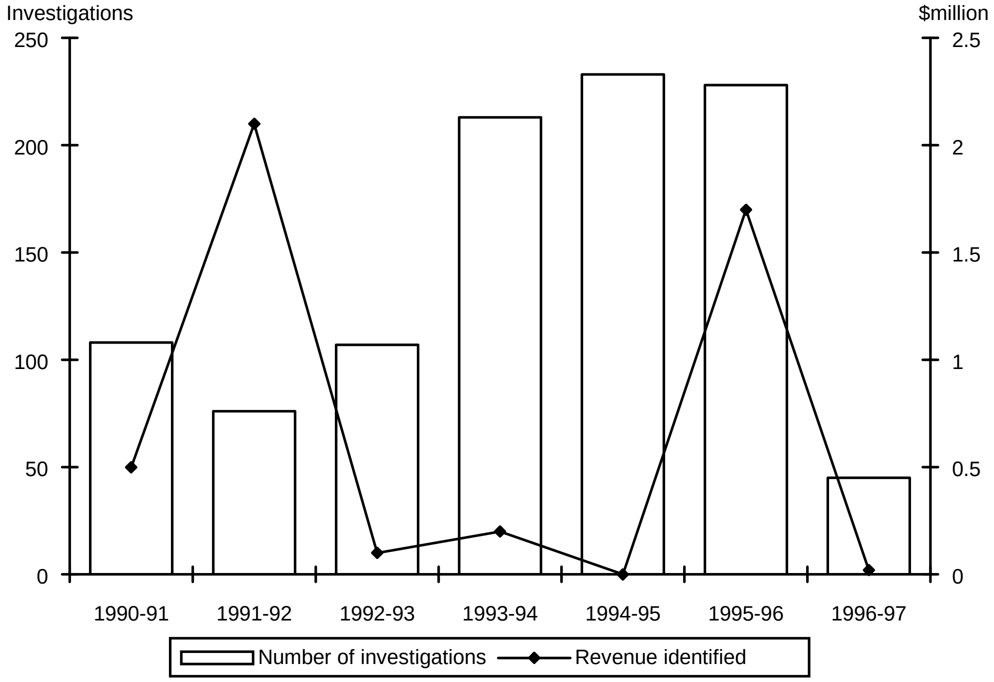
Investigation activities

5.68 All investigations of stamp duty payments carried out by the State Revenue Office, are aimed at ensuring that:

- tax avoidance or evasion is identified;
- correct taxes have been paid in a timely manner, complete records have been maintained and accurate information has been provided by taxpayers; and
- taxpayers meet their obligations under the relevant tax legislation.

5.69 Chart 5K outlines the number of investigations undertaken by the State Revenue Office into the collection of motor vehicle stamp duty by dealers and the additional revenue identified from those investigations over the period 1990-91 to 1996-97.

CHART 5K
INVESTIGATIONS CONDUCTED OF DEALERS AND ADDITIONAL REVENUE IDENTIFIED



5.70 While the level of investigation activity in relation to dealers was high during the 1993-94 to 1995-96 financial years compared with previous years, there was a substantial decline in this activity during the 1996-97 financial year due to a re-direction of resources to other areas of the State's tax base.

5.71 A standardised approach is followed by the State Revenue Office's investigators in undertaking investigations of dealer transactions, including the formal notification of the investigation, organising visits to the selected dealers, examination of relevant documentation maintained at the dealers' premises and subsequent reporting of findings.

5.72 In conducting such investigations, information submitted by the dealers in their monthly stamp duty returns, is checked against records maintained by the dealer to ensure all stamp duty amounts have been accurately remitted to the State Revenue Office and that dealers have complied with the requirements of the Act.

5.73 However, audit observed that the State Revenue Office does not liaise with VicRoads prior to the conduct of such investigations, notwithstanding that VicRoads maintains a record of all individual dealer transactions that have been processed. **To further enhance the targeting and cost effectiveness of investigations and compliance activities, there is scope for greater use of information retained by VicRoads.**

Performance management framework

5.74 The State Revenue Office's performance management framework, as it relates to motor vehicle stamp duty collection, primarily comprises reporting on actual collections compared to budget. The development and utilisation of more comprehensive performance indicators, such as the number of dealer investigations, the number of assessments made and the benefits and costs of such investigations may further assist in improving the effectiveness of this revenue collection activity.

❑ ***RESPONSE** provided by the Chief Executive of VicRoads*

Identification of market value for stamp duty purposes

VicRoads has previously raised this issue on a number of occasions with the SRO. Any initiative to develop a verifiable measure of market value is strongly supported.

Service Agreement

Although the development of a Service Agreement is the responsibility of the service purchaser (SRO), VicRoads has initiated a draft agreement in recognition of the need for such a document.

This draft document has been submitted to the SRO on several occasions and VicRoads is continuing to negotiate the formulation of an initial agreement.

VicRoads - Performance management framework

Monthly volume and financial reports are currently produced within VicRoads. It is expected that other performance reporting will be generated as an outcome of the upcoming Service Agreement with the SRO.

Detection of understatement of stamp duty

After requests from VicRoads, the SRO instructed that VicRoads staff use the Glass's Guide when reviewing declarations of market value. This guide provides three levels of assessment of a vehicles market value, namely fair/average, average and above average condition. However, as long as a vehicle's declared market value falls within the total range it is accepted, in accordance with the SRO's instruction.

The introduction of computer based copies of the Guide and automation of minimum valuations would enable the production of exception reports of possible understated market value. It is noted that the cost of implementing the required enhancements is considerable. The issue has however been discussed with the SRO which is the responsible body for such enhancements.

VicRoads believes that the 58% figure is misleading as the market value assessment of the vehicles used in the sample was compared to the average value of a specific make and model. No allowance was made for any vehicle which fell into the fair/average range (eg. ex-taxis, poorly maintained vehicles, vehicles with few options, unpopular sub models and colours etc.).

❑ ***RESPONSE*** *provided by the Chief Executive of VicRoads - continued*

VicRoads provided the auditors with samples for four specific makes and models which compared declared value to the fair/average range of market value. These results showed variations of only 0.5% to 4% of possible understated market values. The results of these examinations have not been included in the auditor's report.

Based on the above information, the estimated $10.8 million of stamp duty forgone per annum is considered to be substantially overstated.

Actions taken on transactions with syspect market valuations

VicRoads acts as a collection agency on behalf of the SRO and therefore the SRO should provide a framework of policy and business rules for the implementation of such actions.

Stamp duty payable by dealers

The recommendation would place an additional and unnecessary step in the process if VicRoads were to assess all stamp duty declarations now submitted by dealers to the SRO. It would also require VicRoads to engage additional resources to handle these referrals.

VicRoads believes that there should be no change in the current referral arrangements for dealers. Any identified deficiencies in the current system should be addressed by the SRO.

Investigations activities

VicRoads will continue to respond positively to any request for assistance from the SRO for information to assist its investigations.

❑ ***RESPONSE*** *provided by the Commissioner of State Revenue*

Revenue Foregone/Correct identification on the market value

The revenue foregone estimate of $10.8 million is considered excessive as it was based on a specific dealer's guide value using the limited information contained on the notice of acquisition. The SRO believes that the extent of revenue foregone under current arrangements is minor. Our investigation of suspect declarations as supplied by VicRoads, further supports the conclusion that any revenue leakage is small.

Further, it should be noted that the application to transfer requires that both the buyer and seller to verify the market (sale) price. The Auditors suggestion that in 58 per cent of the transfers, the buyer and seller knowingly underdeclare is not acceptable.

SRO and VicRoads counter staff use the Glass's Guide to help them determine if the declared market value reasonable, ie the market value is within the value range in the guide. Glass's is a dealers reference or guide which cannot be literally taken as it is restricted in its literal application in private to private market transactions.

❑ ***RESPONSE** provided by the Commissioner of State Revenue - continued*

The Auditors have used Glass's guide as the definitive basis on which to determine under-declaration of market value. We must stress that Glass's Guide is only an industry guide which cannot be literally applied as a standard benchmark against each sale. The Glass's Guide in its terms and conditions of subscription and renewal states "The subscriber acknowledges and accepts that the information contained in the services and updates is only intended as a guide and/or indicator as to the approximate market values and the information may be out of date or may be rendered out of date or may otherwise be inaccurate due to market fluctuations and other circumstances occurring subsequent to the research for and publication of the service and updates". The Auditors chose to use a mid point value assuming average/fair condition, rather than using the full stated range which is the practice at VicRoads and State Revenue. This was always going to give rise to variations. Market value determination was also based on the information provided on a notice of acquisition which is limited and provides no indication as to the condition of the vehicle.

The value for stamp duty purposes is described in the Act (137B(1)a) as - "the price at which a motor vehicle might have been reasonably sold, free from encumbrances in the open market or the purchase price, which ever is the greater". In other words, the market value would generally be agreed as being the price paid between a willing buyer and a willing seller in an arms length transaction. In many ways the price (market value) of a vehicle depends on a range of both subjective and qualitative measures, these are appearance, general condition, options fitted, maintenance/repair schedule etc. One has only to look at the weekend papers for any category of vehicle to find there is a significant range of advertised sale prices that will vary to the Glass's Guide. These reflect the realities of the market in that each sale is viewed in isolation as is the respective worth any buyer will attach to an individual vehicle.

Simplification of the Act - Assessment of value based on the Dealer's Guide

The proposal to incorporate a Dealer's Guide within the legislation would in fact increase the complexity and administrative costs under the current Act. The Glass's Guide is a dealers guide which means that it is not a generally available information source for the general public. Administrative costs would be incurred in setting up and maintaining a system to make this information available to the general public. The guide is also limited in that is revised monthly and does not cover all vehicles sold within Victoria nor does it specifically cover all options or accessories that may be fitted to the vehicle.

Currently stamp duty is imposed on an ad valorem basis (value of the underlying transaction) whereas the imposition of duty on a prescribed basis would change the underlying nature of the tax.

❑ ***RESPONSE** provided by the Commissioner of State Revenue - continued*

Service Agreement/Performance Management Framework

Steps have been taken to prepare a formal service agreement between the State Revenue Office and VicRoads and it is expected that will be finalised by the end of December. However it should be noted that the current level of review and interaction is reflective of the time and effort that has been put in between the SRO and VicRoads over the period to improve the administration and collection of motor car stamp duty. The issue of letters querying the declared market value is an administrative procedure that has been agreed between the SRO and VicRoads. SRO has also provided training to VicRoad's counter staff to assist in the application of this procedure.

Investigations

Investigations on recent current year referrals have not produced results that would suggest the amounts of revenue generated would significantly exceed the individual investigation costs as the determination of market value is very subjective. Currently the Act places the onus on the purchaser to provide a declaration signed by the seller and purchaser on the market value of the vehicle being transferred. The information on the notice of acquisition is limited and further information is required to assist an investigator to determine if there has been an under-declaration of value before proceeding to issue an assessment. Additional work is required on a case by case basis to obtain sufficient information to determine on a reasonable basis whether to issue an assessment or conclude the matter.

The Audit report suggests that the absence of detailed monthly returns on sales from used car dealers raises a further risk of underpayment. No evidence has been produced by the Auditors to support this comment. In order to reduce compliance costs, monthly returns were replaced with a remittance advice. This also reduced the administration costs for the SRO. The Act (137 AA to 137 AG) sets out all the requirements to be satisfied for Registered Used Car Dealers including record keeping. In 1991-92 the SRO undertook a detailed audit of car sales at both new and used car dealers. The results of that audit did not bear out your office's claims that significant revenue leakage was occurring through the under-declaration of market value. Ongoing monitoring and investigations of car dealers since then, has confirmed that there is a high level of compliance.

The Audit report also suggests the transfer of investigation staff's skills to VicRoads would also be effective and efficient. This recommendation fails to fully understand the required investigation skill and administrative support structures and systems that would be necessary to support a very limited operation. The administration process would involve issuing assessments, followup and collection of outstanding assessments. This proposal would be neither effective or efficient.

It was also suggested that SRO does not liaise with VicRoads on investigations. There are monthly liaison meetings which regularly deals with all aspects of the operation between both offices. VicRoads data is utilised in the conduct of investigations however not all relevant data is available from the VicRoads database.

Performance Management Framework

The information referred to in the Audit report is currently available and is used by the SRO to manage and monitor current activity.

❑ ***RESPONSE** provided by the Commissioner of State Revenue - continued*

Future Developments

Following our discussions with the Auditors, steps will be taken to see if it is cost effective to develop the VicRoads database further to enable the system generation of a query and a subsequent followup letter for suspect under-declaration of market values within a defined set of rules. This may provide for an effective monitoring and followup system without the administrative overheads.

PART 6

Expenditure

VICTORIAN
AUDITOR-
GENERAL'S
OFFICE

Auditing in the Public Interest

Summary of State expenditure

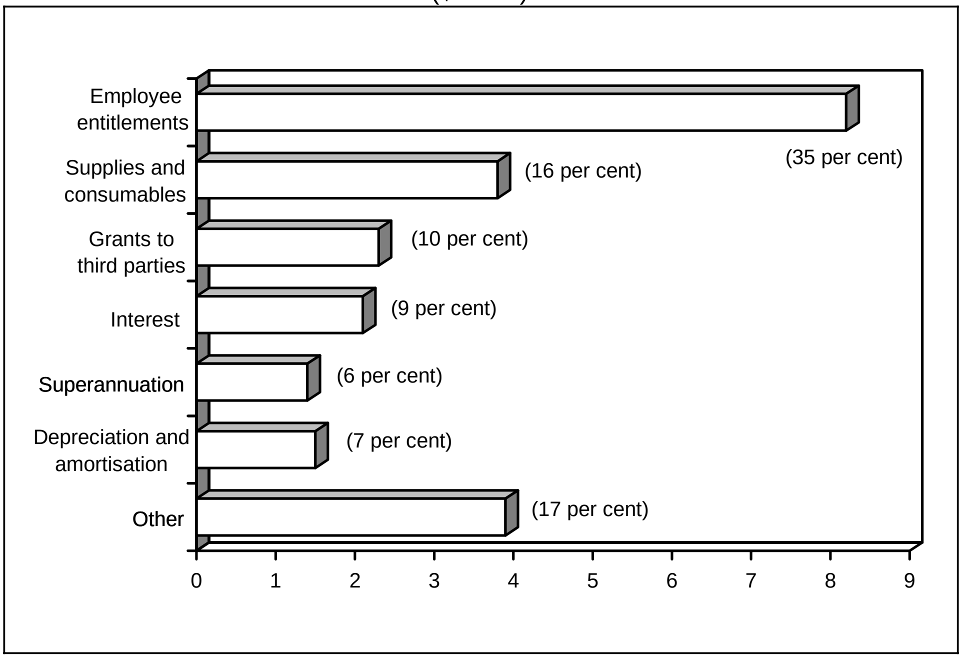
6.1 **During the 1996-97 financial year, the operating expenses of the State totalled $23.1 billion** and mainly comprised costs associated with employee remuneration and related leave and superannuation entitlements, the purchase or production of supplies and consumables, debt financing costs, and grants and other transfer payments to external organisations. Table 6A provides a summary of the operating expenditure for the year.

TABLE 6A
OPERATING EXPENDITURE, 1996-97
($billion)

Item	*Amount*
Employee entitlements	8.2
Supplies and consumables	3.8
Grants and other transfer payments	2.3
Interest and other financing costs	2.1
Superannuation	1.4
Depreciation and amortisation	1.5
Other expenses	3.8
Operating expenses before abnormal items	**23.1**

6.2 As shown above, the costs associated with employee entitlements, the purchase of supplies and consumables (including the cost of the production of electricity by government-owned generation businesses), interest, and grants to external organisations account for around 77 per cent of total operating expenses. Chart 6B further illustrates the major expenditure categories for the year.

CHART 6B
MAJOR OPERATING EXPENDITURE CATEGORIES, 1996-97
($billion)



Summary of Consolidated Fund transactions

6.3 As mentioned previously in this Report, the Consolidated Fund is the Government's main operating account and records the expenditure incurred by Departments under the authority of parliamentary appropriations, associated with the funding of programs and other financial obligations of the State.

6.4 **The Consolidated Fund payments for the year totalled $21.9 billion**, which was $2.6 billion greater than budget expectations. However, these payments included the application of the proceeds received from the privatisation of State-owned enterprises mainly towards the retirement of budget sector debt.

6.5 When the transactions associated with the application of privatisation proceeds and a further amount of $1.2 billion paid to the Treasury Corporation of Victoria for application towards debt retirement are excluded, **the year's Consolidated Fund payments were $696 million below budget expectations**. Table 6C provides a summary of the year's gross payments.

TABLE 6C
1996-97 ACTUAL AND BUDGETED PAYMENTS
($million)

Item	*1995-96 Actual*	***1996-97 Actual***	*1996-97 Budget*	***Variance from Budget***
Recurrent -				
Annual appropriations *(a)*	12 271	**12 709**	13 298	**(589)**
Special appropriations	1 695	**1 807**	1 713	**94**
Total recurrent	13 966	**14 516**	15 011	**(495)**
Works and services -				
Annual appropriations	1 759	**1 918**	2 120	**(202)**
Special appropriations	4 640	**5 482**	2 170	**3 312**
Total works and services	6 399	**7 400**	4 290	**3 110**
Total payments	20 365	**21 916**	19 301	**2 615**

(a) Does not include expenditure on finance charges of $947 million (1995-96, $290 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.

6.6 Departmental expenditure was generally below budget expectations, particularly in the recurrent sector. The following major factors favourably impacted on the year's payments outcome:

- Budget sector debt financing charges were $259 million below budget estimates due to the achievement of savings from the application of privatisation proceeds towards debt retirement, lower than anticipated interest rates in the year and certain payments associated with structured financing not proceeding. However, these budget savings were in part offset by additional interest costs associated with the restructuring of the debt portfolio in the year;
- Funds set aside for the Treasurer to meet urgent claims of $71 million were not required;

- Spending associated with the transfer of certain repatriation services from the Commonwealth Government to the State was $67 million below budget expectations;
- An amount of $28 million associated with the relocation of the Coode Island Chemical Storage Facility to Point Lillias was not utilised due to a government decision not to proceed with this project in the year; and
- Expenditure on health services was $24 million lower than expected due to reduced Medicare Agreement funding from the Commonwealth Government;

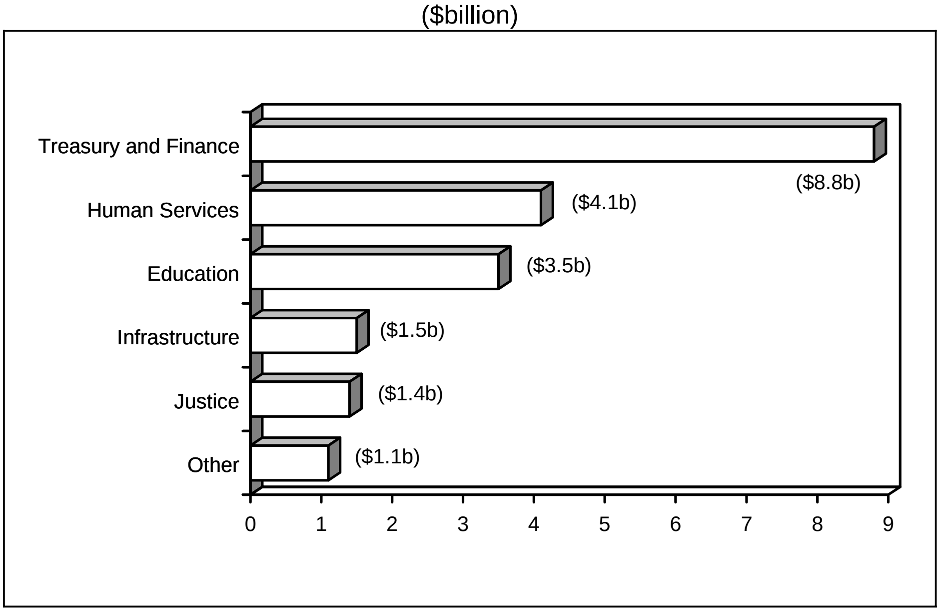
6.7 However, these savings were to an extent offset by the following expenditures that were not specifically budgeted:

- contributions to the State Superannuation Fund were increased by $54 million due to additional redundancy payments incurred in the provision of employee departure packages and targeted separation packages;
- a refund of $38 million to the State Electricity Commission of Victoria of State-equivalent taxation payments previously made by Hazelwod Power Corporation, which was subsequently repaid to the Consolidated Fund;
- additional payments of $19 million associated with the receipt of additional Commonwealth grants under specified school assistance programs; and
- additional outlays of $13 million associated with the commencement of the rationalisation of the Jolimont rail yards and other transport-related programs.

Major spending departments

6.8 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 6D below, these portfolios collectively represent 95 per cent of total Consolidated Fund payments.

CHART 6D
DEPARTMENTAL EXPENDITURE LEVELS, 1996-97 *(a)*
($billion)



(a) Represents total net appropriation payments.

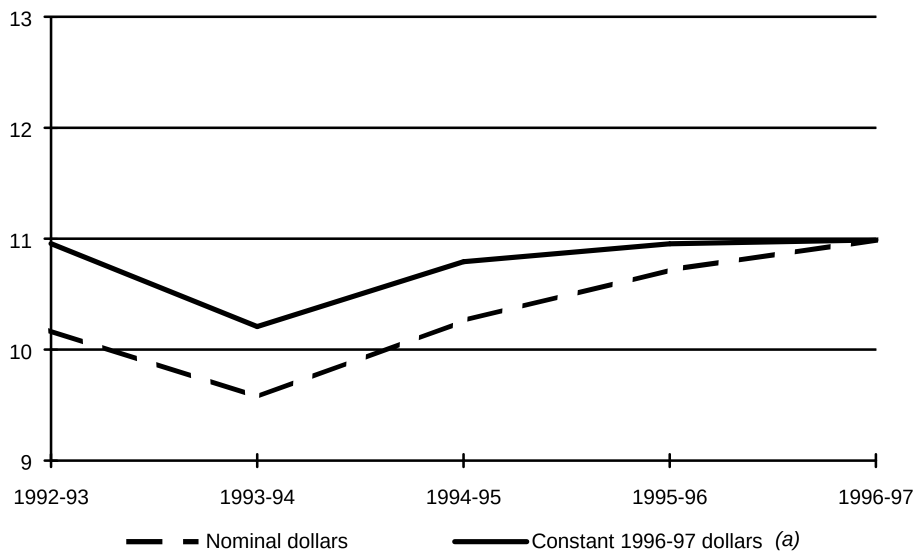
Trends in level of operating expenditure

6.9 A major objective of the Government is to deliver high quality services at least cost to taxpayers. To assist in achieving this objective, in recent years, the Government has embarked on a substantial management reform program which, inter alia, involves a shift of focus from the funding of departments on the basis of inputs to the funding of specific outputs delivered.

6.10 A key element of this shift in financial management focus will involve the development of meaningful performance indicators to facilitate departmental accountability for the delivery of specified outputs, at the required standards. In this regard, substantial work is currently underway within departments in relation to the specification of outputs and the development to appropriate performance indicators.

6.11 **Given that considerable work remains to be undertaken in regard to the development of robust output specifications and associated performance indicators, it is difficult to undertake a comprehensive and conclusive assessment of trends in the level, quality and cost-efficiency of service delivery by departments**. Notwithstanding this limitation, audit undertook an analysis of trends in the level of Consolidated Fund operating expenditure incurred by departments since the 1992-93 financial year. This analysis excluded abnormal expenditure items, finance charges, superannuation costs and certain payments associated with previously established financial support arrangements. Chart 6E illustrates the result of this analysis.

CHART 6E
CONSOLIDATED FUND OPERATING EXPENDITURE, EXCLUDING ABNORMAL EXPENDITURE ITEMS, FINANCE CHARGES, SUPERANNUATION COSTS AND MAJOR FINANCIAL SUPPORT ARRANGEMENTS
($billion)



(a) Represents constant 1996-97 dollars, based on the Australian Bureau of Statistics (ABS) gross non-farm product price indices (*ABS National Accounts* - No. 5206).

6.12 The chart highlights that **while core departmental operating costs have increased in nominal terms by around 8 per cent over the past 5 years, the level of these costs has remained relatively constant in real terms since the 1992-93 financial year**. In particular, while there was a significant reduction in the level of expenditure in the 1993-94 financial year, since that date expenditure levels have increased, with the major factors contributing to this increase, as advised by the Department of Treasury and Finance, as follows:

- various new policy measures introduced by the Government;
- transfer of responsibility for the funding of certain activities from the Commonwealth Government to the State; and
- higher costs associated with increases in demand for public services and increases in wages and related employment costs.

6.13 **The completion of the development of comprehensive and robust output specifications and associated performance indicators, in future years, should assist in more conclusive assessments being undertaken on the extent to which the Government is achieving one of its key objectives, namely, the provision of high quality services at least cost to taxpayers.**

❑ ***RESPONSE*** *provided by the Secretary, Department of Treasury and Finance*

Approximately $171 million (approximately 1.7 peer cent) of the nominal 8 per cent increase over 5 years relates to adjustments to the 1996-97 result for items reclassified from Works and Services to current expenditure as identified by audit in Table 3E.

DTF notes that most of this reclassification relates to items which are associated with specific capital projects and as such are once-off in nature. The remainder relates to reclassifications of payments which are ongoing and have now been correctly reclassified for 1997-98. However, to more accurately present the trend of payments since 1992-93, the reclassifications should also be adjusted over the earlier years and the once-off transactions should be excluded from the 1996-97 result. ***Applying these adjustments and excluding the once-off payments produces a corrected nominal increase of approximately 6 per cent over the 5 year period (or a 1.6 per cent decrease in constant price terms).***

Finance charges

6.14 Debt-related payments represent a major component of aggregate Consolidated Fund payments. In particular, **finance charges paid from the Consolidated Fund in the year, which represent the annual cost of borrowings previously raised by the Government to meet the State's obligations, in 1996-97 totalled $1.4 billion**. Table 6F provides details of interest paid in the period in relation to Public Account borrowings compared with the previous year.

TABLE 6F
INTEREST CHARGES PAID ON PUBLIC ACCOUNT BORROWINGS
($million)

Item	***1996-97***	*1995-96*
Treasury Corporation of Victoria (TCV) borrowings	**1 372**	1 945
Other financing *(a)*	**52**	60
Total interest paid *(b)*	**1 424**	2 005

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

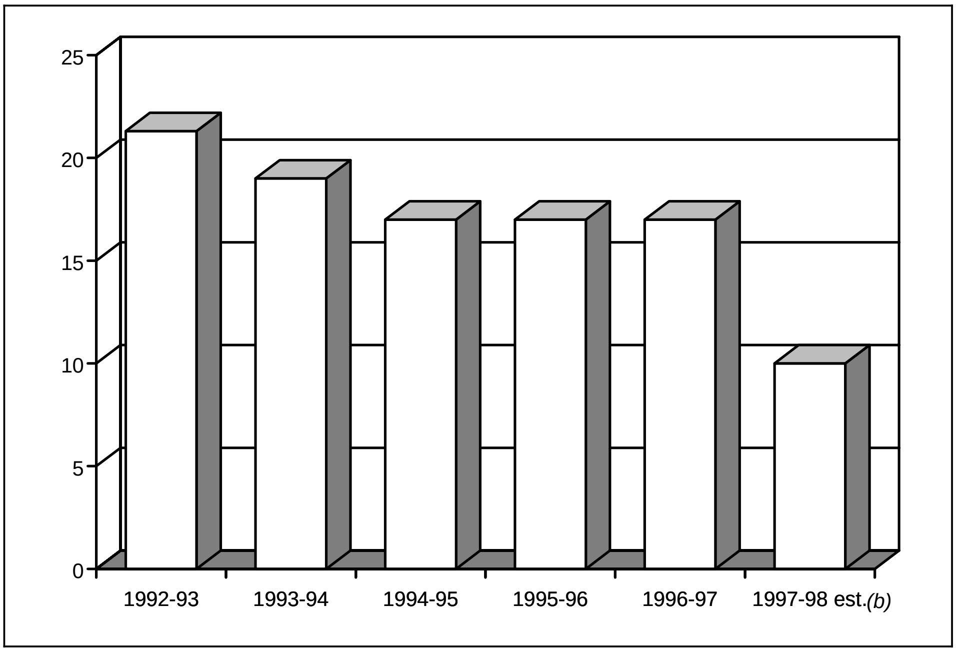
(b) A further amount of $947 million (1995-96, $290 million) of finance charges were offset against new borrowings outside the Consolidated Fund by the Treasury Corporation of Victoria.

6.15 The major factors contributing to the decrease in interest paid was the reduction of budget sector debt in the year resulting from the application of privatisation proceeds and the restructure of the budget sector debt portfolio during the year.

Impact of borrowings on the Consolidated Fund

6.16 Chart 6G highlights the impact of finance costs on the budget over the past 5 years.

CHART 6G
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 contained in the *1997-98 Budget Papers.*

6.17 The chart illustrates that the impact of finance charges on the budget has declined in recent years, reflecting the favourable outcome of the Government's privatisation program and the budget management strategies.

State's credit rating

6.18 The State's credit rating is a major determinant of the level of finance charges that are payable by the Government on borrowings. In this regard, 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"*.

6.19 As highlighted in my previous Reports to the Parliament, while the difficulties experienced in the State's budgetary position and the increasing debt levels in the late 1980s and the early 1990s led to a substantial downgrading of the State's credit rating at that time, enhanced budgetary and debt reduction strategies established by the Government in recent years have positively impacted on the credit rating.

6.20 Subsequent to the State Budget in September 1996, 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"*. Furthermore, in March 1997, this credit agency re-confirmed this rating as remaining stable.

6.21 In December 1996, Moody's Investors Service also raised its rating for long-term Australian denominated debt guaranteed by the State from Aa2 to Aa1. This credit agency stated that this decision was based on the *"... dramatic reduction in public sector net debt occasioned by privatisation, as well as the continuing improvement in the State's budgetary position"*.

6.22 **The progressive upgrade of the credit rating represents a substantial achievement by the Government, reflecting the strengthened financial market confidence in the State's financial standing**. The State's credit rating is now only one rung below the highest rating of AAA, therefore, the Government is well placed to achieve its long-term objective of attaining this rating.

Australian Grand Prix Corporation

6.23 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 at Phillip Island have been outlined in my previous Reports to the Parliament.

6.24 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. Subsequently, 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.

6.25 Subsequently, the Australian Grand Prix Corporation was established in October 1994 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. In November 1994, the Corporation assumed certain rights, assets and liabilities of the MGPP by agreement with the company.

Formula One Grand Prix

6.26 The costs incurred by the State in relation to the set-up and staging of the first Formula One Grand Prix event in Melbourne in March 1996 were outlined in my October 1996 Report to the Parliament. An analysis of the second Formula One Grand Prix event, which was staged in Melbourne in March 1997, is outlined in this Report.

6.27 **The net operating costs incurred by the State on the Formula One Grand Prix project, determined on an accrual basis, relating to the 1996-97 financial year were $6.7 million,** including depreciation and amortisation of $3.2 million relating to the utilisation of associated infrastructure and other assets, and net costs of $778 000 met by the Public Transport Corporation in relation to the event.

6.28 **Since the inception of the event, the net aggregate operating costs incurred by the State totalled $18.4 million**, which included set-up and establishment costs of an operating nature of $4.8 million, and depreciation and amortisation of $6.6 million.

6.29 A study undertaken by a consultant 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, including an estimated $6.9 million generated from additional taxation receipts to the State. The conclusions in this study were not subject to my Office’s scrutiny. A similar study was not undertaken for the 1997 Grand Prix event.

6.30 Table 6H illustrates the outcome achieved in staging the event for the 1996-97 financial year.

TABLE 6H
COSTS INCURRED BY THE STATE IN RELATION TO THE STAGING OF THE FORMULA ONE GRAND PRIX EVENT, 1996-97
($million)

Item	*Amount*
Australian Grand Prix Corporation operating loss in staging the 1997 event, **excluding** other costs detailed below	**2.7**
Add -	
Depreciation and amortisation costs	**3.2**
Public Transport Corporation net operating costs incurred in relation to the event *(a)*	**0.8**
Total operating cost to the State *(b)*	**6.7**

(a) The Public Transport Corporation (PTC) incurred total costs of $1.2 million in relation to the event, comprising $904 000 in relation to the provision of buses as a result of the public transport strike during the Grand Prix weekend, $99 000 in additional associated wages and $196 000 in other costs. However, the PTC received a gross amount of $421 000 from the Australian Grand Prix Corporation as a reimbursement, which was consistent with the amount charged in 1996 for the provision of a shuttle tram service.

(b) A further amount of $1.4 million was contributed by public sector agencies relating to sponsorships which were negotiated on a commercial basis.

6.31 **While the Australian Grand Prix Corporation aimed to achieve a self-funding position for the 1996-97 financial year, the actual result was an operating loss of $2.7 million, before depreciation and amortisation and costs met by other entities**. A major factor contributing to the unfavourable outcome was a shortfall in sales revenue on grandstand and general admission ticket sales, which were adversely affected by a public transport strike during the Grand Prix weekend.

6.32 In addition to the operating costs associated with the staging of the event, during the 1996-97 financial year, works were undertaken by the Corporation under licence for Parks Victoria at a cost of $188 000, which were funded by the State and the related assets transferred to Parks Victoria. Further costs of $5.2 million associated with race infrastructure were also funded by the Government, which included payments relating to assets previously acquired by the Corporation.

6.33 In relation to future Formula One Grand Prix events, the Corporation's objective as outlined in its Annual Report is to make a direct positive contribution to Government, taking into account the taxation receipts generated by the event. There are a number of inherent 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 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 or otherwise impacting on the Corporation; and delays in the establishment of the required temporary facilities.

6.34 As indicated in my previous Reports 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.

6.35 As also indicated in my October 1996 Report, the Treasurer in March 1996 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 1997 Grand Prix event. Nevertheless, the State retained certain exposures, including claims in excess of the insurance policy limits and certain commercial risks.

Australian Motorcycle Grand Prix

6.36 As outlined in my October 1996 Report to the Parliament, in May 1995 the Government announced the return of the Australian Motorcycle Grand Prix to Phillip Island. This event is also to be managed by the Australian Grand Prix Corporation.

6.37 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.

6.38 **Under the arrangements, 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 $3.2 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, estimated a $63 million economic benefit to the State, and $3.7 million in State Government tax receipts, attributable to the event.

6.39 **During the 1996-97 financial year, Consolidated Fund contributions of $944 000 were provided to the Corporation to meet set-up costs incurred in relation to the Motorcycle Grand Prix event to be held in October 1997, taking the aggregate contribution by the State towards this event to $1.3 million since the 1995-96 financial year.**

6.40 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 taken 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.

Electricity industry reforms - payments to external service providers

6.41 My previous Reports to the Parliament and earlier Parts of this Report have included extensive comment on the Government's reforms relating to the electricity industry. In particular, these Reports have commented on the results achieved by the Government from the privatisation of individual electricity businesses and the costs associated with the reform program.

6.42 This section of the Report provides comment on the aggregate costs incurred by the Department of Treasury and Finance during the period 1994-95 to 1996-97 on the engagement of external service providers, including consultants and contractors, in relation to the electricity industry reforms. Furthermore, the Report comments on the processes adopted by the Department for the selection and engagement of external service providers which have been engaged primarily to provide advice and support in respect of industry reforms.

6.43 While the report focuses on the processes adopted for the selection and engagement of external service providers, it does not seek to judge the cost-effectiveness of the use of the external service providers or to comment on the extent to which these service providers have contributed to the achievement of the Government's overall policy objectives.

Extent of the use of external service providers

6.44 **The audit review identified that in the 3 year period covering 1994-95 to 1996-97, the Department entered into approximately 130 separate contractual arrangements which resulted in expenditure totalling $106 million on external service providers, including consultants and contractors, primarily related to electricity industry reform**. Services provided through these arrangements included the provision of advice and support, and the conduct of various studies and analyses, in the following areas:

- legal and regulatory;
- communication and advertising;
- industrial relations;
- financial and accounting matters;
- environmental audit;
- technical matters;
- executive search and remuneration;
- training; and
- project management.

6.45 **An analysis indicated that 7 external service providers accounted for around $96.9 million, or approximately 90 per cent, of total payments made by the Department to external service providers in relation to the electricity reforms over the above period.** Details of such payments are outlined in Table 6I.

TABLE 6I
PAYMENTS BY THE DEPARTMENT TO MAJOR EXTERNAL SERVICE PROVIDERS, 1994-95 TO 1996-97
($million)

Service Provider	*Amount*
CS First Boston	46.9
KPMG Peat Marwick	26.8
Freehill Hollingdale & Page	6.9
DGJ	6.1
Troughton, Swier & Associates *(a)*	5.6
Mallesons Stephen Jaques	3.5
Arthur Robinson & Hedderwicks	1.1
Total	**96.9**

(a) Excludes payments as a departmental officer and separate consultancy payments of $682 000 for Dr Troughton prior to May 1996.

6.46 Given the concentration of a large proportion of expenditure to a small number of contracts, audit decided to focus on these significant contracts, which resulted in a coverage of around 70 per cent of the total contract payments to external service providers during the period under review. The audit review centred around the processes adopted for the selection and engagement of these external service providers. In conducting this audit, reference was made to the guidance provided in the Victorian Government Purchasing Board's *Supply Policies and Guidelines* or existing regulations as appropriate, which set out appropriate public sector practice for the engagement of such providers and the issue of service contracts.

6.47 In particular, the audit review encompassed an examination of 2 of the largest engagements, that is the arrangements with CS First Boston (as financial adviser to the electricity reform program) and KPMG Peat Marwick (as accounting adviser to the electricity reform program). In addition, the audit review examined the contractual arrangements relating to the externally appointed project leader to the reform program, and a number of other contractual arrangements. Detailed comments on the results of this audit review follow.

Project Leader for the reform program

6.48 During July 1993, Dr Peter Troughton was temporarily appointed as a consultant by the Department and, in October of that same year, was engaged under an executive officer contract as the Project Leader of the former Victorian Electricity Supply Industry Reform Unit within the Department. The Unit, which managed the reform of the electricity supply industry in Victoria, was resourced primarily by consultants and contractors.

6.49 As from February 1995, Dr Troughton's contractual status reverted back to that of a consultant, however, Dr Troughton continued to lead the Unit in his capacity as a consultant.

6.50 **The appointment of Dr Troughton as a consultant, for an average of 12 days a month up to 31 December 1995, was not subject to a tender process**. The Department approved this approach on the basis that:

- it would be extremely difficult to recruit a candidate through a public tender process who had the combined breadth of experience and the necessary detailed knowledge of the electricity supply industry in Victoria; and
- Dr Troughton had unique skills that could not be matched among public sector personnel and in the external market place at that time.

6.51 This consultancy engagement was approved at an estimated cost of $429 200, however, 2 subsequent variations to the contract took its total value to $681 700 and extended the contract period to June 1996.

6.52 **Upon the expiration of a number of consultancy arrangements within the Department, including that of Dr Troughton, a decision was taken by the Department during July 1996 to seek the engagement of the consultancy firm of Troughton, Swier & Associates, which included a number of former members of the Department's Reform Unit, including Dr Troughton, without engaging in a competitive tender process**. The rationale advanced by the Department when approving a decision not to seek competitive tenders for this consultancy, in essence, were:

- the Government did not wish to lose the expertise, experience and knowledge of the members of the consultancy firm given the potential risks associated with poor decision-making which could have resulted from the selection of less qualified and proven resources if the selection was based on price alone;
- the complexity and magnitude of the project would entail significant task familiarisation by new consultants and would therefore incur additional cost;
- it was considered that "apart from being an unnecessary costly time consuming exercise", it was highly unlikely that a tender process would present the Government with an alternative appointment; and
- it was considered unlikely that any external party would have a bona fide reason to be aggrieved by the selection approach adopted by the Department.

6.53 Under the contract awarded to Troughton, Swier & Associates during July 1996 following approval by the Victorian Government Purchasing Board the firm was engaged to act as principal consultant and to provide strategic and general project management services relating to Government reforms in the electricity, gas and aluminium industries until 30 June 1999. **The Department has estimated the total cost of the contract at $24.1 million over the 3 year period, including annual escalation by a fixed percentage and further estimated increases in line with movements in the average weekly earnings index.** The fee structure has 3 key elements, including:

- daily fees, based on normal commercial completion of service requirements;
- deferred payments, subject to the satisfaction of specified performance criteria; and
- bonus payments, which are also subject to the satisfaction of specified performance criteria.

6.54 In the absence of a competitive tender process, a substantial benchmarking exercise was undertaken which included using a consultant engaged by the Department to assess the reasonableness of the fee structure. The results of the consultant's work indicated that the proposed fee structure was consistent with their estimate of the task.

6.55 While Troughton, Swier & Associates commenced the provision of services to the Department under the current arrangements during July 1996 and an interim contract was agreed between the consultants and the Government in September 1996 to provide a basis for further negotiation on the performance-based elements of the proposed contract fee structure, the finalisation of the contract did not occur until September 1997.

6.56 The aggregate payments to Troughton, Swier and Associates for the year ended 30 June 1997 totalled $5.6 million.

Financial and accounting advisers

6.57 **The firms of CS First Boston and KPMG Peat Marwick were separately engaged during February 1994 as the financial and accounting advisers, respectively, for the electricity industry reform program. The contractual arrangements entered into with these firms have resulted in payments of $47 million to CS First Boston and $26 million to KPMG Peat Marwick during the 3 year period ending 30 June 1997, mainly comprising success fees that become payable upon the successful privatisation of individual electricity industry businesses.**

6.58 Key matters noted in respect of the selection and engagement of these external service providers are detailed below.

Period allowed for the preparation and evaluation of tenders

6.59 The audit review identified that the Invitation to Tender document for both the financial and accounting advisers was issued on 21 December 1993, with written submissions required from prospective tenderers by 7 January 1994.

6.60 In audit opinion, **such a short period which included a number of public holidays for the preparation of tender submissions may not have allowed sufficient time for the preparation of competitive tenders, particularly given the unique nature, uncertain scope and multi-million dollar value of the proposed contracts.** Audit was, however, advised by the Department that prospective tenderers had been previously informally alerted to the possibility of tenders being required within a short timeframe in relation to these services.

Retrospective approval to conduct a selective tender process

6.61 While best public sector practice and government policies require contracts with an estimated value in excess of $50 000 to be subjected to a full public competitive tendering process unless it is impracticable or inexpedient to do so, only a selective tender process was employed for both of these contracts, under which tender submissions were only sought from a selected number of potential suppliers. It was also identified that the decision not to proceed with a full public tender process was retrospectively approved by the Department after selective tenders had in fact been called and after a recommendation to appoint the successful firms had been made.

6.62 The rationale advanced by the Department for the conduct of a selective tender process in these instances was that a full public tender could not be conducted within the proposed timeframes needed for the commencement of the services and that tenders had only been sought from the major external service providers to ensure access to the best advice available.

Finalisation of contract documentation

6.63 While the financial and accounting advisers commenced providing services to the Department in January 1994, the contracts between the Department and the advisers, which were in the form of a letter of engagement, were not formally executed until May 1994. Audit was advised that the Department's former Electricity Supply Industry Reform Unit's approach at that time was that any work undertaken prior to the formal approval of contracts was at the risk of the tenderer and that no payments would be made prior to the signing of contracts.

6.64 Subsequent to the approval of the initial appointments, a number of later approvals were provided by the Treasurer and the appropriate purchasing authority, that is either the former State Tender Board, the Victorian Government Purchasing Board or the Department's Accredited Purchasing Unit, for changes in the values of the contracts. These changes to the contracts mainly related to the progressive quantification of possible success fees to be paid to the financial and accounting advisers as the number, type and estimated value of entities to be privatised became known or were able to be estimated, or as changes occurred to the agreed fee structures included in the contracts.

Deliverables

6.65 As part of the audit examination of these engagements, consideration was given to the extent to which clear measurable deliverables existed in the contractual arrangements. In this regard, it was found that while a broad description of the scope of work was specified in the original contracts, the exact extent and nature of the services to be provided were not precisely specified at the time of the appointment of both advisers according to the Department, due to:

- The unique nature of the privatisation program, the scale of which was unprecedented in Australia, which precluded a precise specification of the required extent and exact nature of work to be performed; and

- The cradle-to-grave approach taken by the Department in appointing the advisers, which meant that the Department sought to contract with the advisers for the term of the entire reform process rather than on an incremental or piecemeal basis. This approach was adopted in the belief that it would ensure continuity of independent advice, continued access to accumulated knowledge of the reform process and would avoid conflicts of interest which could arise from an incremental approach to the appointment of advisers.

6.66 **The appointment of the advisers without the precise specification of deliverables heightened the need for the Department to exercise substantial judgement in the management and review of the services provided by these advisers.**

Success fees

6.67 As mentioned previously, the contracts for these advisers provide for the payment of fees calculated on various bases during the different phases of corporatisation and privatisation of electricity industry entities. The most significant element, by far, of the amount payable is the success fees. These fees, which become payable on the privatisation of each entity are basically calculated as a specified percentage of the sale proceeds arising from each privatisation.

Financial adviser - CS First Boston

6.68 The original contract between the Department and the financial adviser specified the formula to be applied in the calculation of success fees based on sale proceeds of up to $10 billion. The Department advised that the need for this formula to be renegotiated in the event that sale proceeds eventually exceeded $10 billion was considered in early discussions between the Department and the financial adviser. However, the re-negotiation of fees in such circumstances was not provided for in the original contract.

6.69 With the sale of Yallourn Energy in March 1996, the fee cap in the original contract was exceeded and the success fees on that sale were calculated on proceeds up to $10 billion, with no fee being paid on that proportion of the sale proceeds in excess of that figure.

6.70 Subsequently, a new contract was negotiated which significantly varied some of the original contract conditions. In particular, no limit was placed on the total proceeds on which success fees were to be calculated and the level of fees was negotiated at a lower rate than that which applied in the original contract.

6.71 The Treasurer approved the new fee structure during July 1996. The reduced success fee formula became effective prior to the sale of Hazelwood in August 1996 and was applied to the remaining electricity entities approved for privatisation.

6.72 Audit was advised by the Department that it had reached agreement with the Victorian Government Purchasing Board that the Board's approval would not be required if contract re-negotiation resulted in no improvement on the initial agreement. The Department's opinion was that such an improvement had not occurred and it advised the Victorian Government Purchasing Board accordingly prior to making any further success fee payments.

6.73 In audit opinion, in the light of the significant changes, as outlined in paragraph 6.70, an improvement on the original contract had occurred. Accordingly, it would have been a preferable course of action to seek the approval of the Victorian Government Purchasing Board of the new arrangements prior to executing the new contract. Furthermore, while the new contract was deemed to have commenced during April 1996, it was not formally executed until 1997.

6.74 **Following the execution of the new contract, further estimated success fees of $18.8 million became payable, albeit at a lower rate, in respect of privatisations occurring after the original cap of $10 billion proceeds had been reached.**

Accounting adviser - KPMG Peat Marwick

6.75 The audit examination identified that the tender submission by KPMG Peat Marwick proposed fee arrangements including daily charge rates together with a success fee calculated as a percentage loading on daily charge rates. In particular, the tender submission indicated that in respect of sale proceeds-based success fees, consideration needed to be given to whether such a fee basis would be seen as impairing the firm's independence in the eyes of prospective investors relying on independent reports produced by the firm.

6.76 However, the preferred fee arrangements outlined in the tender were not approved by the Department due to concerns over the potentially open-ended nature of the costs to the Government and the large amount potentially involved, should the Government choose to privatise all entities. Consequently, the fee structure that was adopted as part of the contractual arrangement between the Department and the accounting advisers included success fees for trade sales, as opposed to floats, solely as a percentage of sales proceeds. This fee structure was considered by the Department to provide an incentive to the advisers to complete the task quickly and to maximise the sale values of the entities to be privatised.

6.77 It should be noted that KPMG was the only shortlisted tender deemed by the Department to satisfy the non-price related selection criteria and, accordingly, the Department did not consider it necessary to seek revised fee proposals from the other shortlisted tenders.

6.78 Subsequent to the establishment of the original contract arrangements with the accounting advisers, the State during July 1996 re-negotiated fee arrangements for trade sales of generation entities in response to the apparent potential for super profits to accrue to KPMG under the original fee structure. This re-negotiation led to a reduction in certain success fee rates for trade sales of generation entities and introduced progressive time-based fees, subject to an upper limit and not rebateable against success fees.

Other external service provider arrangements

6.79 In addition to the contractual arrangements discussed above, audit examined a number of smaller service provider engagements entered into by the Department. The matters identified in relation to these engagements are discussed below.

Industrial relations adviser

6.80 KPMG Peat Marwick was initially engaged in April 1994 as joint industrial relations advisers, using a selective tender process. However, in respect of this engagement audit found that:

- only a week was allowed for the preparation of tenders;
- the Treasurer had retrospectively approved an initial $43 000 cost overrun on the contract which had an original approved cost of $50 000;
- a further $75 000 extension to the contract was approved by the Treasurer in August 1994 and subsequently by the former State Tender Board in September 1994; and
- the contract was not formally executed until September 1994, even though the engagement for the provision of services was approved in April 1994.

6.81 **Subsequently, in October 1994, KPMG Peat Marwick was engaged by the Department as its sole industrial relations adviser for an initial contract amount of $65 000, without undergoing a tendering process, and this contract was subsequently extended several times, which resulted in a final contract amount of $467 000. The Department approved the decision not to call for tenders on the basis of the proven performance of KPMG.**

6.82 The Department subsequently determined in mid-1996 that further extensions to the industrial adviser arrangements would be subject to a competitive tender process as the role of the industrial relations adviser was to be broadened to include gas and aluminium reform. However, audit noted that approval to waive the calling of full public tenders was granted by the Department on the basis that a public advertisement would “ignite the trade unions and other opponents of reform” as gas privatisation was imminent. KPMG Peat Marwick was subsequently appointed in December 1996 following a selective tender process and approval by the Victorian Government Purchasing Board with the new contract awarded at a value of $444 800 for the 2 year period ending 31 December 1998.

Generation Victoria disaggregation study

6.83 In February 1994, officers of the Department conducted interviews with CS First Boston NZ Ltd and KPMG Peat Marwick regarding their suitability to undertake a joint development of a scoping study on the disaggregation of Generation Victoria. Subsequently, a decision was made by the Department to engage these firms to undertake the study. Given that development of the study was already encompassed within KPMG's role as accounting adviser, fees in respect of the work performed by KPMG were paid under that contract. However, in respect of CS First Boston NZ Ltd's role, the audit examination identified that:

- tenders were not called due to the short timeframe in which the study was to be undertaken;
- appropriate approval to waive the calling of tenders was not given;
- while a verbal quote for the cost of the services to be provided was given in February 1994, it was not until June 1994 that written documentation to support the quote was received by the Department; and
- while the work was completed in March 1994 at a total cost of $87 000, it was not until September 1994 that the Treasurer retrospectively approved the expenditure incurred, with the delay in this approval attributable, at least in part, to difficulties encountered in obtaining written quotes and accounts from the company.

Legal and regulatory services

6.84 As part of the electricity reform process, the Department established a Legal and Regulatory Committee to direct and oversee work undertaken by the electricity businesses to facilitate and implement their disaggregation and corporatisation. Partners from 4 law firms, namely, Freehill Hollingdale and Page, Mallesons Stephen Jaques, Arthur Robinson & Hedderwicks, and Clayton Utz, were appointed to participate in the Committee's activities. An audit review of these arrangements highlighted the following:

- Initially, a selective tender process was employed to engage the 4 partners from October 1993, at an anticipated total retainer of **$15 000 each**. The Department subsequently sought and received **approval to extend these arrangements to a maximum cost of $100 000 in December 1993 for each appointment** for the period December 1993 to June 1994;
- As the nature of the partners' roles proved to be more "hands on" than initially anticipated by the Department and the scope of their role expanded, it became evident that the total cost of the arrangements would exceed initial estimates. Accordingly, **in June 1994, the Department received retrospective approval from the Minister for additional costs of $800 000,** bringing the total cost of these arrangements to $1.2 million;
- **A further extension to the contract sum of $1.4 million was approved in June 1994** by the State Tender Board, covering the period up to 30 September 1994, bringing the total cost of these arrangements to $2.6 million; and
- **The contractual agreements covering these arrangements, which commenced in October 1993, were not formalised until November 1994**.

Overall Audit Comment

6.85 **Notwithstanding the unique nature of the Government's electricity industry reform program and the limited expertise available from the private sector to assist in the reform process, audit nevertheless concluded that there was greater scope for more competitive processes to be adopted by the Department in the engagement of consultants and contractors given the magnitude of taxpayers' resources involved in the reform process and paid to these external service providers. Furthermore, the approval of expenditure after the provision of services is not considered to be consistent with proper management practice.**

Firearm buy-back scheme

6.86 At a special meeting of all Australasian Police Ministers Council on 10 May 1996, agreement was reached to implement effective firearms reform and control, through a major overhaul of firearm laws throughout Australia. Subsequently, in July 1996 the Victorian Government proclaimed amendments to the *Firearms Act* 1958 that included the prohibition of the following categories of firearms:

- semi-automatic shotguns;
- pump action shotguns; and
- semi-automatic rifles.

6.87 A national amnesty was also declared to enable firearm owners to surrender and obtain compensation for prohibited firearms without fear of prosecution, regardless of whether such firearms were registered. The amnesty in Victoria operated from 2 July 1996 to 30 September 1997.

6.88 The resolutions of the Australasian Police Ministers Council were given further effect through the passage of the *Firearms* Act 1996.

6.89 Guidelines on compensation for the surrender of prohibited firearms were distributed by the Commonwealth Law Enforcement Board covering, among other things, the amount of compensation payable for various categories of surrendered firearms. The cost of the scheme has been met by the Commonwealth Government, funded by way of an increase in the Medicare levy of 0.2 per cent, with a total of $500 million committed to the scheme nationally.

6.90 **As at 30 September 1997, a total of 207 200 firearms had been surrendered in Victoria at a total compensation cost of $101.8 million. In addition, 15 800 non-prohibited firearms were also surrendered, which did not attract any monetary compensation.**

6.91 Table 6J illustrates the number and value of surrendered prohibited firearms across the various collection centres in Victoria.

TABLE 6J
NUMBER AND COMPENSATION
PAID ON SURRENDERED FIREARMS

Location	*Firearms surrendered*	*Compensation*
Metropolitan -	(no.)	($'000)
Box Hill	14 800	7 380
Dandenong	37 000	16 356
Heidelberg	25 700	12 743
Sunshine	26 400	12 820
World Trade Centre	5 200	6 470
Other	500	138
Total Metropolitan	109 600	55 907
West -		
Ballarat	14 400	6 801
Geelong	9 400	4 295
Hamilton	4 000	1 978
Horsham	4 200	2 007
Other	3 100	1 257
Total West	35 100	16 338
North-West -		
Mildura	4 400	1 929
Other	3 600	1 674
Total North-West	8 000	3 603
North -		
Bendigo	13 800	6 266
Other	800	315
Total North	14 600	6 581
North-East -		
Shepparton	14 600	7 187
Wangaratta	5 800	2 965
Wodonga	5 900	2 876
Other	400	165
Total North-East	26 700	13 193
Gippsland -		
Sale	8 600	4 258
Other	4 600	1 915
Total Gippsland	13 200	6 173
Total Victoria	**207 200**	**101 795**

6.92 Victoria has recorded the highest number of surrendered firearms of any State or territory, representing 32 per cent of total firearms surrendered across the country. The average amount of compensation paid in Victoria per firearm surrendered was $491 which was comparable with the national average.

Administration of the scheme

6.93 The firearms buy-back scheme was operated from up to 58 collection centres, including temporary and permanent collection centres, across the State, with a small proportion of firearm collections occurring at police stations and at firearm dealer locations.

6.94 A project team was established within the Department of Justice to manage the scheme and each collection centre was managed by a person contracted to the Department. However, the key functions of firearm collection, recording, identification, valuation, security, data entry, transportation, storage and destruction were performed by an independent contractor engaged by the Department.

6.95 Tenders in relation to the appointment of the above contractor were invited from 4 organisations on 17 July 1996 following consideration of registrations of interest received earlier that month, with a closing date of 22 July 1996. This resulted in an extremely short period for the preparation of tenders. Following the assessment of tenders which was conducted on 23 July 1996, the preferred tenderer was selected on 25 July 1996, however, the **formal contractual arrangements with the successful tenderer were not finalised until January 1997, some 5 months after the commencement of the scheme.**

6.96 As at 30 September 1997, a total of $9.5 million had been incurred by the State in the administration of the scheme, covering salaries, contract payments, media costs, equipment and system development costs. An additional amount of $3 million was applied towards the development of a new firearm licensing and registration system to enable effective nationwide registration of all firearms. These costs were met using Commonwealth Government funding of $13 million.

6.97 Assets purchased using Commonwealth funding to administer the scheme, including computer and communications equipment valued at $650 000, were transferred to the Office of the Chief Commissioner of Police on completion of the scheme.

Allegations of irregularities

6.98 During February 1997, allegations of inappropriate practices in the operation of the firearm buy-back scheme in Victoria were made, including that:

- collection centre staff were purchasing non-prohibited firearms;
- firearm valuers at collection centres were inflating compensation payments in certain circumstances;
- owners were assembling old firearm pieces to resemble firearms in order to claim compensation;
- owners were obtaining fraudulent receipts and claiming specialised work and modifications on their firearms to qualify for greater compensation; and
- collection centre staff were attempting to sell new firearms to owners handing in banned firearms.

6.99 A subsequent police investigation into these allegations during February 1997 was unable to identify direct evidence of a criminal nature. However, the police investigation found that several persons, employed at a number of collection centres had purchased non-prohibited firearms. The Department took the following action in response to the identified irregularities:

- dismissed 2 valuers from 2 collection centres;
- reassessed the value of compensation payments made to 3 parties who were identified as having received favourable valuations;
- dismissed a Collection Centre Manager; and
- reprimanded 2 staff involved in the purchase of non-prohibited firearms.

6.100 A further review of the firearms buy-back scheme was subsequently commissioned by the Minister for Police and Emergency Services, which was undertaken by management consultants and finalised in March 1997. This review highlighted some control deficiencies in the processing of transactions, and concluded that the Commonwealth guidelines had been closely followed and that the average compensation payment in Victoria was in line with national averages.

Audit review

6.101 In the above context, audit undertook a review of the scheme focusing on the following key areas:

- identification and valuation of firearms;
- compliance with applicable legislation, policies and procedures;
- management framework adopted for the administration of the scheme; and
- contractual arrangements with the external service providers.

Compensation payable for surrendered firearms

6.102 The amount of compensation payable for surrendered prohibited firearms was established by the Commonwealth Government. The compensation payable to individuals was based on the average retail prices for both new and used firearms as listed in dealers' catalogues across Australia as at March 1996, while firearm dealers were compensated on the basis of their published selling prices of firearms as at that date. Under the arrangements, the prices for surrendered firearms prescribed by the Commonwealth were not negotiable for firearms valued below $2 500. However, firearms listed at amounts of $2 500 or more could be referred to a panel for review if any disputes arose over individual valuations.

6.103 During the period August 1996 to June 1997, numerous updates to the original Commonwealth Government price list were made to account for additions of firearms not previously included within the list or to revise values.

6.104 A critical aspect of the valuation of firearms was the accurate identification of each surrendered firearm type and model. Once the firearm was correctly identified, compensation amounts were then set in line with the Commonwealth Government price list. Firearm valuers were specifically appointed at each firearm collection centre to undertake the identification or recognition of the surrendered firearm and nominate the price to be paid in accordance with the price list.

6.105 An examination by audit of amounts paid for surrendered firearms revealed no material variances from the Commonwealth Government price list, however, audit noted that in the case of 2 particular models of firearms valued at less than $2 500, the State had paid above the Commonwealth prescribed prices in the belief that this would achieve a more accurate reflection of the value of the firearms. While existing records preclude the preparation of a verifiable estimate of the amount paid above the Commonwealth price list for these 2 models, the best estimate of departmental officers was that up to $12 000 was paid in excess of the Commonwealth price list for these 2 models.

6.106 Audit was also informed that compensation of $882 000 was paid for 247 fully-automatic firearms, notwithstanding that compensation for such firearms was not originally provided for within the relevant Commonwealth legislation. Nevertheless, the surrender of such firearms was considered by the Department to be in the public interest.

Compensation for loss of business

6.107 At the Australasian Police Ministers Council meeting in May 1996, it was resolved that firearm dealers would be eligible for compensation for any loss of business, as a consequence of changes to the firearm laws. Loss of business was defined as *"... the difference between the value of the business prior to the new legislation and the value of the business following the impact of the new legislation"*. The key principles to be applied in valuing firearm dealers loss of business were as follows:

- compensation to be available to any firearm dealer whose business included the sale, repair or importation of firearms;
- firearms dealers to arrange for a certified valuation of loss of business to be conducted by an appropriately qualified professional person according to commercially accepted standards;
- the dealer to include the reasonable cost of the valuation in the claim for loss of business;
- the dealer to accept the valuation provided; and
- the valuation to be subject to independent review.

6.108 Within Victoria, a firm of chartered accountants was contracted to develop a model for compensating firearm dealers for loss of business, which was subsequently accepted with certain adjustments as the national model at the July 1997 Australasian Police Ministers Council meeting. Salient features of the model included:

- only licensed firearm dealers to be entitled to compensation for loss of business;
- if a licensed firearm dealer proved that the business had become unviable as a direct result of the amended legislation, and the dealer wished to leave the industry, the dealer would be compensated; and
- any licensed firearm dealer wishing to make a claim for loss of business could only do so once.

6.109 Dealers were given until 30 September 1997 to register their intention to claim for compensation of loss of business, with final claims to be lodged by no later than 15 May 1998. **As at 30 September 1997, 3 final claims and 135 intentions to claim for loss of business had been received by the Department.** Audit was advised that a firm of chartered accountants has been engaged to undertake the assessment of all compensation claims, prior to the finalisation of any payment under such claims. **At the date of preparation of this Report, no payments had been made by the Department.**

❑ ***RESPONSE*** *provided by the Secretary of the Department of Justice*

Administration of the scheme

Agreement was reached with the proposed contractor on 1 August 1996 on the basis for the conduct of the buyback. In view of the urgency to commence the "buyback", it was necessary to commence the scheme ahead of formal signing of a contract.

Allegations of irregularities

The project at all times reported any suspected breaches of the law to the Police for independent and immediate investigation. Specific incidents that arose were quickly addressed and appropriate action taken. The issue of staff arranging the purchase of non-prohibited firearms was terminated as soon as it came to management attention. The police investigation of this issue considered that no offence had been committed.

Compensation payable for surrendered firearms

The Commonwealth developed the national price list which was settled in August 1996. However, the list did not satisfy the implementation of the buyback scheme and required some interpretation as to the needs of the States and the peculiarities of their firearm markets, rather than have an ongoing process of changing the price list for individual circumstances, as they emerged.

Two firearms in Victoria caused considerable discussion:

- *Browning A5 Light Twelve semi automatic shotgun with a Commonwealth list price of $875*
- *Beretta A302 and A303 semi automatic shotgun with a Commonwealth list price of $700.*

- ***RESPONSE** provided by the Secretary of the Department of Justice - continued*

The Browning Light Twelve at manufacture in 1977 retailed for $755, whereas the standard equivalent Browning A5 retailed for $595. The Commonwealth list price for the A5 was determined at $1 100, $225 above that determined for the A5 Light Twelve. The Project determined to apply the $1 100 where necessary to complete the surrender.

The Beretta A301 had a compensation price of $750 however the later and more expensive models, A302:303, had a compensation price of $700. Again where necessary to complete the surrender the owner of a A302 or an A303 was offered $750.

Where approached by States and Territories, including Victoria the Commonwealth agreed to reimburse the State for monies expended by way of compensation on fully automatic firearms.

In the Spring session 1997 of the Commonwealth Parliament the National Firearms Program Implementation Act 1996 was amended to give legislative effect to this policy decision.

PART 7

Assets of the State

VICTORIAN
AUDITOR-
GENERAL'S
OFFICE

Auditing in the Public Interest

SUMMARY OF STATE ASSETS

7.1 Assets represent the resources that are controlled by the Government which are available for application towards the provision of services and the delivery of programs. These resources, when combined with employees and external service providers, enable the Government to pursue the achievement of its objectives and the discharge of its responsibilities to the community.

7.2 The assets of the State mainly comprise physical assets (including Crown and freehold land and buildings, plant and equipment, roads and other infrastructure), investments, receivables and cash at bank.

7.3 **The Government's Annual Financial Statement discloses that, at 30 June 1997, assets with an aggregate value of $71.4 billion were controlled by the Government**. Table 7A provides a summary of these resources.

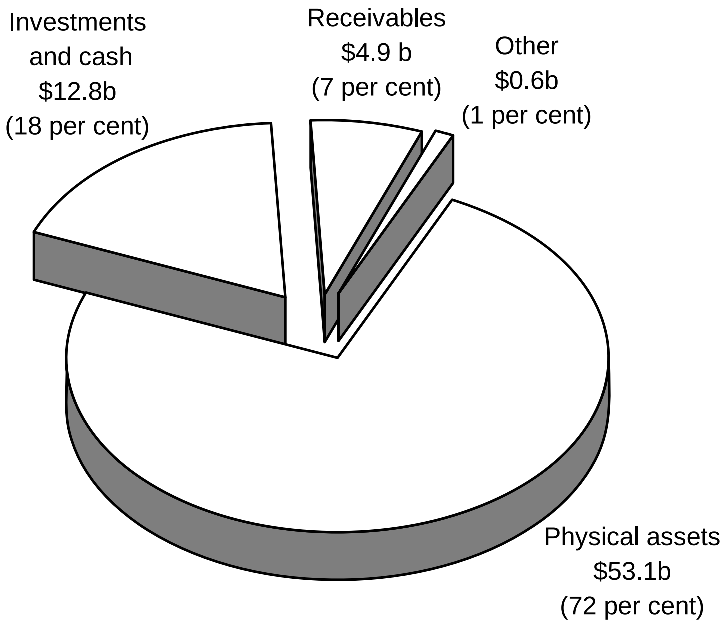
TABLE 7A
SUMMARY OF STATE ASSETS
($billion)

Type of assets	*Amount*
Physical assets -	
Land and buildings	20.5
Plant and equipment	18.9
Roads	12.1
Other	1.6
	53.1
Financial assets	18.3
Total State assets	*(a)* **71.4**

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

7.4 As shown in the table, physical assets represent by far the largest asset category, accounting for around 74 per cent of total assets. This substantially reflects the State's responsibilities in relation to Crown land, and the provision of public infrastructure and services. Chart 7B llustrates the major components of the State's assets.

TABLE 7B
COMPOSITION OF STATE ASSETS
($billion)



Physical assets

7.5 As indicated earlier in this Report, the State's physical assets mainly comprise Crown and freehold land, buildings, roads, infrastructure systems and other plant and equipment. The enhanced management of these resources has been a major focus of government reforms over many years. In particular, my previous Reports to the Parliament have commented extensively on the various initiatives introduced by the Government to enhance public sector asset management, including:

- 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; and
- establishment of the central Managed Insurance Fund, to provide insurance protection to departments and other budget sector agencies.

7.6 **The implementation of these initiatives has contributed to a substantial improvement in the management of the State's resources and, in turn, the State's financial performance**. In particular, the implementation of the asset identification, valuation and reporting program has facilitated the enhanced accountability of departments in relation to resources they control and will enhance decision-making due to the availability of more complete information.

7.7 Substantial progress has been made in recent years in the identification, valuation and reporting of assets. In particular, during the 1996-97 financial year, the value of certain infrastructure assets, and art and historical collections was recognised in the financial statements of the relevant government agencies for the first time. These assets, which have also been recognised in the Government's Annual Financial Statement, include:

- formation earthworks associated with road pavements managed by the Roads Corporation, valued at approximately $2.8 billion;
- works of art and collections held by the National Gallery of Victoria, valued at $600 million; and
- museum and library collections held by the Museum of Victoria and the Library Board of Victoria, valued at approximately $466 million.

7.8 However, certain assets of the State are yet to be recognised by the relevant agencies, including certain parcels of Crown land vested in, or controlled, by the Department of Natural Resources and Environment including unused roads, channel reserves, water races and drainage reserves, certain hydro scheme-related assets and certain legislated land leases relating to facilities such as the Flemington and Caulfield Racecourses, and the Melbourne Cricket Ground. At the date of preparation of this Report, the Department was in the process of assigning responsibility for these assets to relevant entities which, where appropriate, would facilitate their future recognition in financial statements.

Level of financial assets

7.9 Financial assets included in the Government's Annual Financial Statement 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, receivables from external parties, and cash and deposit balances.

7.10 The financial asset holdings of the public sector at 30 June 1997 stood at $18.3 billion, representing an increase of around $3 billion when compared with the audited financial asset holdings in the previous year. Table 7C shows the composition of these balances as at 30 June 1997.

TABLE 7C
FINANCIAL ASSETS OF THE STATE
($billion)

Type	*Amount*
Investments	10.9
Receivables	4.9
Cash	1.9
Other assets	0.6
Total State assets	*(a)* **18.3**

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

7.11 The increase during the year in the level of the State's financial assets is mainly attributable to favourable financial market conditions as at 30 June 1997 which have positively impacted on the reported value of investments held by public bodies (which includes unrealised market gains), an increase in the level of investment balances held by the State Electricity Commission of Victoria as at 30 June 1997 attributable to the Government’s privatisation program, and a general increase in the level of receivables.

Gas industry assets

7.12 My May 1996 *Report on Ministerial Portfolios* commented on the status of the Government’s extensive reform program for the gas industry, which forms part of the broader program of public sector reform that also covers the electricity, water and port sectors. The Government’s objectives for the corporatisation and privatisation of the gas industry include:

- achieving the lowest possible sustainable gas prices for Victorian consumers;
- maximising customer choice;
- providing a more efficient industry that encourages investment;
- providing the framework for an effective and sustainable energy market through the integration of gas, electricity and other energy products so that customers can better manage their energy purchases;
- ensuring a regulatory environment that provides consumers with the best protection in terms of price, service and safety standards;
- ensuring the long-term security of supply;
- encouraging the development of an efficient national gas market; and
- reducing the level of public sector debt.

7.13 In September 1994, the Government embarked upon the restructuring of the gas industry. As an initial step, the *Gas Industry Act* 1994 was enacted, with effect from July 1994. The main purpose of the Act was to facilitate the disaggregation of the former Gas and Fuel Corporation of Victoria, through the transfer of property, rights and liabilities associated with the gas distribution and transmission businesses into 2 State-owned corporations, namely:

- *GASCOR (trading as Gas & Fuel)***,** principally responsible for the sale and distribution of natural gas, and the sale of appliances at a retail level. The Albury Gas Company Limited was also vested in GASCOR; and
- *Gas Transmission Corporation*, principally responsible for the transportation of gas through the transmission pipelines, the storage of gas for transport customers, and the construction and operation of transmission pipelines and storage facilities.

7.14 This process was followed by the dissolution of the former Gas and Fuel Corporation of Victoria and the transfer of the residual property, rights and liabilities to the State Electricity Commission of Victoria. The associated gas exploration company, GFE Resources Limited, was initially vested in the Treasurer of Victoria and the business was then sold in August 1995 to private interests. Detailed comment on the sale of this business was presented in my October 1995 *Report on the Statement of Financial Operations*.

Recent reforms

7.15 The Government acknowledged that the implementation of further reforms within the gas industry was dependent upon the resolution of a petroleum resource rent tax (PRRT) dispute between GASCOR, Generation Victoria and the gas producers, Esso and BHP. This dispute was finally settled in November 1996, which cleared the path for further reforms by the Government. Detailed comment on the resolution of the PRRT dispute was provided in my May 1997 *Ministerial Portfolios Report,* with a further summary of the settlement also provided later in this Report.

7.16 In March 1997, the Government announced further substantial reforms within the gas industry. The key elements of these reforms include:

- Unbundling the distribution operations and separation of the retail operations currently performed by GASCOR into 3 “stapled” gas businesses, each comprising a gas distributor and a gas retailer, in line with the national gas reform agenda. The 3 gas distributors will own and maintain the existing low pressure distribution network, purchase gas through the wholesale gas market and construct network extensions, whereas, the gas retailers will sell gas directly to consumers;
- Establishing a gas services company to provide certain support services to the gas industry businesses;

- Separating the ownership and management of the transmission assets, which will continue to be owned and managed by the Gas Transmission Corporation (GTC), and the market operating functions within the wholesale gas market, which will be transferred to the new, yet to be established entity, Victorian Energy Networks Corporation; and
- Gasmart, the retail appliance division of GASCOR, will be equally owned by the 3 gas distributors.

Profile of the new businesses

7.17 Under the new arrangements, separate gas retail and gas distribution companies have been created. The businesses have been operationally effective from July 1997, with their legal establishment anticipated in December 1997, at which time the businesses will cease to operate as divisions of GASCOR.

7.18 These new companies will be established under Corporations Law, operating on a fully commercial basis under independent boards. However, until the privatisation of the retail and distribution companies which is anticipated during 1998, these businesses will be governed by certain administrative and operational requirements of the *Gas Industry Act* 1994 and be accountable to Victorian taxpayers.

7.19 Each retailer will initially service a geographically defined franchise customer base. The retailers present the public face of the industry and will ultimately be able to compete for franchise customers as and when they become contestable, with full contestibility to occur by September 2001. A brief profile of each retail company's service responsibilities follows.

RETAIL COMPANIES - A SNAPSHOT

kinetik ENERGY	**Kinetik Energy** The company to service approximately 398 000 customers, covering a distribution area including Melbourne's north-eastern and outer western suburbs, and western and north-central Victoria. This business is attached to the gas distributor known as Westar.
energy 21	**Energy 21** The company to service the eastern Melbourne areas, the Mornington Peninsula, and northern and eastern Victoria. Energy 21 will have the highest customer density, with approximately 517 000 customers. This business is attached to the gas distributor known as Stratus.
IKON	**Ikon Energy** The company to service approximately 504 000 customers extending over western, central and south-eastern Melbourne. This business is attached to the gas distributor known as Multinet.

7.20 While each of the 3 gas distributors, namely Westar, Stratus and Multinet are attached to individual retailers, their geographical area of operation is not fully aligned to the associated retailer, with an overlap of around 50 per cent in terms of distribution volumes.

7.21 In addition to the above reforms, the following further structural changes and regulatory arrangements have been established:

- Office of the Regulator-General to monitor gas prices to franchise customers, gas distribution prices and services, and to regulate the distribution of gas;
- Australian Competition and Consumer Commission to regulate the prices and services associated with the transmission of gas;
- Office of Gas Safety to ensure that safety requirements are maintained in the restructured gas industry; and
- A Gas Industry Ombudsman to be appointed to investigate consumer grievances.

7.22 As part of the reform process, in March 1997, the Treasurer announced that gas prices to franchise customers would be capped below the cost of inflation until the year 2001, when a fully competitive retail market will be in operation.

National gas reform

7.23 The Victorian reform program has been developed against a background of broader national developments within the gas industry, reflecting the Government's commitment to the implementation of policies designed to increase competition and introduce market forces within the national gas industry. The State's active involvement in the reform process is also particularly significant given that Victoria's gas distribution and retail system is Australia's largest such system, supplying approximately 1.3 million customers across metropolitan Melbourne and regional Victoria, and Albury and Moama in New South Wales.

7.24 The national gas reform framework was developed and agreed by the Council of Australian Governments (COAG) in February 1994. Since that time, all State governments and the Federal Government have agreed to introduce a range of gas industry reforms which will result in:

- the removal of barriers to trade within and between the States;
- the implementation of a uniform national framework for third party access to gas transmission pipelines;
- no new exclusive franchises being issued and a plan developed to implement more competitive franchise arrangements; and
- the corporatisation of publicly-owned gas utilities and vertical separation of transmission and distribution activities.

7.25 To remove the isolation of the Victorian gas market and to further progress the objectives of the national reform program, a number of pipeline developments have also been proposed or are under consideration to connect the Victorian and New South Wales gas transmission systems.

7.26 The benefits arising from the inter-connection of the Victorian and New South Wales transmission systems will include:

- the creation of a more competitive environment for gas production and supply in Victoria;
- enhanced security of supply for Victoria; and

- the stimulation of exploration for, and development of, gas fields in Victoria's onshore and offshore basins.

7.27 Following the structural reform of the Victorian gas industry, the Government expects to proceed with the privatisation of the industry during 1998, "provided public benefit can be demonstrated".

PART 8

Liabilities and Commitments

VICTORIAN
AUDITOR-
GENERAL'S
OFFICE

*Auditing in the
Public Interest*

AGGREGATE LIABILITIES OF THE STATE

8.1 As indicated previously, a key focus of the Government's financial management strategies in recent years has been the effective management and reduction of State liabilities and the associated costs, so as to strengthen the State's financial position thereby improving its capacity to finance works and programs. Consequential improvements in liability management, combined with the implementation of a substantial privatisation program and various other initiatives, have been pivotal to the substantial reduction in the level of State liabilities and the improved budgetary position in recent years.

8.2 In this Part of the 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.

8.3 **The Government's Annual Financial Statement discloses liabilities of the State totalling $50.6 billion at 30 June 1997**, mainly comprising borrowings, payables, unfunded superannuation and other employee related entitlements. This position represents **a reduction of $6.2 billion in the level of liabilities when compared with the previous year's audited balances, which was mainly due to the privatisation of 2 electricity generation companies and the application of the resultant sale proceeds mainly towards the reduction of State debt.**

8.4 Table 8A illustrates the composition of the State's liabilities at 30 June 1997.

TABLE 8A
COMPOSITION OF STATE LIABILITIES
($billion)

Type	*General government*	*Public trading enterprises*	*Public financial enterprises*	***Total June 1997***	*Total June 1996*
Borrowings	12.8	7.3	21.2	**21.0**	26.4
Unfunded superannuation liabilities	15.1	0.1	-	**15.2**	15.2
Other employee entitlements	2.0	0.4	-	**2.4**	1.9
Payables and other liabilities	3.2	2.2	7.8	**12.0**	13.3
Total State liabilities	**33.1**	**10.0**	**29.0**	*(a)* **50.6**	*(a)* **56.8**

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

8.5 As shown in the above table, **as at 30 June 1997, borrowings and unfunded superannuation liabilities were the largest components of the State's liabilities. Collectively, these items account for 71 per cent of total liabilities**.

8.6 In addition to the liabilities disclosed above, **the State also has quantifiable contingent liabilities of around $1.3 billion** (1995-96, $2 billion). These liabilities, which are contingent in nature, represent potential commitments the occurrence of which is dependent on future events or outcomes.

8.7 Furthermore, the State has entered into various arrangements giving rise to operating lease and capital commitments, which are not included as part of State liabilities as the relevant goods or services had not been received or consumed at balance date**. The aggregate value of the State's operating lease and capital commitments as at 30 June 1997 were $2.6 billion (1995-96, $2.7 billion). However, these do not include the State's commitments under outsourcing contracts entered into for the provision of services to the public sector.**

BORROWINGS

8.8 Borrowings represent the largest component of State liabilities and predominantly comprise public sector debt 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. The reduction of this debt and the enhanced management of this element of State liabilities have been key elements of the Government's overall financial reform program in recent years.

8.9 **The State's accumulated borrowings at 30 June 1997 amounted to around $21 billion, compared with the audited balance of $26.4 billion in the previous year.** Table 8B illustrates the major sectors contributing to this position.

TABLE 8B
STATE DEBT, 1996-97
($billion)

Sector	*Amount*
General government	12.8
Public trading enterprises	7.3
Public financial enterprises	21.2
Inter-sector eliminations	(20.3)
Total State debt	**21.0**

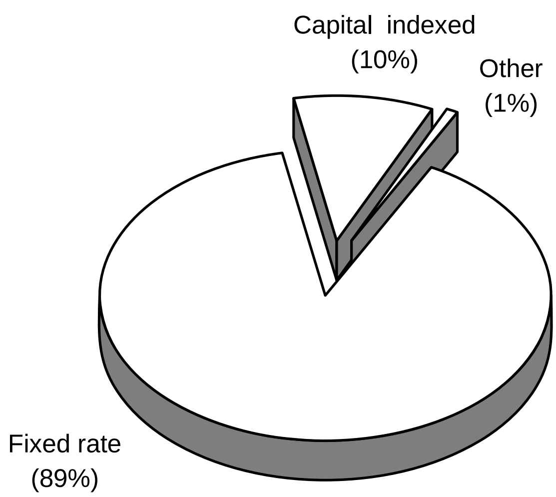
8.10 **The reduction of $5.4 billion in the level of State borrowings in the year mainly reflects the impact of the Government's electricity industry privatisation program under which 2 electricity companies were sold and the application of surplus Public Account funds towards debt retirement**.

Borrowing composition and maturity profile

8.11 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 associated financial risks. As explained in my previous Reports to Parliament, 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.

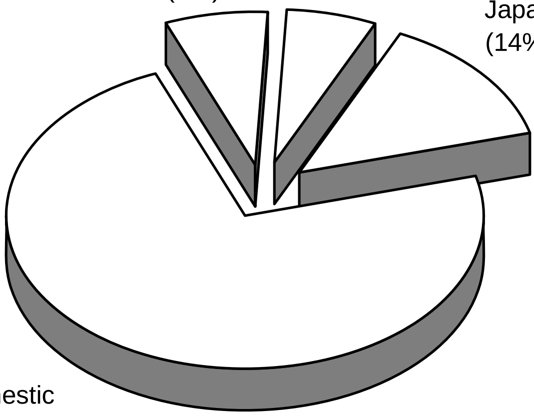
8.12 To minimise interest costs and exposures to specific financial markets, the State borrows domestically and overseas, and in various forms, commonly referred to as fixed rate, floating rate and capital indexed borrowings. These borrowings are complemented, as deemed appropriate, by the use of various 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 or retirement. Charts 8C and 8D show the composition of State debt at 30 June 1997 in terms of the forms of borrowing, and the markets in which they are raised.

CHART 8C
COMPOSITION OF STATE DEBT,
BY INSTRUMENT TYPE, AT 30 JUNE 1997 *(a)*
(per cent)



(a) Based on market value.

CHART 8D
COMPOSITION OF STATE DEBT,
BY MARKET, AT 30 JUNE 1997
(per cent)

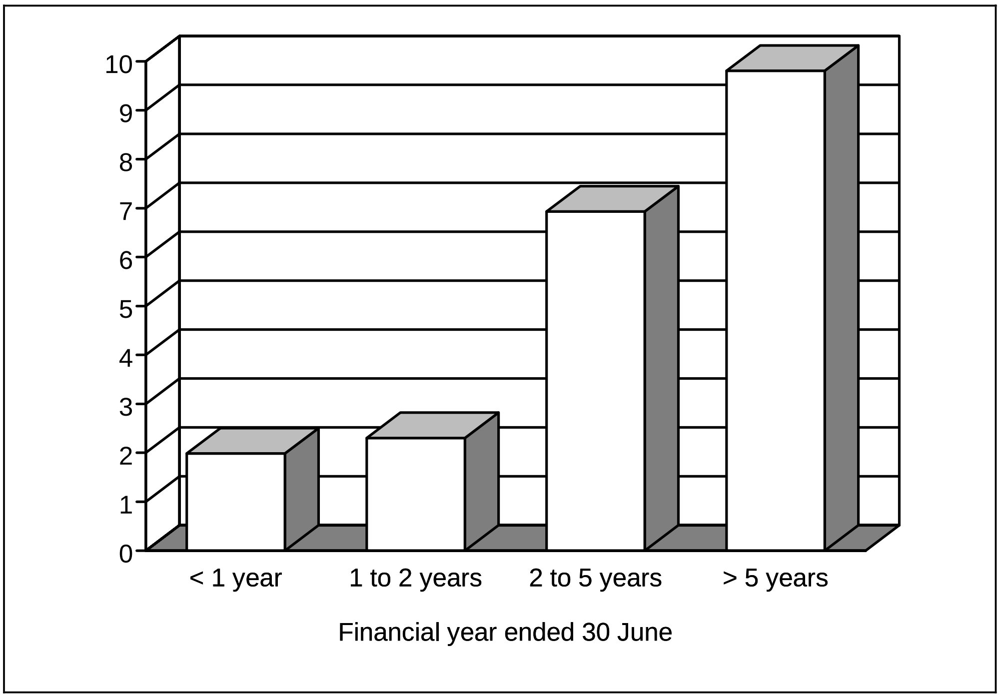


8.13 As illustrated by the above charts, the State's debt portfolio predominantly comprises fixed rate instruments, with these instruments accounting for 89 per cent of the debt portfolio at 30 June 1997. As a result of holding this type of instrument, the State's exposure to interest rate volatility has been minimised. While borrowings have been raised in both domestic and foreign markets, the State’s exposure to foreign currency fluctuations has been minimised through the establishment of appropriate hedging arrangements.

State debt maturity profile

8.14 An analysis of the State debt portfolio at 30 June 1997 indicates that around 53 per cent or $11.2 billion (book value) of the portfolio will mature and require repayment or refinancing in the next 5 years. **During 1997-98, $2 billion will require repayment or refinancing**. Chart 8E illustrates the maturity profile.

CHART 8E
STATE DEBT MATURITY PROFILE, AT 30 JUNE 1997 *(a)*
($billion)



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

Budget sector debt restructure

8.15 A key objective of the Government's debt management strategy, as espoused in the *Budget Sector Debt Portfolio - Three Year Management Plan* established by the Department of Treasury and Finance in April 1994, was to enhance the management of the State's Budget Sector Debt Portfolio (BSDP) and the associated financial risks, to ensure:

- certainty of funding for the refinancing of maturing debt and the Public Account;
- budget sector debt retirement receipts are applied within a short timeframe after receipt of privatisation proceeds; and
- the cost of funds of the BSDP does not exceed agreed benchmarks.

8.16 On the establishment of the plan, it was envisaged that the portfolio management approach would be subsequently reviewed to determine whether the objectives of the debt portfolio were being met in the most efficient and cost-effective manner. Accordingly, a re-assessment of the management objectives of the portfolio, in light of the current operating environment, was initiated by the Department in December 1995.

8.17 As a result of the review, a revised management approach for the budget sector debt portfolio was approved by the Treasurer in July 1996 and implemented in December 1996. The new Treasury Management Policy sets out the long-term risk management philosophy and objectives of the budget sector and articulates the risk management guidelines to be followed in order to achieve key management objectives for the budget sector treasury operations, namely:

- achievement of relative certainty of interest cost over the budgeting period, while minimising the net borrowing costs;
- minimisation of refinancing risk;
- utilisation of privatisation proceeds to retire debt at a benchmark cost; and
- identification and management of the financial and operational risks of budget sector treasury operations in a conservative manner.

8.18 To assist in the achievement of these objectives, the budget sector debt portfolio was restructured in December 1996 with emphasis on:

- reducing the number and complexity of loans; and
- minimising refinancing risk through the adoption of an even maturity profile.

8.19 The primary reason for the debt restructure was to enhance the management of the conflicting risk management objectives associated with the early retirement of debt and ongoing financing requirements of the budget. Consequently, the Department separated the BSDP into the following 2 distinct portfolios:

- *Core Borrowing Portfolio,* comprising that part of the portfolio intended to be held to maturity and used to meet the day-to-day requirements of the Public Account. The objective of this portfolio is to achieve certainty of borrowing costs, with an even spread of debt maturities to minimise the interest rate and re-financing risk; and
- *Debt Retirement Portfolio,* comprising that part of the portfolio intended to be retired prior to maturity through the application of privatisation proceeds. The objective of this portfolio is to ensure that interest rate movements or other market forces do not increase the buy-back price of the debt.

8.20 **The restructure and repricing of the budget sector debt portfolio at interest rates prevailing in December 1996 resulted in an increase of $320 million in the value of the debt portfolio reported by the Department of Treasury and Finance. However, the Department has estimated that the portfolio restructure will generate annual interest savings to the budget of $156 million.**

Motor vehicle sale and leaseback arrangements

8.21 In May 1994, the Cabinet's Budget and Expenditure Review Committee (BERC) requested the former Department of Finance to examine available leasing options for the establishment of outsourcing arrangements in respect to the budget sector vehicle fleet, so as to facilitate improvements in fleet management and the achievement of cost savings.

8.22 Subsequently, in October 1994, the Department of Treasury and Finance was advised by its corporate advisers that it should call for expressions of interest for the provision of fleet financing proposals and then evaluate these proposals to determine whether it wishes to proceed to tender. In particular, **the advisers considered that the implementation of a genuine private sector operating lease arrangement had the potential to effectively deliver benefits, through the disciplines that would be imposed by a private sector lessor for the management of the risks associated with motor vehicle ownership**. It was estimated that annual savings of $27.8 million, equating to $139 million in net present value terms over a 10 year period, could result from the implementation of an operating lease arrangement *vis-a-vis* the retention of the status quo.

8.23 In October 1994, the Cabinet Committee agreed to call for expressions of interest from the private sector for the submission of fleet financing proposals. The Committee also required that budget sector agencies seek to outsource fleet management services, as part of the leasing arrangement. Subsequently, in February 1995, the Department called for expressions of interest from organisations which had the capability to provide fleet lease arrangements. The successful lessor was expected to enter into arrangements for the sale and leaseback of the existing fleet of about 8 500 vehicles and the supply of leased vehicles as and when required. Respondents were advised that the State would not provide indemnities, other than those related to normal care and use of leased motor vehicles, however, it was recognised that some potential risks may fall on the State as lessee. The Government subsequently received 9 expressions of interest, mainly from banking and financial institutions.

8.24 The Government's financial advisers recommended to the Department in August 1995 that 5 proposals be shortlisted. The advisers also recommended that the leasing facility be made available to all government agencies, including public hospitals and local government. It was considered by the advisers that an operating lease arrangement for the government vehicle fleet could result in savings of around $31 million a year for new vehicles acquired at a cost of $100 million a year. Consequently, in August 1995, the Cabinet Committee gave approval for the Department to proceed to tender for the sale and leaseback of the vehicle fleet.

8.25 In September 1995, the Department called for registrations of interest from private sector vehicle fleet managers for the provision of fleet management services by October 1995 and, subsequently, advised the 5 shortlisted proponents that following a preliminary evaluation of the funding proposals, the Government intended to identify and appoint a joint financier and fleet manager. Subsequently, the Department provided the proponents with a list of 9 approved fleet managers and requested further proposals, setting out fleet management options, by December 1995.

8.26 Following an evaluation of the proposals, in February 1996, the Department's financial advisers recommended to the Minister of Finance the selection of 2 shortlisted tenderers who would be expected to confirm their willingness to work with any fleet managers classified by the Government as "preferred fleet managers". In April 1996 the Department selected LeasePlan Australia Ltd (LeasePlan) as the single preferred fleet manager.

8.27 In May 1996, following the evaluation of the final tenders from the shortlisted parties, the Department's advisers recommended to the Department the nomination of the Commonwealth Bank of Australia (CBA) as the preferred tenderer for the sale and leaseback of the government vehicle fleet. Subsequently, **in September 1996, following approval by Cabinet, the Minister for Finance announced the sale and leaseback of the Government's vehicle fleet to the CBA.** The estimated proceeds of $190 million from the arrangement were to be mainly used to repay State debt, which would result in estimated interest savings of $14 million a year and further savings resulting from the sale and leaseback arrangements estimated at $29.7 million a year. At the time of that announcement, the new arrangements were expected to come into place by December 1996.

8.28 Subsequently, in June 1997, the Victorian Government Purchasing Board approved the appointment of LeasePlan, Orix Australia Corporation Limited and DAS Fleet as a panel of providers of fleet management services to government for a period of 2 years. However, LeasePlan remained the designated preferred fleet manager.

8.29 Finally, in June 1997, the Minister formally approved the appointment of the CBA as a vehicle fleet financier and, in July 1997, approved the execution of the formal contracts. The Minister was advised by the Department that the sale value of the fleet would be around $168 million, which was $22 million less than the initial target of $190 million. The Department advised that the reduced level of proceeds mainly resulted from agencies significantly reducing their fleet numbers in advance of the sale, with final vehicle numbers being around 800 vehicles less than the original target of 8 200 vehicles.

Outline of arrangements

8.30 The Master Lease Agreement is the key document setting out the terms and conditions relating to the motor vehicle sale and leaseback arrangements entered into between the State and the CBA. The agreement is operative in perpetuity, however, the State has the right to give notice to terminate the financing facility, which is capped at $220 million, either at the end of its third anniversary, the end of its sixth anniversary or at annual intervals after its seventh anniversary. Once the non-renewal option is activated, the CBA is entitled to progressively reduce and cancel the facility limit over a 7 year wind-down period to enable the satisfactory management of the residual value of the vehicle fleet from the CBA's perspective. However, the CBA is not able to terminate the financing facility prior to the seventh anniversary, other than in the event of a default by the State.

8.31 Under the agreement, in July 1997, the State sold and leased back around 7 200 vehicles at a value of $168 million, which was paid into the Consolidated Fund. The valuation of the vehicles was based on an average valuation of a sample of vehicles at various agencies provided by independent valuers contracted to the Department. Subsequent tranches of vehicles to be leased by the State will comprise new vehicles acquired by the CBA from suppliers, with the State not having any right or option to purchase the leased vehicles.

8.32 The term of the individual vehicle leases funded under the CBA financing facility will depend on the particular vehicle and usage thereof. Broadly, the rental term will expire when the vehicle has reached 40 000 kilometres or 2 years service from its purchase date or, in respect of special equipment fitted to a vehicle (e.g. police lights) a term of 80 000 kilometres or 5 years service. The vehicle lease may be terminated if the State no longer requires the use of the vehicle.

8.33 **The motor vehicle financing facility is effectively non-cancellable prior to July 2000** due to the State's requirement to make prohibitive termination payments in conjunction with the requirement to return the vehicle fleet to the CBA in the event of termination. Generally, these termination payments will be equivalent to the aggregate of all rental amounts payable by the State until the expiry of the individual vehicle rental agreements and a yield adjustment fee so as to cause the CBA to achieve an agreed rate of return on its financing.

8.34 Under the arrangements, the following circumstances may cause termination:

- failure by the CBA to remedy a material default, including a material breach of its obligations or an event of insolvency, within a specified period (unless the State chooses to continue using the vehicles for the remaining lease term);
- the Government determines that the facility is inconsistent with government policy, or an event occurs which results in the arrangements becoming uneconomic from the State's perspective;
- the utilisation of the facility falls below 10 per cent of the facility limit for a continuous period of 12 months;
- the State initiates voluntary termination of the arrangements by giving at least 90 days notice to the CBA;
- the State has defaulted under the agreement or repudiated its obligations under the agreement; and
- a change in law renders the arrangement unlawful for the CBA to provide a leasing facility.

8.35 During the vehicle lease periods, the State is required to make monthly lease payments in arrears in respect of each vehicle, mainly based on the vehicle purchase price not including an estimated residual value, any prepaid services charges (e.g. registration, insurance, estimated fuel and oil costs and other operating costs), the cost of any vehicle accessories or optional equipment, and any charges payable to the CBA as the principal fleet manager. However, **the financing risk effectively resides with the State, as the lease payments are designed to ensure the achievement by the CBA of a required rate of return**, based on a benchmark rate, and are subject to adjustment mechanisms to take account of factors such as residual values and profit and losses on the sale of vehicles during the term of the facility. Furthermore, rental payments may be adjusted under the following circumstances:

- a change in tax law which affects the CBA;
- the CBA has applied an incorrect rate of depreciation on a vehicle for tax purposes, based on government representations and is denied a tax deduction;
- certain underlying assumptions documented in the agreement are found to be incorrect or no longer applicable; or
- a sales tax exemption declaration by the State is disallowed by the Australian Taxation Office.

8.36 In the event that the arrangements are terminated and hence no subsequent leases are entered into, the State is required to pay a lump sum or increased rental on the remaining leased vehicles as compensation for any loss of yield incurred by the CBA.

8.37 **The motor vehicle residual value risk also effectively remains with the State** as:

- where there is an early termination of the transaction and the balance of the *Profit and Loss Account (PLA)*, which is established under the provisions of the agreement to account for vehicle sales, is a negative amount as a result of estimated vehicle residual values not being realised, the State is required to fund an amount sufficient to bring the PLA balance to zero;
- although the residual value of individual vehicles is fixed for the term of the individual lease vehicle leases, the residual value schedule (used in the determination of lease payment calculations) can be amended to take account of the balance of the PLA, thus impacting on future lease payments on new leases;
- the 7 year wind-down period provided under the leasing arrangements substantially mitigates the residual risk to the CBA from the termination of the arrangements at the nominated intervals by allowing the CBA to maximise vehicle values through their orderly disposal;
- the Australian Taxation Office was advised by the CBA that there is a 95 per cent level of confidence that the balance of the PLA at the expiry of the facility is expected to be small and, accordingly, there is minimal residual risk to the CBA at facility expiry; and
- if there is a positive balance in the PLA at the end of the facility period, the State will be entitled to that benefit.

8.38 Other key terms of the sale and leaseback arrangements include:

- the State has provided an indemnity to the CBA against the financial impact of a change in law which requires the State to withhold or deduct taxes from a lease payment;
- in the event that the CBA is required to meet any tax in the nature of a domestic withholding tax or is required to make any special deposit in respect of any assets or liabilities of the CBA which results in the increase in costs incurred by the CBA, the State has agreed to compensate the CBA for the increased costs;
- the State is required to pay a commitment fee to the CBA on the undrawn balance of the facility limit;
- the State may be obliged to pay an overdue return fee where vehicles are retained for a period exceeding the vehicle maximum specified number of kilometres or duration;
- the State has required the CBA to purchase insurance policies which exclude any excess;
- the CBA is not liable for a failure of delay in obtaining or delivering any vehicle or if a wrong vehicle is delivered;
- the State's obligations to meet lease payments are not affected by any defect in the condition, operation or damage of the vehicles leased;
- the State is liable for all costs incurred as a result of the State's failure to comply with the agreement or the reckless use of the vehicle; and
- the State has assumed all risk and liability for the possession, use, operation, maintenance and storage of the vehicle during the lease term.

8.39 In relation to the taxation status of the leasing arrangements, the Department advised that the CBA had successfully obtained private binding tax rulings which supported the deductability of associated costs for taxation purposes.

Assessment of sale and leaseback arrangements

8.40 Based on an audit assessment of the arrangements established by the Government for the sale and leaseback of vehicles within the budget sector, **it is my opinion that, in substance, these arrangements constitute a financing facility, which should be included as part of the State's liabilities in the 1997-98 financial year.** The major considerations in support of this view include:

- the facility is effectively non-cancellable for the first 3 years of its term;
- the State is required to absorb all residual value risk where there is an early termination of the transaction; and
- the lease payments over the facility term are intended and designed to ensure the achievement of a required rate of return on the CBA financing, with minimal risk to the CBA.

8.41 **The Government expects the arrangements to generate substantial savings through the improved management of the motor vehicle fleet and reduced interest costs resulting from the application of the proceeds received by the Consolidated Fund towards debt retirement**.

❑ ***RESPONSE*** *provided by the Secretary, Department of Treasury and Finance*

The conclusion that the facility gives rise to a liability of the State, as it represents a "financing facility", is not agreed.

The transaction under consideration is acknowledged to be a lease and since the accounting profession has issued a relevant standard in 'AAS17 Accounting for Leases', (AAS 17), that standard should be considered the fundamental reference point for evaluation of the transaction.

The standard contains objective tests for classification of leases as between operating and finance. For example, there are specific tests relating to the lessee's ability to cancel the lease, the proportion of the asset's useful life covered by the lease and the relationship between the present value of lease payments and the asset's fair value at inception of the lease.

In this regard, the analysis fails to recognise the fact that, prior to entering into the transaction, the government was provided with independent accounting advice from a 'big six' accounting firm which confirmed that, based upon consideration of the tests contained in AAS 17, the facility is of an operating lease nature.

Importantly, the thrust of the tests contained in the standard is that probable acquisition of assets under a lease is a key characteristic for classification as a finance lease. There is clearly no such possibility under this facility.

Accordingly, the facility will be accounted for as an operating lease facility by the Department of Treasury and Finance.

Termination of transport sale and leaseback arrangements

8.42 As outlined in my October 1996 *Report on the Statement of Financial Operations,* during the 1989-90 financial year the Public Transport Corporation at the direction of the Treasurer entered into a series of sale and leaseback transactions relating to transport rolling stock assets, including suburban trains, locomotives, light rail vehicles and buses. Following concerns expressed by audit regarding the initial classification of these arrangements as operating leases, the arrangements were re-classified as finance leases and have been disclosed as liabilities of the State in the previous Statements of Financial Operations.

Locomotive and train leaseback

8.43 The major transaction entered into by the Corporation during 1989-90 was a $351 million sale and leaseback arrangement relating to rolling stock assets, comprising 33 G-Class locomotives, 25 N-Class locomotives and 50 Comeng suburban trains for an initial term of 7 years with an option to extend the lease term for a further 5 years.

8.44 In June 1996, the Treasurer exercised the option under the arrangements to purchase the leased assets at the end of the initial lease term at an estimated cost of $291 million, comprising a capital cost of $122 million to acquire the equipment and $169 million for deferred rentals. However, there were a number of variables which could impact on this estimate, including the market value of the assets, which was required to be determined by way of independent market valuations.

8.45 In September 1996, financial consultants engaged by the lessor advised that the indicative market valuation for the rolling stock was between $127.5 million and $144.5 million. This valuation contrasted with the asset values recorded by the Corporation which indicated that the Comeng suburban trains alone had a written-down book value of $183 million as at 30 June 1997.

8.46 Subsequent to a review by the Department’s legal advisers of the indicative market valuation provided by the financial consultants and negotiations between the lessors and departmental officers, **in January 1997, the Treasurer agreed to an offer for the early termination of the transaction at a cost of $299.5 million**, representing full payment for the rolling stock assets which would fully discharge the State’s liabilities. This termination amount mainly comprised $169 million for deferred rentals, $129 million in respect to the outstanding principal amount payable, a premium of $1.4 million to facilitate the hedging by the lessors of any exposure associated with the market valuation for the assets being in excess of the principal amount outstanding at the end of the initial lease term of June 1997, and management and other fees. Consequently, the ownership of the previously leased assets was transferred from the lessor to the Corporation at the date of settlement.

8.47 **By exercising the option for an early termination of the lease, the risk to the State of purchasing the equipment at higher current market values at the expiration of the initial lease term was eliminated.** The early termination of the arrangements also resulted in an estimated $1 million saving to the State, comprising an amount of $700 000 in interest saved on early termination and approximately $300 000 which would have been incurred in relation to the valuation of the fleet at the end of the lease term.

Bus and light rail vehicle leaseback

8.48 A further series of sale and leaseback arrangements was established during the 1989-90 financial year, involving the sale of 60 MAN buses, 154 Z-Class trams, 13 A-Class trams and 183 other trams, for a total consideration of $97.2 million, with the leaseback of these assets for an initial term of between 7 to 10 years.

8.49 Between September 1996 and November 1996, the Department of Treasury and Finance received notifications from the financier that they wished to exercise an option to sell the 60 MAN buses leased by the Corporation and to terminate the associated sale and leaseback arrangements. Under the arrangements, the lessor had an option, by giving not less than 6 months notice to the Treasurer, to sell the equipment to the Treasurer at a price equal to 30 per cent of the equipment cost of $13.8 million. Consequently, **under the exercised option, a total amount of $4.3 million was paid by the Department to the lessor on expiry of the relevant lease components**, comprising:

- *Tranche 1* - $2.8 million paid in December 1996;
- *Tranche 2* - $350 000 paid in April 1997; and
- *Tranche 3* - $1.1 million paid in June 1997.

8.50 On expiration of the lease components, ownership of the buses was transferred to the Treasurer.

8.51 Audit was advised by the Department of Treasury and Finance that the leasing arrangements for the remaining rolling stock are expected to run their full term.

Accelerated Infrastructure Program

8.52 As outlined in my previous *Reports on the Statement of Financial Operations*, during the 1994-95 financial year, the Department of Treasury and Finance initiated steps to wind-up the Accelerated Infrastructure Program, principally due to the significant financial exposures to the State associated with the Program.

8.53 The Program was established in the 1990-91 financial year by the then Government, in conjunction with a major private bank, to provide accommodation for certain government agencies, principally police stations and law courts. The financing arrangements involved the leasing by the Government of buildings constructed by a special purpose vehicle, a wholly-owned subsidiary of the bank, with the construction costs funded through the issue of capital indexed bonds maturing over a 20 year period. The provision of a government indemnity to bondholders effectively transferred the financing risk associated with the arrangements to the State.

8.54 In June 1995, an initial payment of $200 million was made from the Consolidated Fund to finance the acquisition of a significant portion of the bonds issued by the financing company. During the 1995-96 financial year, an additional payment of $48 million was made for the acquisition of the majority of the remaining bonds, with the process of acquiring the remaining bonds held by private bondholders completed in November 1996, at a cost of $9.9 million during the 1996-97 financial year.

8.55 **The bonds acquired by the Government as at 30 June 1997 which are valued at $258 million are disclosed as part of the State's non-current assets in the Government's Annual Financial Statement.**

8.56 At the time of preparation of this Report, the Government was reviewing the structure the program including the possible restructuring and unwinding of the program relating to the 12 existing properties. In this regard, in December 1996, the Acting Treasurer approved a budget of $1.75 million for costs to be incurred in reviewing the program.

Financial obligations of the SECV

8.57 Parts 4 and 7 of this Report provide detailed comment on the Government's electricity and gas industry reform programs, involving the fundamental restructure of these industries and the subsequent privatisation of key associated entities. Following the disaggregation of the electricity and gas industries, the State Electricity Commission of Victoria (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 Snowy Mountains power consortium inter-connecting agreement and the electricity arrangements relating to the Portland and Point Henry aluminium smelters;

- 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 materials including asbestos, and site rehabilitation. Related clearance costs are estimated at $50 million, with completion expected in March 1999; and
- Resolution of certain other residual issues of the electricity and gas industries.

8.58 **Based on the SECV's financial statements as at 30 June 1997, its financial position, not including its interest in (i.e. the amount receivable from) the State's electricity businesses of $35 million, was a net asset position of $392 million.**

Major developments since June 1996

8.59 In my October 1996 *Report on the Statement of Financial Operations,* I outlined the major developments and transactions of the SECV during the period July 1995 to June 1996. Further major developments since the 1995-96 financial year are outlined below:

- Reduction in the value of residual electricity industry debt from $42 million at June 1996 to $3.8 million at June 1997, resulting from the application of proceeds from the sale of the generation companies. Detailed comment on these sales is contained in Part 4 of this Report;
- Under the sale agreement relating to United Energy, the SECV provided an indemnity to the purchaser concerning the deductibility of franchise fees for taxation purposes. In August 1997, the Federal Court upheld an unfavourable ruling provided by the Australian Taxation Office in relation to the deductibility of these fees. The SECV has fully provided in its financial statements for an amount of $85 million in respect of this indemnity. Further comment on this matter is provided in Part 4 of this Report;
- Payments of $3 billion of the electricity business sale proceeds to the Consolidated Fund, for subsequent application towards budget sector debt retirement. This amount included a payment of $88 million to the Consolidated Fund to reimburse the cost of electricity supply industry privatisation met by the Department of Treasury and Finance;
- Payment of $74 million to the Electricity Trust of South Australia for the termination of the Interconnector Operating Agreement in April 1997, as outlined later in this Part of the Report;
- Termination in May 1997 of an external contract associated with the demolition of the former Yallourn power station complex due to a dispute with the contractor relating to the performance of its obligations. As at the date of preparation of this Report, legal action was in progress between the SECV and the contractor in relation to the termination of the contract. The SECV had also called for tenders to be submitted by interested parties by late October 1997 for the completion of the demolition works;
- Sale by the SECV of its equity interest in HRL Limited, as outlined in Part 4 of this Report;

- Administration, on behalf of the State, of the remaining financial obligations and exposures arising from the sale of the generation businesses. The claim period for general warranties and indemnities under each sale agreement for the electricity distribution businesses has expired, with no claims received by the State; and
- The purchasers of the State's remaining interest in the Loy Yang B Power Station have lodged certain claims with respect to the completion of the construction of the Loy Yang B Power Station. The State was negotiating with the purchasers to reach a satisfactory outcome for this matter.

8.60 In addition, in September 1997, the Government introduced draft legislation in the Parliament under which the the Port of Melbourne Authority, Port of Geelong Authority and Port of Portland Authority will be abolished, with their residual assets and liabilities transferred to the SECV.

Melbourne Water debt assumption

8.61 In January 1997, the Department of Treasury and Finance assessed various options to improve the capital structure of Melbourne Water, to enable the adoption of the Government benchmark for dividend distributions from the Corporation, under which dividends and tax equivalent payments would equate to around 65 per cent of operating profit before tax.

8.62 Subsequently, Melbourne Water was advised by the Department that the most appropriate capital structure to achieve the required outcome would involve a transfer of debt from the Corporation to the State, with a corresponding increase in Government's contributed capital in the Corporation. The Treasurer subsequently advised the Corporation that debt with a book value of approximately $250 million would be transferred to the State in late February 1997, under the authority of a direction pursuant to the provisions of the *State Owned Enterprises Act* 1992.

8.63 In late February 1997, a Deed of Novation was executed between the Melbourne Water, the Treasury Corporation of Victoria and the Treasurer, effectively transferring debt with a market value of approximately $283 million (book value, $250 million) from Melbourne Water to the State and releasing the Corporation from all associated liabilities and obligations.

8.64 The aggregate dividend payments made by Melbourne Water to the Consolidated Fund during the 1996-97 financial year were $140 million, compared with $49 million paid in the previous year. The increased level of payments reflects a combination of the impact of the debt assumption on the Corporation's financial operations and increased profits achieved by the Corporation.

UNFUNDED SUPERANNUATION LIABILITIES

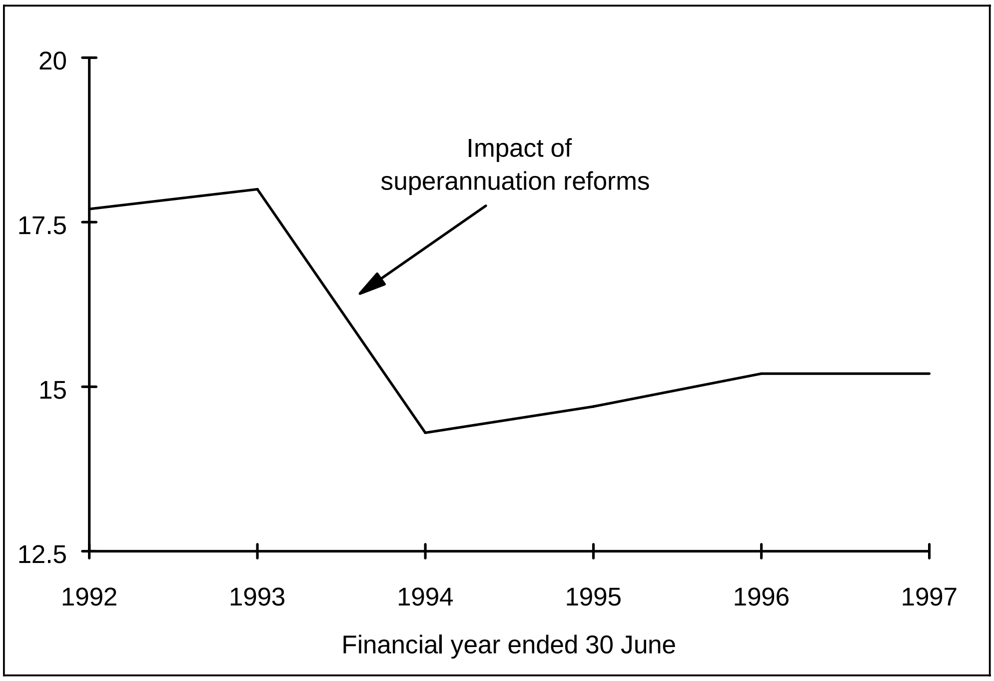
8.65 Unfunded superannuation liabilities represent the second largest component of the State's liabilities. These financial obligations comprise employer superannuation contributions yet to be paid by the Government and certain public sector bodies to superannuation schemes in respect of services previously 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.

8.66 **As disclosed in the Government's Annual Financial Statement, the unfunded liabilities of public sector superannuation funds to be met by the Government as at 30 June 1997 totalled $15.2 billion, which was consistent with the previous year**. The unfunded superannuation liabilities relate to the following sectors:

- Budget, $14.8 billion (30 June 1996, $14.7 billion); and
- Non-budget, $401 million (30 June 1996, $505 million).

8.67 Chart 8F shows the movement in the level of the State's superannuation liabilities since 1992.

CHART 8F
MOVEMENT IN THE STATE'S UNFUNDED SUPERANNUATION LIABILITIES
($billion)



8.68 My previous *Reports on the Statement of Financial Operations* have explained that the substantial reduction in the overall level of public sector unfunded superannuation liabilities since 1992 was principally due to the 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 the 1993-94 financial year.

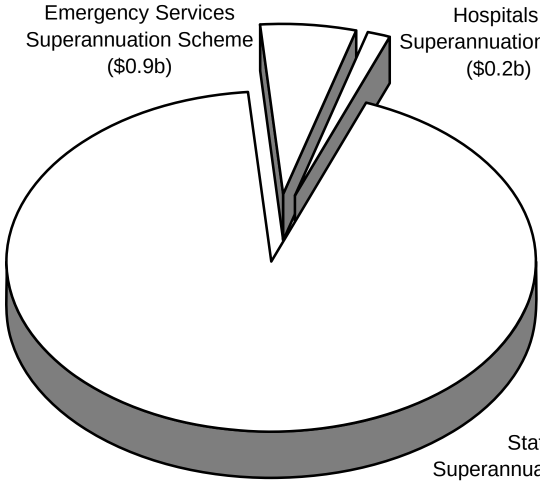
8.69 The reason for an overall upward trend in the level of unfunded superannuation liabilities since 1994-95, as advised by the Department of Treasury and Finance, was mainly due to government superannuation contributions failing to keep pace with the increase in the accruing liabilities of the superannuation funds.

8.70 In the Government's *1997-98 Budget Papers* it was identified that, despite the superannuation reforms implemented to date, the unfunded liabilities will continue to increase in real terms over the next 5 years, as members' age and length of service increases and as the number of pensioners increases. However, beyond that time, these liabilities are expected to fall steadily, as the closure of defined benefit schemes in previous years will lead to a decline in the number of beneficiaries.

8.71 The level of the unfunded liability as at 30 June 1997 was consistent with that of the prior year, mainly due to an increase in the market value of investments managed by public sector superannuation funds (a significant proportion of which is unrealised), resulting from favourable market conditions, together with additional superannuation payments made by the Government in the year, which was offset by an equivalent increase in the accrued liabilities during the year.

8.72 Chart 8G illustrates the superannuation funds principally responsible for managing the unfunded liabilities of the State at 30 June 1997.

CHART 8G
UNFUNDED LIABILITIES OF PUBLIC SECTOR SUPERANNUATION FUNDS TO BE MET BY THE GOVERNMENT, 30 JUNE 1997
($billion)



Additional superannuation payments

8.73 As outlined in my October 1996 *Report on the Statement of Financial Operations*, in July 1996, an actuary appointed by the Victorian Superannuation Board advised the Government on the value of additional contributions that should be made in future years to the State Superannuation Fund to assist in reducing the growth in the State's unfunded liabilities. Consistent with the actuary's advice**, during the 1996-97 financial year, the Department of Treasury and Finance made payments totalling $364 million to the State Superannuation Fund in relation to the State's unfunded liabilities**.

8.74 In December 1996, the actuary recommended to the Minister for Finance that superannuation funding targets, as measured by the ratio of fund assets to accrued liabilities, should be increased from 18 per cent in 1996-97 to a preferred level of 28 per cent by the year 2006-07. In particular, the actuary recommended an additional payment to the State Superannuation Fund of $493 million in the 1997-98 financial year. Furthermore, the actuary recommended that the Government consider providing additional one-off contributions to the Fund to be applied towards payments to be offered to members or former members in lieu of future benefit obligations.

8.75 **In May 1997, the Minister for Finance approved a "top-up" payment of $473 million to the Victorian Superannuation Board for the 1997-98 financial year to maintain the funding position of the State Superannuation Fund, consistent with the actuary's earlier recommendation in July 1996.**

OTHER EMPLOYEE ENTITLEMENTS

8.76 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.

8.77 **The State's financial obligations in respect of accrued employee entitlements, excluding unfunded superannuation liabilities, at 30 June 1997 amounted to $2.4 billion (1995-96, $1.9 billion).** Table 8H outlines the key components of these obligations.

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

Type	***1997***	*1996*
Long service leave	**1.7**	1.4
Recreation leave	**0.5**	0.4
Other employee entitlements	**0.2**	0.1
Total	**2.4**	**1.9**

8.78 The increase of $500 million in the year in the level of outstanding employee entitlements mainly related to long service leave, which was substantially impacted by:

- a reduction in the discount rates applied by agencies in the calculation of long service leave liabilities as at 30 June 1997, which acted to increase the present value of these liabilities; and
- a 3 per cent increase in public sector employee salaries in December 1997.

PAYABLES AND OTHER LIABILITIES

8.79 Financial obligations in the nature of payables and other liabilities mainly relate to 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 St Vincent's Hospital, accrued interest on State debt, outstanding claims for transport accident and workers compensation, amounts owing to creditors, and various other amounts payable and accrued at year-end.

8.80 **The State's financial obligations in respect to amounts payable and other liabilities at 30 June 1997 totalled $12 billion, compared with $13.3 billion in the previous year. Table 8I outlines the key components of these obligations.**

TABLE 8I
PAYABLES AND OTHER LIABILITIES,
AS AT 30 JUNE
($billion)

Type	***Total 1996-97 (a)***	*Total 1995-96 (a)*
Outstanding claims	**6.6**	5.5
Flexible electricity tariff obligations	**1.4**	1.3
Infrastructure projects *(b)*	**0.1**	0.3
Payables and other accrued expenses	**3.9**	6.2
Total payables and other liabilities	**12.0**	**13.3**

(a) The total balances are presented net of inter-entity eliminations, i.e. 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.

8.81 The decrease of $1.3 billion in the year in the level of payables and other accrued expenses was mainly due a reduction in accrued interest resulting from the retirement of debt in the year and the restructure of the budget sector debt portfolio and the elimination of liabilities associated with privatised electricity businesses. However, these reductions were to an extent offset by an increase in the outstanding claims liabilities of the Transport Accident Commission and the Victorian WorkCover Authority.

Flexible electricity tariff arrangements

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

8.83 **Payments made by the Consolidated Fund under the flexible electricity tariff arrangements in 1996-97 totalled $175 million (1995-96, $124.3 million), which was consistent with budget expectations.** The increase in the level of payments made during the current year compared with the previous year was mainly due to a decrease in the price of aluminium.

8.84 **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 $1.8 billion at 30 June 1997 ($1.6 billion, 30 June 1996), comprising $1.3 billion in relation to the Portland smelter and $450 million associated with the smelter at Point Henry.** The increase in the aggregate level of the liability since the previous year mainly relates to the expected decline in aluminium prices expressed in real terms, over the remaining term of the arrangements.

8.85 **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 $1.4 billion**. This amount has been included in the Government’s Annual Financial Statement as part of general government liabilities. Nevertheless, the State’s actual exposure is ultimately dependent on future aluminium prices and inflation levels.

Termination of World Congress Centre financing arrangements

8.86 My previous Reports to the Parliament 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, which was developed to cater for national and international conventions, exhibitions and related activities. The World Congress Centre, which was constructed at a cost of $149 million, together with the World Trade Centre and the Melbourne Exhibition Centre, has contributed to Melbourne's prominent role in the convention and exhibition market.

8.87 The Centre’s financing arrangements broadly consisted of bank financing of the Centre’s construction and the 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 was required by February 1997. The arrangements also provided for the sale of the Centre in the year 2002, at which time all outstanding debt would be repaid.

8.88 The key external parties involved in the financing arrangements comprised:

- The banks (the finance unitholders) which provided the financing for the construction of the Centre;
- The Melbourne Convention Centre Property Trust consisting of a trustee (Allco Nominees Vic Pty Ltd), an investment unitholder (Allco Investment Ltd), the finance unitholders and a trust manager (Allco Management Ltd); and
- The World Congress Centre Melbourne Pty Ltd, an exempt proprietary company acting as Centre Manager for the property trust, with responsibility for operating the Centre on behalf of the trust. The Victorian Tourism Commission has a 40 per cent interest in this company.

8.89 The State's obligations under the financing arrangement were 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.

8.90 Over previous years, my Office 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**.

8.91 As outlined in my October 1996 Report to the Parliament on the *Statement of Financial Operations*, **in May 1996 the Treasurer approved the commencement of negotiations by the Department of Treasury and Finance for the acquisition of the Centre, which would effectively result in the termination of its financing arrangements.** The Treasurer supported a preferred termination date for the arrangements of February 1997, being the date on which the redemption of the private sector equity investment in the Centre was required to be effected at an estimated overall cost of $176 million, comprising a cost of $149 million for redeeming the units in the Trust, and $27 million for the payment of capital gains tax and a termination amount.

8.92 In September 1996, a termination strategy was proposed by the Department under which the State would directly purchase sufficient units in the property trust to enable the redemption of the Centre's financing and the subsequent purchase of all trust investment units. Under this strategy, the State would become the sole beneficiary of the property trust, enabling the subsequent termination of the trust and the assignment of the Centre and its land to the Melbourne Centre Exhibition Trust (MCET). Subsequently, in October 1996, an offer to terminate the arrangement was made by the State to the trustee, under which:

- the State would acquire in February 1997 all finance units for the redemption price of $149 million;
- the State would acquire 300 investment units at their face value of $1 per unit;
- the trustee would grant to the State a sub-lease over the Centre;
- the lease would be terminated some time after February 1997 and the subject land transferred to the MCET; and
- a private ruling would be sought from the Australian Taxation Office to identify the taxation implications for the unitholders in respect of this proposal.

8.93 However, in December 1996, a revised strategy was proposed. Under the revised strategy, it was proposed that in February 1997 the Treasurer would lend sufficient funds to the trust to enable the trustee to redeem the finance units, rather than the State directly acquire units in the Trust. Simultaneously, it was proposed that the trustee sub-lease the Centre to the MCET for the period February 1997 to June 1997, followed by the acquisition of the trust investment units by MCET in July 1997. The trustee would then be replaced by State Trustees Limited which would vest the property lease to the MCET and the Secretary of the Department of Infrastructure would transfer title of the land to MCET.

8.94 Subsequently, following concerns raised by one finance unitholder, the State agreed to the retention of the current trustee until the existing indemnities had lapsed. The finance unitholder was concerned that a change in trustee may impact on the ability to claim under these indemnities.

Termination arrangements

8.95 **In February 1997, the Government entered into an *Unwinding Deed* with the trustee, the trust manager, the Centre manager, the investment and finance unitholders and the MCET to effect the termination of the financing structure. Under the Deed, in February 1997, the State was required to finance costs totalling $157.3 million**, mainly comprising:

- a loan facility of $149 million to the trustee to finance the redemption of the finance units; and
- a payment of $8.3 million made to the trustee, including $5.3 million for the final scheduled distribution payment to finance unitholders, with the balance mainly used to fund a final interest swap payment.

8.96 Consequently, the trustee and trust manager were released from their obligation under the previous financing structure to borrow funds to redeem the finance units in February 1997.

8.97 Other key terms of the Unwinding Deed were as follows:

- On the date of the finance unit redemption, the trustee was required to sub-let the Centre, its car park and the licence of the business to the MCET (the sub-lease arrangements are further discussed below);
- The MCET agreed to purchase the trust investment units for an amount of $300 in July 1997, or at a later date as agreed by the parties. Furthermore, the MCET was given the power of attorney on the behalf of the trustee, the trust manager and the investment unitholder to execute all documents in relation to the sale of the investment units to the MCET;
- The trustee granted the MCET an option to subscribe for up to 250 million units at a subscription price of $1 per unit. Subsequently, in September 1997, the MCET exercised this option and subscribed for 154 million units in the Trust, with the consideration comprising the extinguishment of the $149 million loan facility; and
- The trust manager to be entitled to receive a fee of $40 000 in relation to the provision of services for the period following the redemption date.

8.98 Consistent with the provisions of the Unwinding Deed, the trustee subsequently distributed the assets of the trust to the MCET and, in September 1997, the MCET purchased the investment units, at which time the legal ownership of the Centre transferred to the MCET.

8.99 Under the Deed, the State retained the following key obligations and provided the following indemnities:

- The State to remain responsible for meeting any payments, as determined by the trust manager, so as to cause the effective annual rate of return of the finance unitholders to equal the agreed rate of return under the previous financing arrangement for the period up to the date of termination. In relation to the taxation implications of the termination arrangements, the finance unitholders requested the Australian Taxation Office to provide a tax ruling on the termination of the transaction. As at the date of the preparation of this Report, audit was advised that this ruling had not been received;
- The MCET has provided an indemnity to the trust and the Centre manager against all claims and demands made by past or present employees in relation to the period to or after the date of finance unit redemption;
- Although the previous Centre management agreement between the trustee and the Centre manager was terminated, the Centre manager has retained a right to make claims under that agreement in relation to liabilities suffered or incurred before the redemption date. The costs of these claims would ultimately be borne by the State;

- The Treasurer confirmed that the unwinding arrangements did not diminish the powers or rights of the trustee to make any claim for payment under indemnities previously provided under the financing structure, before or after the date of settlement, notwithstanding the removal or resignation of the trustee or the release of any of the trustee’s obligations;
- An indemnity was provided to all parties to the unwinding arrangements against any costs and expenses, including legal costs incurred in connection with the unwinding arrangement and the finalisation of any outstanding tax matters, any stamp duty levied in connection with the arrangements and any liability to pay taxes; and
- An indemnity was provided against any costs and expenses properly incurred by the trustee in connection with the negotiation and execution of the Centre lease and licence, and its role as sub-lessor and licensor.

Centre sub-leases and business licence agreement

8.100 As previously mentioned, in February 1997, the trustee entered into an agreement with MCET under which MCET was granted a sub-lease of the Centre and its car park, and an exclusive licence to operate the Centre and the associated business. This agreement is to continue until the earlier of 30 June 2012 or the date MCET advises the trustee of the termination of its interest in the Centre. However, there is provision under the arrangement for the term of the sub-lease to be extended for a period of 25 years from the nominated termination date of 2012.

8.101 Therefore**, as from February 1997, MCET has become responsible for the operations of the World Congress Centre**. Specifically, under the established sub-leasing arrangements, MCET is required to:

- perform all the obligations imposed on the trustee as the lessee, and to allow nothing to be done on the sub-leased premises which would constitute a breach of the lease;
- pay a nominal annual rent to the trustee;
- only use the sub-leased premises for convention centre, car park and associated uses;
- acquire any additional property at own cost; and

8.102 Furthermore, the MCET has agreed to indemnify the trustee against:

- any liability or loss relating to the non-payment of rent, or any other amount payable by MCET or for a breach of any lease terms;
- all damages, costs or losses resulting from a MCET breach of the agreement or any death, injury or damage to property occurring on the sub-leased property, except to the extent to which the death, injury or damage to property occurs as a result of the negligence of the lessee;
- all costs or losses arising, directly or indirectly, in association with control and operation of the Centre; and
- all stamp duty relating to the agreement documentation.

Management of the Centre

8.103 Immediately following the termination of the previous financing structure, the World Congress Centre was renamed the Melbourne Convention Centre and is now operated and marketed jointly with the Melbourne Exhibition Centre under the name *Melbourne Convention and Exhibition Centre*.

8.104 The MCET has entered into a management agreement with the existing Centre manager which is to operate to December 1997, with an option to extend the termination date by 6 months, which provides for:

- the Centre manager to be the sole manager and agent for managing, operating and administering the Centre;
- a management fee of $150 000 a year to be payable by MCET to the Centre manager; and
- the Centre manager to indemnify the MCET for any liability stemming from action brought against MCET by reason of a breach of the agreement by the Centre manager.

Potential budget implications

8.105 In February 1997, the Minister for Industry, Science and Technology advised the Treasurer of his support to the merger of the Centre but indicated that if the operating performance of the joint facilities resulted in a net loss, then this would have to be dealt with by the Government. Given these concerns, and in recognition of the Treasurer's guarantee under the pre-existing Centre financing arrangements, prior to the termination of the arrangements, the Department of Treasury and Finance agreed to retain responsibility for the following financial obligations in relation to the Centre:

- the Centre's contingent liabilities that have accrued or originated prior to February 1997;
- any termination or redundancy costs for employees of the Centre existing at February 1997 and incurred until a manager has been appointed to jointly operate the World Congress Centre and the Melbourne Exhibition Centre; and
- any stamp duty payable by MCET on the transfer of the Centre as part of the termination arrangements.

8.106 In addition, the Department agreed to meet the future capital requirements of the MCET arising from the Centre and the Melbourne Exhibition Centre, if the MCET did not have sufficient internally-generated funds. In this regard, in 1996-97, the Centre was refurbished at a cost of $3 million which was funded by the retained earnings of the MCET. The Government also plans to fund the construction of a covered pedestrian bridge connecting the Centre to the Exhibition Centre, associated riverbank improvements and enhancements to the facade of the Centre at a proposed cost of $10 million.

8.107 In relation to the operating performance of the consolidated Melbourne Convention Centre, the Treasurer considered that the recent termination of the World Congress Centre's financing structure had created the potential for the co-ordinated promotion and improvement of the business of both venues, which if conducted effectively, would boost the Victorian economy and reduce the need for direct government assistance. Therefore, it was considered that any consideration of budget support for the Centre should follow a comprehensive review of all operational and management issues, which should seek to develop appropriate solutions to any projected problems.

Overall effect of termination arrangements

8.108 In summary, the effect of the arrangements established by the Government in February 1997 to terminate the financing structure developed in the mid-1980s to finance the construction and operation of the World Congress Centre has been that:

- **The State provided loan funding of $149 million to the Centre trust to enable the repayment of the outstanding Centre financing, together with a further amount of $8.3 million mainly to finance associated funding costs and a final distribution payment to finance unitholders. In addition, the State has a potential liability in relation to capital gains taxation payable associated with the termination of the financing arrangements;**
- **As from February 1997, the Centre is sub-leased and operated by the MCET;**
- **The Centre property trust investment units were purchased by the MCET at a nominal cost in September 1997, at which time the legal ownership of the Centre was transferred the MCET;**
- **The State has retained responsibility for meeting any payments, as determined by the trust manager, so as to cause the effective annual rate of return of the finance unitholders to equal the agreed rate of return under the previous financing arrangement over the full period of the transaction; and**
- **The State now has direct ongoing responsibility for the funding of any future operating deficits or capital funding requirements in relation to the Centre.**

Exchange of electricity between the south-eastern States

8.109 The May 1997 *Report on Ministerial Portfolios* briefly commented on the inter-connection operating agreement which was established in 1986 between the State Electricity Commission of Victoria (SECV), the Electricity Commission of New South Wales (ECNSW) and the Electricity Trust of South Australia (ETSA). The agreement facilitated the construction of inter-connecting electricity transmission assets and the exchange of electricity between the south-eastern States as from March 1990, for a period of 20 years.

8.110 Due to subsequent concerns regarding the operation of the inter-connection operating agreement, in December 1993, the SECV entered into an associated contract which committed it to provide the ETSA with a firm energy capacity of 200 megawatts a year, and additional energy if available. This contract was subsequently transferred to Hazelwood Power Corporation Ltd (Hazelwood) in 1995 and expired in April 1997. **The pricing of the contract was well below current energy market prices**. In particular, **ETSA was paying only an average $13 per megawatt** for all electricity acquired from Victoria and, accordingly, Hazelwood received support payments from other Victorian generators and the SECV to elevate the revenues it received under the contract to prices equivalent to around 88 per cent of the contract price between the generators and the electricity distribution businesses.

8.111 Given that the cost of energy imported to South Australia from New South Wales and Victoria was significantly less than the cost of local energy, under the inter-connector arrangements, in recent times the ETSA chose to reduce the quantity of local energy generated and, instead, import any unused generation capacity from the SECV or the ECNSW. **In June 1996, the Department of Treasury and Finance identified that, due to the increasing level of energy imports by the ETSA, Victoria incurred losses of approximately $100 million a year under the inter-connector arrangements.**

Proposals to terminate the inter-connection operating agreement

8.112 Following preliminary negotiations between the parties to the inter-connection operating agreement which were focused on the establishment of alternative arrangements which would give effect to the agreement through the use of instruments that were more compatible with the proposed national electricity market, in February 1996, the ETSA submitted a proposal to the Department of Treasury and Finance, involving:

- Termination of the inter-connection operating agreement, with the ETSA to enter into a 15 year hedge contract with the SECV involving an initial energy price of $11 per megawatt, representing the price paid at that time by the ETSA under the inter-connection operating agreement. It was also proposed that the energy price in the hedge contract would be indexed against a pool price after the first year of the contract; and
- the ETSA to be compensated for the transmission assets which were installed in Victoria at a cost to the ETSA of around $40 million (1985 dollars). These assets were valued by the Department of Treasury and Finance at $64 million as at June 1994, and the ETSA estimated that the present value of the income derived from the assets to 2010 was around $42 million.

8.113 The ETSA proposal was based on the notion that there was substantial long-term excess generating capacity in Victoria and the short-run marginal cost of production in Victoria would continue to be substantially less than energy generation in South Australia. Accordingly, South Australia was seeking to maintain the contractual benefits to which it considered it was entitled under the inter-connection operating agreement.

8.114 The Department identified that, if the ETSA proposal was accepted, the SECV would be required to purchase energy from generators in Victoria, with the State funding the difference between the market price of electricity in Victoria and the contract energy price or, alternatively, the Government would be required to direct the remaining government-owned generators in Victoria to enter into the contract with the ETSA, which would cause a significant reduction in their business values.

8.115 In response to the proposal, in May 1996, the Treasurer of Victoria indicated to the responsible Minister of the South Australian Government that the proposed hedge was materially at odds with the commercial instruments available in the market, in terms of duration and price. Consequently, the proposal was not acceptable to the State as the counterparties (Victoria and New South Wales) would incur a cost of around $400 million in present value terms. However, the Treasurer indicated that he was cognisant of the possible adverse impact on the wholesale electricity price in South Australia of the termination in April 1997 of the ETSA agreement and was therefore willing to put into place some form of supplementary arrangement which would mitigate the effects of the impact, while representing sensible commercial arrangements for Victorian generators. The Treasurer also indicated a preparedness to recognise the ETSA's investment in the Victorian high voltage grid.

8.116 In July 1996, the Department presented a counter-offer to the ETSA for the termination of the inter-connection operating agreement. This offer involved a payment of $54 million by the SECV to the ETSA as compensation for the inter-connector assets, currently owned by PowerNet Victoria, and the establishment of a hedge contract with a 2 or 5 year term, under which the SECV would make certain payments to the ETSA when the wholesale price of electricity exceeded a specified price and the ETSA would make payments to the SECV when the price fell below the specified price.

8.117 However, this offer was rejected by the South Australian Government as it was considered that it failed to provide a fair basis upon which the ETSA could justify termination of the inter-connection operating agreement. In September 1996, a counter-offer was submitted by the South Australian Government to the Treasurer, involving a compensation payment of $100 million to the ETSA and a 5 year hedge contract.

8.118 **In October 1996, the relevant parties agreed in-principle to terminate the inter-connection operating agreement in April 1997. The agreement involved a termination payment of $77 million to the ETSA, to be jointly funded by the SECV and by the ECNSW based on the original levels of investment, with South Australia able to purchase electricity freely in the wholesale electricity market at the prevailing prices.**

Benefits derived from termination

8.119 In October 1996, the Department of Treasury and Finance was advised by its financial consultants that Victoria would substantially benefit from entering into the proposed inter-connection operating agreement termination agreement and making the $74 million payment to the ETSA, being the State's share of the total proposed settlement payment of $77 million. In particular, the Department was advised that:

- The present value of the potential future losses to Victoria, if the inter-connection operating agreement was to continue to its termination date, would range between $502 million and $638 million;
- The value of the compensation payment was favourable when compared with the possible compensation value that may be determined through the legal processes;
- Victoria would gain clear title to certain assets located near the Victorian-South Australian border which were originally funded by the ETSA and have an approximate value of $64 million as at July 1994, which would allow the assets to be included within PowerNet Victoria's asset base and would clear the way for any future privatisation of the entity;
- The sale of the Victorian generators was partly predicated on the basis of the establishment of a national market, allowing the export of electricity to other States at commercial prices. Therefore, the continuation of the agreement would have been inappropriate in such a commercial environment; and
- The continued existence of the agreement could jeopardise the receipt of Victoria's competition dividend payments from the Commonwealth Government for the implementation of the national electricity market.

Termination agreement

8.120 In April 1997, the Victorian Government agreed to proceed with the termination of the inter-connection operating agreement and for the Victorian Power Exchange (VPX) to enter into a new inter-connected system control agreement with the New South Wales Electricity Transmission Authority (Transgrid) and the ETSA Transmission Corporation, which will regulate technical inter-connection issues and will expire on implementation of the fully deregulated national electricity market.

8.121 The inter-connection operating agreement was terminated on 30 April 1997, on execution of a termination agreement between Pacific Power, the SECV, the ETSA Corporation, Transgrid, the VPX, the ETSA Transmission Corporation, and PowerNet Victoria. The agreement involved:

- each party agreeing to release the other parties to the agreement and their successors, from any action, claim, demand or obligation in connection with the inter-connected system;
- the ETSA Transmission Corporation becoming a participant of the Victorian pool on termination of the agreement and to purchase electricity in the same manner as other participants in the pool;

- a compensation payment of $77 million, in lieu of the termination of the ETSA's rights pursuant to the inter-connection operating agreement and in recognition of its investment in the Victorian transmission assets, to be payable by the SECV and Transgrid in proportions of $74 million and $3 million, respectively;
- the ETSA Transmission Corporation not to be liable for any transmission charges levied by the VPX and PowerNet until the national electricity code applies; and
- ownership of the relevant interconnection transmission assets to transfer to PowerNet Victoria, the ETSA Transmission Corporation and the New South Wales Electricity Transmission Authority, respectively.

8.122 To give effect to the termination of the inter-connection operating agreement, the Administrator of the SECV was directed by the Treasurer on 30 April 1997 to execute the above termination agreement and to execute a hedge agreement to extend the general price conditions of the ETSA hedge contract, which expired on that date, for a further month until 30 May 1997.

8.123 Furthermore, an Order-in-Council, issued in late April 1997, provided an exemption to the ETSA Transmission Corporation and the nominated South Australian Trader for the requirement to obtain a licence for the sale of electricity in the Victorian wholesale electricity market from the commencement of the national market until 30 June 1998 or the expiry of the Interconnected Power System Co-ordination Agreement, whichever is the earliest. However, this exemption only applies if the relevant electricity is sold within the wholesale electricity market operated and administered by the VPX and in accordance with Pool Rules.

8.124 In June 1997, **the SECV advised the Department that the total losses incurred by the Corporation in relation to its inter-connector electricity trading activities during the period July 1994 to May 1997 were $147 million, comprising the settlement payment of $74 million and accumulated trading losses of $73 million. Given the substantial losses incurred by the State as a result of the operation of the prior electricity trading arrangements with South Australia, the negotiated terms associated with the termination of these arrangements represent a favourable outcome for Victoria.**

Latrobe Regional Hospital

8.125 In July 1991, the Central Gippsland Hospital located in Traralgon, the Latrobe Valley Hospital at Moe and the St Hilary's Nursing Home at Morwell were merged into a single management structure to form the Latrobe Regional Hospital which operates through the 3 pre-existing campuses. Subsequently, in July 1995, the Latrobe Regional Hospital also assumed responsibility for the provision of psychiatric services in the region from the Hobson Park Hospital, located at Traralgon. The objective of these amalgamations was to improve the effectiveness and efficiency of health service provision within the Latrobe Valley and the greater Gippsland region.

8.126 Both the Traralgon and Moe hospital campuses had been in operation for many years and were considered to be in need of significant upgrade to meet the current health care requirements and future demands of the region.

Proposals to consolidate and upgrade health services in the region

8.127 In 1992, the former Department of Health and Community Services identified that, with the impending introduction of casemix funding by the State Government in July 1993, the viability of the Hospital in its present configuration was questionable.

8.128 Consequently, in early 1993 the then Minister for Health commissioned a review of acute health services within the region to provide a recommendation as to the suitability of the current provision of core services at the Moe and Traralgon campuses and to identify the preferred and most desirable arrangements for the adequate provision of the Hospital's non-core services. This review, undertaken by a consultant affiliated with a firm of chartered accountants, concluded that the provision of specialist services from ageing facilities across several locations was unsatisfactory and that it would be preferable for the Hospital to operate from a single campus. The consultant envisaged a new "greenfields" site as the preferred option as the existing sites of Moe and Traralgon were not considered adequate for expansion.

8.129 The former Department commissioned a further consultant in November 1993 to examine and report on all matters relating to the facilities required to optimise acute health care services in the Latrobe region, and the actions necessary to ensure the ongoing viability of the Latrobe Regional Hospital under casemix funding. This review culminated in the release of the "MasterPlan Study" in March 1994 which also recommended the consolidation of the individual hospital campuses and, in particular, the redevelopment of the existing Traralgon site into a single campus. Subsequently, the Board of the Latrobe Regional Hospital commissioned an independent review of the "MasterPlan Study" in May 1994 which resulted in the release of a report in that year that confirmed the recommendation for the consolidation of the hospital at the existing Traralgon site.

Consideration of private sector involvement in the provision of hospital services

8.130 In November 1994, the then Minister for Health approved the development of a tendering process for the establishment of a new Latrobe Regional Hospital which would include co-located private health care and teaching facilities. The Minister indicated that the tenders should allow for any site to be considered and should be assessed against the option of a redevelopment by the Government at an alternative site at Traralgon.

8.131 Subsequently, in June 1995, consistent with the framework developed under the Government's Infrastructure Investment Policy, the Latrobe Regional Hospital Project Steering Committee was established to recommend to the then Minister for Health and the Treasurer the most appropriate form of private sector involvement in the redevelopment of the Hospital and to oversee the evaluation of submissions and negotiations with the private sector proponents. The Steering Committee was comprised of representatives from the former Department of Health and Community Services, the Department of Treasury and Finance and representatives from the private sector. The Committee was supported by a project team which had been previously established in March 1995, comprising a project director, project manager and consultants from a variety of disciplines.

8.132 During May and June 1995, the financial adviser to the Project Team prepared a series of discussion papers which were considered by the Committee in forming its recommendation that the project should be progressed under a build, own and operate (BOO) model of private sector participation. The first of these discussion papers identified the precedents for private sector participation in health projects within Australia, with emphasis on the differing forms of participation and the perceived advantages and disadvantages flowing to the public sector from such involvement. A further discussion paper assessed the various models for private sector involvement in the provision of hospital services, ranging from full privatisation to joint venture arrangements. However, no single preferred model emerged from this discussion.

8.133 In July 1995, a benchmarking methodology was developed by the financial adviser to the project team to determine a financial benchmark as one component against which the private sector submissions would be assessed to determine whether it would be feasible to allow private sector participation in the project on the basis of a BOO arrangement. It was considered that the project would only proceed if submissions were at or below the desired benchmark level. The benchmark represented the net present value of the cost to the Government, after allowing for Commonwealth grants, to operate and maintain over the term of the proposed arrangements, an equivalent public hospital in an equivalent rural setting with the same service profile.

8.134 A probity auditor was appointed by the Steering Committee in August 1995 to ensure the equitable treatment of private sector proponents during the tendering process.

8.135 Subsequently, in September 1995 the Steering Committee recommended to the Minister and the Treasurer that a registration of capability should be sought from the private sector on the basis of a BOO model for the delivery of health services to public patients in the Latrobe Valley and the broader Gippsland area. The Committee concluded that the option to build, own, operate and transfer (BOOT) the facility would be inappropriate due to potential adverse taxation implications and the desire of the Government to transfer the risks associated with the ownership of the facility to the private sector.

Registrations of capability and shortlisting of private sector providers

8.136 In October 1995, the then Minister for Health announced the Government's commitment to the development of the Latrobe Regional Hospital by seeking registrations of capability from interested parties in the private sector for the provision of improved public patient health services to the communities of the Latrobe Valley and the broader Gippsland region, with a closing date for submissions in November 1995.

8.137 The proposed basis for delivery of health services was a BOO model, with the successful consortia required to deliver a comprehensive range of health services to public patients, while not precluding private patient activity. The development was required to provide at least the same range and scope of services as the existing Latrobe Regional Hospital, with certain specified additional services also to be provided. Under the proposed arrangements, the existing hospital services provided at Moe and Traralgon and inpatient health services at Hobson Park would be consolidated into a single campus.

8.138 Following consultation and agreement with the probity auditor, 2 parties were granted a time extension to lodge their submissions, culminating in the receipt of 7 expressions of interest.

8.139 An evaluation panel comprising representatives from the former Department of Health and Community Services and the Department of Treasury and Finance, with assistance from external consultants, was established to assess the registrations of capability in accordance with the relevant evaluation criteria, as approved by the probity auditor and endorsed by the Steering Committee. The panel concluded that 4 consortia possessed the capacity to respond to the requirements of the project brief, which did not include the 2 parties previously granted a time extension to lodge their submissions. The panel's conclusion was subsequently endorsed by the Steering Committee in December 1995. However, one proponent withdrew from the process after the shortlisting process.

8.140 **The probity auditor verbally advised the Committee that the process followed by the evaluation panel in arriving at its recommendation was considered fair and equitable. Subsequently, the probity auditor resigned due to a potential conflict of interest associated with 2 of the short-listed consortia. In March 1996 a replacement probity auditor was appointed.**

8.141 **In December 1995, the then Minister for Health announced that the existing Latrobe Regional Hospital would be de-commissioned in 1998 and that hospital services in the region would be delivered by a private sector provider**. Subsequently, in February 1996, the responsible Minister and the Treasurer indicated to the Project Team that the development of the hospital would be on a "greenfields" site in order to ensure that there was no disruption to existing service delivery.

Issue of project brief and announcement of preferred private sector provider

8.142 In March 1996, the Government approved the issue of a project brief to the shortlisted consortia. In accordance with this brief, the key objective of the project was to ensure the delivery of a cost-efficient and improved health service to public patients in the Latrobe Valley and the Gippsland region from a new "greenfields" facility located on one site, utilising the BOO model of private sector involvement. The Moe and St Hilary's Nursing Homes managed by the existing hospital were not to form part of the new development. The Department of Human Services established a separate Steering Committee to determine the future of these nursing homes prior to the commissioning of the new hospital.

8.143 **The audit review found that there had been no specific studies undertaken by the Department relating to costs and efficiencies associated with the privatisation of public hospitals or the private provision of hospital services. Furthermore, the analyses undertaken by the financial advisers to the Steering Committee had been limited to the release of discussion papers outlining the commercial advantages and disadvantages of various models of private sector participation and a discussion of precedents for private sector participation in hospital projects across Australia. In addition, the consultancy reports commissioned by the Department did not identify the efficiencies to be gained through privatisation of health services in the Latrobe Valley, only concluding that for the hospital to remain viable and capable of delivering an effective and comprehensive range of specialist inpatient services, redevelopment of a single campus was required.**

8.144 In July 1996, submissions were received from the remaining 3 shortlisted consortia, with 2 of these submissions conditional upon their assumption of the management of the existing Latrobe Regional Hospital in the "transitional period", i.e. the period between the execution of the build, own and operate contracts and commissioning of the new hospital. The third shortlisted consortium had verbally indicated its preference to also assume the management of the Hospital during the transitional period but had not included a management proposal within its bid as it was assumed that management rights were outside the scope of the project brief.

8.145 In September 1996, after detailed consideration of the submissions by the assessment panels, the Steering Committee recommended to the Minister for Health and the Treasurer that Australian Hospital Care Ltd (AHCL) be selected as the preferred consortium to enter into contractual negotiations to build, own and operate the new Latrobe Regional Hospital.

8.146 A firm of chartered accountants was appointed by the Project Team in September 1996 to undertake a due diligence review and determine the funding requirements to ensure the continued provision of quality service delivery from the hospital during the transitional period. The review was finalised in November 1996, resulting in the formulation of a business plan which was incorporated into the Transitional Management Agreement subsequently established between the parties under the development arrangements.

8.147 **In October 1996, the Minister announced the selection of Australian Hospital Care Limited (AHCL) as the selected private sector provider to build, own and operate the new hospital, which is estimated to have a construction cost of $56 million and to be completed by April 1998. However, the completion date was subsequently revised to August 1998**. The company is one of the largest private hospital operators in Australia and the largest in Victoria, having experience in the development and management of a full range of health facilities, including psychiatric, rehabilitation and major acute facilities.

8.148 The probity auditor subsequently concluded that the processes followed in assessing the bids were fair and equitable and that there were no adverse findings arising from the probity investigation with respect to the preferred consortium.

8.149 In order to provide the legislative framework for the Latrobe Regional Hospital to proceed under a BOO model of service delivery, amendments were made to the *Health Services Act* 1988, effective from December 1996, including:

- clarification of the power of the Minister for Health to enter into contracts for and on behalf of the Crown for the supply of services to public hospital patients by private health providers, including provisions dealing with ownership, design, construction and operation of such hospitals;
- outlining the reporting obligations to the State of such hospitals;
- establishing the application of the *Freedom of Information Act* 1982 and the *Ombudsman Act* 1973 to the operations of such hospitals; and
- identification of circumstances in which the Minister may intervene in the management of such hospitals.

Appointment of an administrator and the transitional management arrangements

8.150 Pursuant to the *Health Services Act* 1988, an administrator was appointed in January 1997 to replace the existing Board of Management of the Latrobe Regional Hospital. Under the terms of an agreement between the administrator and the Minister for Health, the administrator was provided the power to enter into a transitional management agreement for and on behalf of the Latrobe Regional Hospital.

8.151 Under the transitional management agreement, the role of the administrator encompasses the following:

- the collection of debts owing to the Hospital prior to AHC assuming management of the hospital;
- facilitating the payment of creditors for goods or services supplied prior to AHC assuming management of the Hospital;
- safeguarding the Hospital's assets and facilitating the disposal and acquisition of assets during the term of the transitional management agreement; and
- assisting in the handover of the Hospital's management obligations under the transitional management agreement.

8.152 The administrator's appointment under the Act is to cease on the commissioning of the new Latrobe Regional Hospital.

Transitional management agreement

8.153 The transitional management agreement which was entered into in January 1997 principally between the Minister for Health, the Administrator on behalf of the Latrobe Regional Hospital, and Australian Hospital Care (Latrobe) Pty Ltd required the company to manage the Hospital for the period February 1997 to the commissioning of the new Hospital which is anticipated to occur in August 1998, and to provide health services to certain quality standards to public hospital patients during this period. The agreement is to cease to have effect in the event that the *New Latrobe Regional Hospital Agreement*, discussed later in this Report, is terminated.

8.154 Under the transitional management agreement, in return for the receipt of casemix and other health care funding, and the right to use the assets of the Hospital, the company has accepted an obligation to provide specified public health care services to defined standards during the period leading to the commissioning of the new Hospital and has accepted any risks associated with the reduction in patient throughput. Other key obligations of the company under the agreement include:

- Responsibility for general repairs, and cleaning, maintenance and repair of plant, equipment and motor vehicles to ensure appropriate service standards are maintained. Furthermore, the company cannot replace any Hospital assets, unless otherwise agreed to by the State or included in the Hospital's business plan;
- Provision of an indemnity to the State against any additional costs arising from a loss of the State's tax-exempt status, resulting from the performance of any obligations under the agreement;
- Arranging and implementing the smooth transfer of operations from the existing Hospital to the new Latrobe Regional Hospital upon its commissioning;
- Provision of an indemnity to the State against all claims for loss, damage, injury or death arising from the management of the Hospital from the date of handover;
- Meeting the Hospital's reporting requirements, including reporting to the Health Services Commissioner and preparing annual reports on behalf of the Hospital, in accordance with the *Financial Management Act* 1994; and
- Provision of an undertaking not to outsource or sub-contract the performance of any of its obligations under this agreement, unless agreed otherwise by the State.

8.155 Under the agreement, the State is required to meet certain obligations, including:

- Payment of service charges to the company for the provision of public hospital services to a required volume and quality standard, and a payment for capital expenditure items up to the maximum amount allowed for under the business plan. However, the State is not obligated to make any payments to the company if services are not provided or to make payments in excess of the amounts specified in the Hospital's business plan, which have been determined in accordance with the Health Services Agreement. Nevertheless, if the State requires that additional services be provided or increased service levels be met, the service charge paid to the company will increase accordingly;
- In the event of a force majeure event involving industrial action against the project or policies of the State which has not been caused by the company, and which has a material adverse effect on the ability of the company to meet the operating costs of the Hospital, the State will be required to pay the costs associated with the industrial action, with the company responsible for mitigating these costs. However, the State's obligation to make payments for the provision of services ceases for the period that the Hospital is not providing those services;
- An obligation to fund any shortfall between the revenue earned directly by the Hospital from the provision of private inpatient services and the projected private inpatient revenue budget agreed annually by the Department;

- Meeting the costs associated with the redundancy of staff, incurred in the period up to the transfer to the new Hospital, including all salaries, wages and leave entitlements for terminated employees accrued to the date of handover;
- An undertaking not to dispose of any plant and equipment which would affect the ability of the company to provide the required level of service;
- Provision of an indemnity to the company against all claims for loss or damage arising out of the ownership, management and operation of the Hospital up to the date of handover in February 1997;
- Provision to the company of the benefit of a number of insurance policies held by the State. However, no guarantee is provided by the State that these insurances are sufficient to cover the company's liability, with the company required to establish any additional cover at its own cost;
- Reimbursement to the company of an amount relating to company employee salaries at the end of the term of up to $600 000 a year, in the event that the projected operating result for the Hospital is achieved by the company, in accordance with the business plan. The company is required to pay to the State the remaining annual operating profits, however, and the company retains the risk associated with the non-achievement of projected results;
- Responsibility for the impact of any industrial relations issues arising as a result of the decommissioning of the existing Hospital and any changes in government policy which discriminate against the company.

8.156 In the event that specified operating defaults occur and such defaults are not cured to the satisfaction of the State, or the defaults cannot be remedied, the State may demand payment from the company as compensation for any damages suffered. The State also has the right to terminate the agreement where certain specified defaults are not remedied within the prescribed cure period and a replacement operator cannot be found under the provisions of the new Latrobe Regional Hospital Agreement, discussed later in this Report. Furthermore, in the event that such a default endangers the health or safety of patients, the State is able to exercise "step-in" rights by temporarily assuming total or partial operation of the Hospital. In this case, the company is required to indemnify the State for all costs incurred while exercising these rights.

New Hospital arrangements

8.157 In January 1997, the New Latrobe Regional Hospital Agreement was executed between Latrobe Regional Hospital Pty Ltd (a special purpose company established by the AHCL consortium), Australian Hospital Care (Latrobe) Pty Ltd (the operator) and the Minister for Health on behalf of the State. Under the arrangements, the company will design, construct and commission the Latrobe Regional Hospital, at its own cost, and will sub-contract to the operator its obligations to provide health services to public hospital patients upon commissioning of the new Hospital for a period of 20 years, with scope to extend this term for a further 5 years subject to mutual agreement between the parties. Other key obligations of the company under the arrangements include:

- The company is required to purchase the land on which the Hospital is to be constructed and to then transfer the ownership of that land to the State with a 99 year lease granted to the company. While the State has a commitment to obtain services from the Hospital for a maximum of 25 years, at the end of this term the Government does not have a commitment to purchase or continue utilisation of the facilities and the company may use the site for other purposes;
- In consideration for the receipt of service charges from the State, the company is required to operate and maintain the Hospital and provide quality services to public hospital patients for the term of the agreement, in line with prescribed performance standards. The service charges mainly comprise payments for casemix activity and payments for specific health-related activities. These charges also include a capital component for the utilisation of the Hospital building, equipment and technology, payment of which is dependent upon service delivery in accordance with contractual obligations;
- The company is required to use its best endeavours to meet the annual hospital revenue budgets. However, if a revenue budget for acute inpatient services is not met or is exceeded, the State will provide funding for any revenue deficiency or, alternatively, the company will reimburse the State for any amount in excess of the budget;
- The company will be responsible for obtaining clinical licences and other authorisations and for ensuring the registration of the Hospital as a health service establishment;
- The company will ensure that it obtains and maintains accreditation under the regulations of the *Health Services Act* 1988 and by Monash University as a Teaching Hospital for medical under-graduates and other health professionals;
- The company and the operator will indemnify the State against any claims made in relation to the Hospital’s ownership, operation or maintenance;
- The company will indemnify the State in respect of all costs incurred by the State as a result of construction defaults and the company and operator will indemnify the State in respect of operating defaults;
- In the event that there are changes in law or government policy which have a material adverse effect on the ability of the company or the operator to perform their obligations under this agreement, the parties agree to consult with a view to resolving any hardships;

- The company and the operator will indemnify the State against all claims for loss or damage arising from the performance or non-performance of any obligations of the company or the operator under the terms of this agreement;
- In the event that the Hospital is damaged or destroyed as a result of a force majeure event and the relevant event was not insured against, the company will pay all costs associated with the repair or rebuilding of the Hospital. Furthermore, following such an event, where the event has caused a partial cessation of the Hospital's operations, the State's obligations to make service payments to the company cease with the exception of a component relating to ground lease rentals associated with the land owned by the State on which the facility is constructed. However, in the case of the complete cessation of the Hospital's operations, the payments from the State will cease for the length of time the specified services are not provided;
- The company will bear all the costs associated with the transfer of patients from the existing Hospital to the newly commissioned Hospital. If commissioning does not occur by the required time, the State may demand the company to pay liquidated damages at a rate of $10 000 a day; and
- The company is required to submit to the State periodic reports in line with reporting requirements of public hospitals and an annual report on the Hospital's activities.

8.158 Under the terms of the agreement, the State has key obligations which include:

- At any time during the development period, the State may request a variation to the construction works, with any costs associated with such variations to be met by the State where such costs exceed $50 000. However, these variation requests must not delay the Hospital's commissioning;
- The State may, at its option, either terminate the agreement, demand a compensation payment from the company or take over the Hospital where a construction default has not been remedied to the satisfaction of the State;
- In the event that the Commonwealth Government withdraws from an in-principle agreement to provide funding for the provision of services for 20 nursing home beds within the Hospital, the State has agreed that it will reimburse the company for the unrecovered capital cost of providing such facilities through the capital component of the services charge, or the provision of an up-front payment if after using all reasonable endeavours the company and operator have been unable to redeploy these facilities;
- The State has agreed not to utilise the existing Hospital sites to provide health services to public hospital patients, on the proviso that there is no unremedied default by the company. In addition, the State has agreed not to enter into any agreement to purchase services from any other health facility in the Latrobe Valley region or construct a new health facility in the region for the term of the agreement; and
- During the development period and the term of the agreement, the State has agreed not to impose any laws or taxes which may discriminate between the company and the operator in relation to the Hospital and other health facilities within the State providing public patient services.

8.159 **In the event of an operating default occurring, including any threat to public health and safety which has not been overcome by the company or operator to the satisfaction of the State, under the New Latrobe Regional Hospital Agreement the State at its option may exercise all or any of the following remedies:**

- **demand a compensation payment from the company and the operator;**
- **appoint a replacement operator;**
- **assume the management of the hospital; and**
- **terminate the agreement where a suitable replacement operator cannot be found at the same price.**

8.160 That is, if at any time during the operating default, the company does not provide the required level of hospital services, and as a result, the State utilises other available resources to provide public patient care, the company must pay to the State a compensation amount equivalent to the cost to the State in providing these services from other hospitals. However, in the event that such a default endangers the health or safety of patients, the State is able to exercise its “step-in” rights, including the temporary assumption of total or partial operation of the Hospital. In exercising these rights, the State will be entitled to retain a sufficient amount of the service charge to meet the reasonable operating costs.

Overall audit assessment

8.161 In summary, under the arrangements established by the Government for the development of the new Latrobe Regional Hospital, a private sector company will design, construct, own and operate the new Hospital. Upon the commissioning of the Hospital, the company through a sub-contracted operator will operate and maintain the new facility, and provide specified health services to public hospital patients in the Latrobe Valley over an initial period of 20 years. In return for the provision of these services, the company will be entitled to receive specified fees from the State, mainly based on casemix activity and the provision of other health-related services. These fees also include a capital component for the utilisation of the Hospital building, equipment and technology, which are designed to enable the company over the initial period to meet its debt servicing and certain other obligations.

8.162 An audit analysis of these complex arrangements indicated that **key risks associated with the development of the new Hospital have been substantially transferred to the private sector company.** These include the risks associated with the construction, commissioning, financing and operation of the Hospital. In addition, the company also bears the demand risk associated with the non-realisation of casemix activity projections over the 20 year service agreement period. However, this **risk is to an extent mitigated as, provided that there is no unremedied default under the contract documents, the State has undertaken not to enter into any new arrangements to purchase specified public health services from any other health facility in the region or to construct a new health facility in the region during the term of the contract. In addition, the State has undertaken to effectively underwrite the Hospital’s own revenue generating activities related to private inpatient services and the recovery by the company of the unrecovered capital costs associated with the provision of services relating to 20 nursing home beds.**

8.163 **In default circumstances where the company does not provide the required level or specified standard of health services and the State utilises other resources to provide public patient care, the company must pay to the State compensation equivalent to the cost incurred by the State in providing such services through other facilities. In addition, if the State exercises its "step-in" rights in the case of default by the company or the operator, which may include the temporary assumption of total or partial operation of the Hospital while alternative public hospital facilities are obtained, the State will be entitled to retain a sufficient amount of the service charge to meet the reasonable operating costs**. However, in the event that the State elects to become the permanent replacement operator of the Hospital, the State must assume the financing obligations of the company under the terms of the financing arrangements.

8.164 Under the arrangements, the State has retained certain financial obligations and risks in relation to this development, including responsibility for the impact of any industrial relations issues arising as a result of the decommissioning of the existing hospital and any changes in government policy which discriminate against the company, and a requirement to execute any documents reasonably required to enable the company to obtain sales tax exemptions for goods or services which comprise any part of the works. However, **in my opinion, despite the retention of these obligations by the State and the other mitigating factors previously discussed, the company bears substantial risks associated with the construction, operation and financing of the new Latrobe Regional Hospital.**

❑ ***RESPONSE*** *provided by the Secretary, Department of Treasury and Finance*

The nature of the objectives set under this project, by necessity, involves substantial research and a sharing of responsibilities between the contract parties. The analysis does not give due recognition to these important considerations.

In this respect, the following points should be noted:

- *The Project Team and Steering Committee visited the Port Macquarie Base Hospital (NSW), as well as the Modbury Hospital and Flinders Medical Centre (SA), to examine these various examples of privatised hospitals. Extensive discussions were also held with officers of the NSW, SA, WA and Tasmanian Health departments with respect to the "lessons to be learnt" from their privatisation experiences. This process resulted in substantial and acceptable levels of risk transfer and a contracted cost below the benchmark for comparable public sector service delivery from a "Greenfields" hospital;*
- *The State is not obliged to make any payments in excess of the funding requirements contemplated in the Business Plan, i.e the company will not be paid any amount in excess of the projected cost of providing services under public sector service delivery and that any cost overruns are to be funded by the company;*

❑ ***RESPONSE** provided by the Secretary, Department of Treasury and Finance - continued*

- *The comments regarding reimbursement of costs are only partially correct. To put the payment in context, it should also be noted that $323 000 of the $600 000 annual payment is represented by replacement salary costs for the Chief Executive Officer and Director of Medical Services and these costs were added back to the surplus/deficit utilised in the Business Plan. Accordingly, the maximum net increase in cost to the State (over and above the public sector continuing to operate the Hospital as estimated in the Business Plan) is $277 000 a year; and*
- *The Report contains comments which indicate the State has underwritten the Hospitals' revenue generating activities and the recovery of unrecovered capital costs associated with 20 nursing home beds. The statement is open to misinterpretation as the State has agreed only to reimburse any shortfall in the private inpatient revenue budget of the Hospital. The reimbursement is consistent with that available to all Victorian public hospitals. The private inpatient revenue budget represents approximately $1.3 million of the Hospital's total projected revenue of $48 million.*

St Vincent's Hospital redevelopment

8.165 As mentioned in my previous Reports to Parliament, in 1991 the State entered into a series of complex arrangements to finance the redevelopment of part of the St Vincent's Hospital, which is owned by the Sisters of Charity, a denominational order committed to providing public health services. The redevelopment project commenced in January 1993 and was completed in October 1995 at an estimated overall cost of $146 million.

8.166 St Vincent's Hospital represents one of Melbourne's major public health teaching and referral centres, admitting around 36 000 inpatients and providing around 260 000 outpatient services during the 1995-96 financial year. The redeveloped facility consists of a 400 bed hospital which provides 10 state-of-the-art operating theatres, a new day procedure facility, modern intensive care and emergency departments, and pathology, pharmacy, medical imaging and food service departments.

8.167 The financial arrangements relating to the Hospital redevelopment provided for the project to be initially funded from a combination of borrowings raised by the Hospital and equity finance provided by banks. 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. 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.

8.168 The Hospital initially raised $146 million to finance the redevelopment, comprising $80 million raised through the issue of bonds and $66 million in equity financing provided by the banks. As at 30 June 1997, an outstanding amount of $118 million has been included as part of the State's liabilities, comprising $77 million owing to bondholders and a further amount of $41 million relating to the associated financing arrangements.

8.169 As commented in my October 1996 Report, in 1992 the private sector project financiers received a taxation ruling from the Australian Taxation Office which did not allow the financiers to claim taxation deductions associated with depreciation of chattels and fixed plant and equipment. Consequently, in November 1995, the Hospital and 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.

8.170 The Hospital subsequently sought the Treasurer's approval to amend the financial arrangements on the basis that the proposed amendments would result in financial benefits to the State through the reduction of rentals. However, the Department of Treasury and Finance considered that only limited savings were available from the proposed restructuring arrangements and that such amendments would financially disadvantage the State if the Hospital relocated prior to the expiry of the existing Health Services Agreement. Accordingly, in October 1996 the Hospital was advised that the State did not wish to revise the existing arrangements on the basis proposed.

Current developments

8.171 Under the existing Health Services Agreement, the Hospital is entitled to receive an annual payment, with the value of such payment determined by the Secretary to the Department of Human Services each financial year, for the supply of a specified level of public hospital services and for the usage of assets in the supply of such public hospital services. Until such time that a determination is made by the Secretary in any one year as to the value of this annual payment, the payment is to be consistent with that provided in the prior year.

8.172 In addition, a payment of approximately $8 million is provided each year to the Hospital under the terms of the Agreement to enable the Hospital to meet its obligations to bondholders for the redevelopment of the Hospital.

8.173 Correspondence between the then Secretary to the Department of Human Services and the Hospital, in October 1995, indicated that the Hospital would expect to receive an annual payment of $11.4 million in respect of the 1995-96 financial year. However, in October 1996, the Hospital received a payment of only $6 million for that year. Consequently, the Hospital threatened to proceed with legal action for the shortfall of $5.4 million.

8.174 A further dispute arose in September 1996 in relation to the determination of the annual payment for the 1996-97 financial year under the terms of the Health Services Agreement. Consequently, in October 1996, the Hospital triggered the "expert determination" provisions under the terms of the Agreement which provide for the re-calculation of the annual payments by an external expert.

8.175 Due to the failure by the Hospital and the Department to reach a mutual agreement as to the expert's engagement, in December 1996 the Treasurer was requested to select an expert. However, this appointment was mutually deferred in order to facilitate negotiations between the Hospital, the Department of Human Services and the Inner and Eastern Healthcare Network for the development of a revised Health Services Agreement in relation to both the financing arrangements and the future role of the Hospital within the health care sector.

8.176 The Department of Human Services and the Inner and Eastern Healthcare Network were in agreement that any proposed funding arrangements must be consistent with an earlier decision to relocate the St Vincent Hospital services to the outer-eastern suburb of Knox and to obtain anticipated efficiencies associated with the relocation. In accordance with this plan, the quantity of services to be purchased by the State from the Hospital, and consequently the level of funding provided, would diminish on the establishment of a new facility at Knox. The obvious outcome was likely to be a downsizing of the current level of St Vincent's Hospital operations.

8.177 Following a breakdown in negotiations between the parties, the Secretary of the Department of Human Services was advised in March 1997 that the Hospital intended to resume the option for an expert determination of the value of operating payments. However, in May 1997, this request was withdrawn as the parties agreed to settle this matter with the Department providing a payment of around $9 million. This payment mainly comprised $3.5 million relating to the 1995-96 financial year, a further $3.5 million relating to the 1996-97 financial year and an amount of $1.8 million relating to increased funding for additional public hospital services provided by the Hospital for the 1996-97 financial period.

8.178 The resolution of the funding disputes was formalised through the execution of a Letter of Agreement in July 1997, under which the Hospital agreed to:

- not pursue litigation in respect of the value the 1995-96 operating payment;
- not challenge the Secretary's determination of the operating payment for the 1996-97 and 1997-98 financial years;
- not pursue any recourse of action if the Hospital is dissatisfied with the level of funding determined by the Secretary for the periods prior to the 1997-98 financial year; and
- a reduction in the allocation of funding for additional hospital services for the 1997-98 financial year.

8.179 **While the funding dispute has been resolved, the Departments of Treasury and Finance and Human Services, recognise the need for a long-term strategic focus in dealing with St Vincent's Hospital in the context of achieving the objectives of the State's Health Plan.**

CONTINGENT LIABILITIES OF THE STATE

8.180 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.

8.181 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.

8.182 **The Government's Annual Financial Statement discloses that the estimated quantifiable contingent liabilities of the State at 30 June 1997 arising from government guarantees and indemnities were around $1.3 billion.** In addition, various other contingent liabilities existed at 30 June 1997 which could not be reliably quantified. These contingent liabilities are summarised in the Government's Annual Financial Statement.

8.183 **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.** As such, it is important that adequate arrangements are established and maintained to facilitate the recording, reporting and management of these instruments.

8.184 In my previous *Reports 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 and, in particular:

- All departments had not 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 had developed a manual for the control and monitoring of guarantees for internal purposes, which was to be made available to departments as necessary; and
- The Department of Treasury and Finance had not fully established its central contingent liability database.

8.185 As part of the audit of the Government's Annual Financial Statement, audit undertook a review of progress made by Departments to improve the recording, reporting and management of the State's contingent liabilities.

8.186 **It is pleasing to report that the Department of Treasury and Finance has now fully established its central contingent liability database and, to further enhance the reporting and management of contingent liabilities, is investigating improvements to the current reporting facilities including the prospect of establishing an interface between individual departmental registers and the central contingent liability database. However, the policy and procedures manual for the control and monitoring of contingent liabilities still had not been issued to Departments. In addition, the Department of Education had not yet established its own contingent liability register to assist in the effective management of its exposures.**

8.187 In order to form an opinion as to whether the contingent liabilities of the State are fairly presented in the Government's Annual Financial Statement 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; and
- review of the procedures adopted by the Department of Treasury and Finance for the recording and monitoring of contingent liabilities.

8.188 Based on the results of these procedures, I am satisfied that the contingent liabilities of the State have been presented fairly in the Government's Annual Financial Statement. Comments follow on the more significant contingent liabilities of the State.

Automated ticketing system

8.189 The arrangements established by the Public Transport Corporation and a private sector consortium in May 1994 for the installation of automated ticketing dispensers and validation machines on all metropolitan trams, buses and railway stations, have been subject to detailed comment in my previous Reports to the Parliament.

8.190 Under the established arrangements, the consortium is responsible for the supply, installation, testing, commissioning, maintenance and management of the ticketing system, with the Public Transport Corporation not obliged to make any payments until the consortium can demonstrate that it has successfully installed and commissioned the equipment.

8.191 As part of the arrangements, 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 the services provided.

8.192 As outlined in my previous Reports to the Parliament, the key milestones that were to be met by the consortium under the automated ticketing system service agreement comprised:

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

8.193 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 Government entered into a collateral agreement to allow the consortium to concentrate on delivering a fully commissioned piloted system by November 1996**. An 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 was terminated prior to its completion.

8.194 The collateral agreement contained a number of specific milestones to be delivered relating to the completion of the pilot stage of the system, including:

- *Formal qualification testing*, aimed at achieving verification by the system development contractors that the system software, hardware and other components met the Corporation's specified requirements. This milestone was achieved by the consortium on issue of certificates of acceptance by its contractors for all sub-systems in April and May 1996;
- *First article acceptance testing*, aimed at ensuring the individual sub-systems delivered by the consortium met the functional specifications of the Corporation when installed in an operational environment. The Corporation issued acceptance certificates in relation to the bus system, and the rail and tram sub-systems in February 1997; and
- *Roll-out acceptance testing*, planned for completion by September 1996, including the installation of the pilot system and the successful completion of system acceptance testing. Acceptance certificates in relation to roll-out acceptance testing were issued by the Corporation in March 1997.

8.195 Subsequent to the completion of the above phases, the Corporation and the consortium were required to undertake commissioning tests by early November 1996 to determine whether the ticketing equipment achieved the performance requirements stipulated in the collateral and service agreements to achieve full pilot system commissioning.

8.196 A dispute arose between the Corporation and the consortium regarding whether commissioning of the pilot stage was achieved by the consortium by November 1996 and whether the consortium was entitled to an extension of time for the completion of this milestone.

8.197 Subsequently, in February 1997, the Corporation advised the inter-departmental Automated Ticketing System Sub-Committee, which comprises representatives from the Corporation and the Departments of Infrastructure, Premier and Cabinet, and Treasury and Finance, that all the equipment required to be rolled-out during the pilot stage had been installed and was operational on stations, trams and buses, however, technical problems continued to occur. In addition, the Corporation advised that an expert had been engaged by the parties who was determining whether the consortium had achieved commissioning of the pilot system by November 1996, with the determination expected to be delivered early in March 1997.

8.198 However, **in March 1997 following the Treasurer's approval, the Corporation entered into the Automated Ticketing Project Collateral Agreement - Supplemental Agreement with the consortium and the project financiers. The purpose of the supplemental agreement was to establish arrangements to enable the collateral agreement to continue and for commissioning of the pilot stage to be achieved within a modified timeframe**. In particular:

- The agreement provided for commissioning of the pilot system to occur by 21 April 1997, with the consortium liable for penalties associated with the proportion of the system component for which commissioning had not occurred by that date;
- The agreement extended the due date for commissioning of the remainder of the system to March 1998, with cut-off for commissioning by June 1998;
- The consortium waived the right to claim for any costs or monetary compensation for any extension of time previously claimed by it for the performance of its obligations under the previous agreements, where the delay was caused by the Corporation;
- The Corporation released the consortium from any claim for compensation resulting from any delay in performance of the service agreement prior to 21 April 1997, including the non-achievement of the pilot stage commissioning or commissioning of the remainder of the system;
- The consortium retained the right to claim for variations to specifications lodged between May 1994 and March 1997, however, these rights were suspended until after commissioning of the pilot stage; and
- The parties agreed to withdraw from any existing disputes arising under the service and collateral agreements which had been previously lodged.

Project status

8.199 In late April 1997, the consortium claimed that the pilot stage commissioning had been achieved in accordance with the various contractual requirements. This claim was, and continues to be, disputed by the Corporation.

8.200 **As at the date of the preparation of this Report, the matters in dispute were still subject to expert determination. Furthermore, the Corporation had issued the consortium with a contractual notice requiring performance under the service agreement in relation to the delivery of the pilot system**.

8.201 Notwithstanding the above, the consortium has proceeded to install automated ticketing equipment across the metropolitan public transport system, however, the Corporation has not commenced making any service agreement payments to the consortium.

Melbourne City Link

8.202 My previous Reports to Parliament have commented on the Melbourne City Link project which is to be completed at an estimated total cost of $2 billion and represents one of the largest infrastructure projects ever undertaken in Australia. The project 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, West Gate and Tullamarine Freeways, together with the upgrading of parts of the South Eastern and the Tullamarine Freeways.

8.203 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 Freeway, and involving 2 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.

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

8.205 In my May 1996 and October 1996 Reports to the Parliament, 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.

8.206 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. 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.

8.207 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.**

8.208 In particular, 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. 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.

8.209 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.

8.210 **In my previous Reports to the Parliament, I indicated that the State's obligations under the existing arrangements 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.**

Status of project

8.211 The Authority has advised that the construction of the Link was currently on target, with the expected opening dates for the Western and Southern Links of April 1999 and December 1999 respectively, remaining unchanged.

City Link construction works.

8.212 Expenditure incurred by the Authority in relation to the project during the period ended 30 June 1995 to 30 June 1997 amounted to $151 million, comprising $78 million expended towards the acquisition of land, $35 million expended towards specified State works and $38 million for other costs, including salaries and administrative expenditure.

8.213 The State's capital commitments which amounted to $242 million as at 30 June 1997 in relation to the City Link have been included as part of the State's capital commitments in the notes to the Government's Annual Financial Statement. These capital commitments mainly relate to specified State works associated with the link and the Exhibition Street extension.

Disputes between parties

8.214 In August 1997, Transurban served several Supreme Court writs on the State in relation to disputes that had arisen regarding:

- the assignment of responsibility for the operating costs of licensed roads during the construction of the Link; and
- access by Transurban to "non-project land" for the construction of permanent works to be performed by Transurban.

8.215 **As at the date of preparation of this Report, audit was advised by the Authority that these disputes had been settled in principle at no additional cost to the State.**

Exhibition Street extension project

8.216 In July 1995, the Government's Steering Committee with responsibility for the Sports Precinct and Jolimont Traffic Management Review, proposed a city access road connecting Exhibition Street to Batman Avenue and the Melbourne City Link. The development of Federation Square and the rationalisation of the Jolimont railyards provided an opportunity for a connection to be developed into the Melbourne central activities district, providing an important direct link with the new proposed parkland near the Federation Square site, the National Tennis Centre, the Yarra River and other activities in the Sport and Entertainment precinct.

8.217 However, as the State was involved in extensive negotiations with Transurban at this time, a significant change in the scope of the City Link project would have delayed the finalisation of the project contract documentation. Consequently, the Government agreed to defer consideration of the recommendations of the review until finalisation of the City Link contract documentation.

8.218 In May 1996, the Melbourne City Link Authority and the Department of Treasury and Finance in consultation with the Office of Major Projects of the Department of Infrastructure, considered the optimum traffic arrangements within the area bounded by the south-east sector of the Melbourne central activities district, Swanston Street, the Yarra River and Punt Road. This review included an evaluation of the proposed city access road by the Sports Precinct and Jolimont Traffic Management Review.

8.219 Following deliberations by these parties, it was concluded that there were significant benefits in providing a better connection between the South Eastern Freeway and the Sports Precinct, with the recommended route being an extension of Exhibition Street over the railyards to Batman Avenue and across Punt Road to the South Eastern Freeway. The following benefits were identified:

- direct access to the City Link from the south-east corner of the Melbourne central activities district;
- significantly improved access from the Sports and Jolimont precincts;
- consolidation of parkland in the Batman Avenue area with the Yarra riverbank;
- significant design opportunities for Federation Square, by allowing the closure of Batman Avenue at St Kilda Road and providing a direct linkage between the new civic square and the river;
- traffic relief for City Link's Southbank interchange; and
- improved traffic flow in Brunton Avenue and Punt Road.

8.220 In October 1996, following an in-principle agreement by the Government to the proposed Exhibition Street extension, the Minister for Planning and Local Government formally announced that the Government had decided to explore the proposal of an extension of Exhibition Street and that, due to the proximity of the extension to the City Link, there would necessarily be some integration of the 2 projects, particularly in the vicinity of the Domain Tunnel. In addition, as a result of the close association between the 2 projects, it was announced that the Government would commence preliminary discussions with Transurban.

8.221 The Government considered 3 basic approaches that could be taken for Transurban to construct the extension of Exhibition Street, including:

- Transurban to perform all extension works on a build, own, operate and transfer (BOOT) basis;
- A partial BOOT approach, with Transurban being responsible for the design and construction of the Punt Road end of the extension and for the operation, maintenance and tolling of the full extension, with the State being responsible for the design and construction of the “city end” of the extension; and
- The State to request Transurban to connect the extension to the Melbourne City Link project at Punt Road, with the State being responsible for the design and construction of the remainder of the extension. Under this option, operation, maintenance and tolling of the extension could either be undertaken by Transurban, another private sector entity, or by the State.

8.222 Following a request from the Melbourne City Link Authority, in December 1996, Transurban submitted a proposal to the Authority for this project. As the State could not provide a specific date by which access to the Jolimont railyards could be provided, given the early stages of the associated rail rationalisation program, Transurban was not in a position to propose a BOOT approach to the project. Nevertheless, Transurban provided an alternative proposal involving the provision of a financial contribution by the company to the State for the cost of construction of the “city end” of the project by a specified commencement date, with the State bearing the construction and timing risks of this part of the connection.

8.223 During this time, the Government agreed in principle to progress the Exhibition Street extension on the following basis:

- a build, own, operate transfer (BOOT) approach to the extension between Burnley and the Tennis Centre, commonly referred to as the *Punt Road end of the extension*;
- the State to be responsible for the design and construction of the extension between the Tennis Centre and Flinders Street, *the city end of the extension*, with a specified contribution to be provided to the State by Transurban;

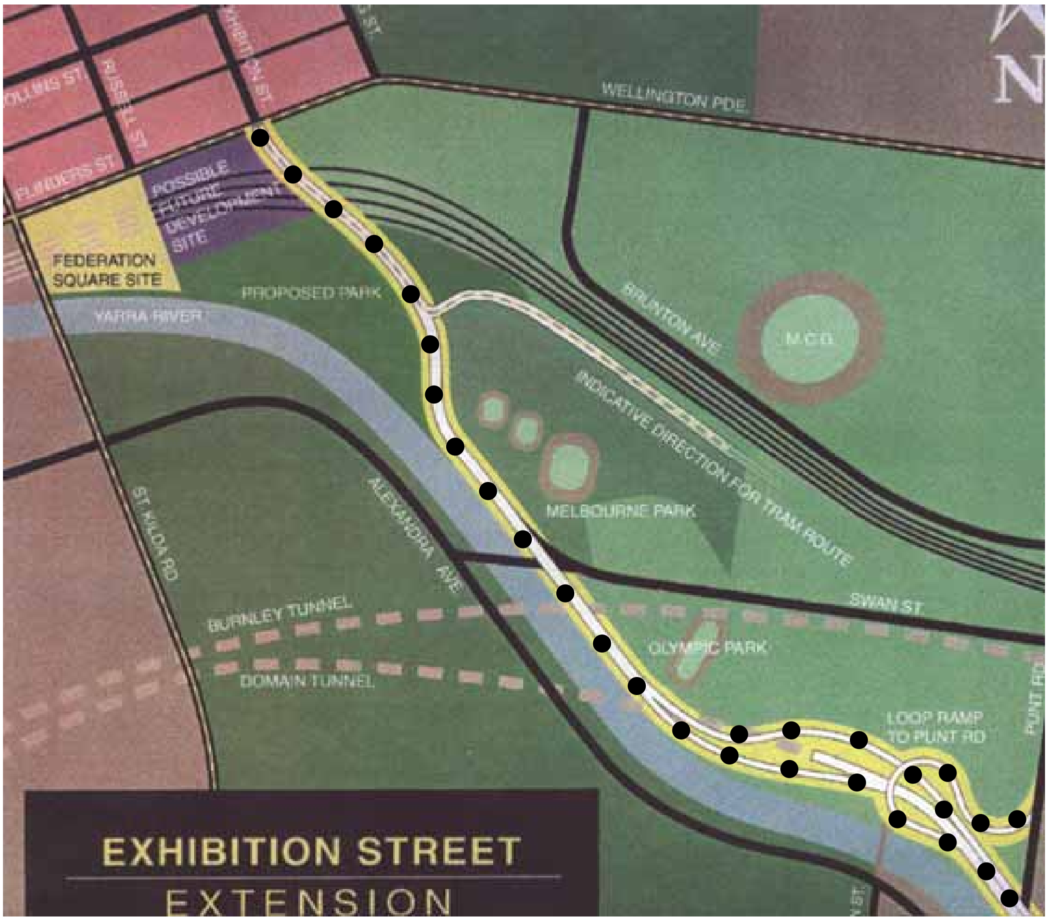
- Transurban to be responsible for the operation and maintenance of the complete connection, including the charging of tolls for each part of the connection; and
- Transurban to proceed with parallel designing of the works for the extension and the rest of the link, with the State to meet Transurban's cost for the design works to March 1997, with a maximum exposure to the State of $2.6 million if the extension does not proceed.

8.224 Subsequently, in February 1997, the Government agreed that the negotiations for the project should progress on a partial BOOT basis, with the State responsible for the construction of the section of the connection between the National Tennis Centre and Exhibition Street. It was also agreed to re-align the Swan Street/Batman Avenue tram line, to run along the centre of the median of the extension to Flinders Street, at an estimated cost of $10 million, with funding requirements to be resolved between the Minister for Transport and the Treasurer.

8.225 In June 1997, the *Melbourne City Link (Further Amendment) Act* 1997 was enacted to facilitate the construction and operation of the Exhibition Street extension project. During this time, the Authority also issued a formal notice to Transurban under the terms of the Concession Deed, advising the consortium of the changes required to facilitate the efficient integration of the Exhibition Street extension with the Link.

8.226 In addition, the Minister for Planning and Local Government formally announced that the State Government would proceed with the extension of Exhibition Street south-east of the central business district in 2 distinct parts, including:

- *Section 1*, comprising the works on the current project area from Burnley to Batman Avenue, east of Swan Street. This section is to be constructed by Transurban for inclusion in the existing City Link project; and
- *Section 2*, comprising new works outside the current project area from Section 1, along Batman Avenue, the Swan Street/Batman Avenue intersection and along a new alignment and structure over the railyards to Flinders Street. This section would be operated by Transurban, or another private sector operator, on the same basis as the existing Link. However, the operator would make a financial contribution to the State for the cost of constructing this section.



8.227 In June 1997, VicRoads, on behalf of the State, issued a functional design and specification document inviting the private sector to participate in the development of the "city end" of the extension project, with tenders closing in August 1997. The successful tenderer for the design and construction of the city end of the extention was announced in October 1997.

8.228 Also in August 1997, Transurban submitted an offer to the Melbourne City Link Authority to proceed with the Exhibition Street extension on a partial BOOT basis. Once the Authority was satisfied that Transurban had met the minimum requirements for the project, it was agreed that the Authority would proceed with further negotiations with Transurban to advance the project. However, **the risk allocation for the extension will differ from the allocation of risk for the existing City Link project, in that the State will take-on the risk of designing and constructing Section 2 of the connection**.

8.229 **In proceeding with the extension project, the parties will be committed to further expenditure of approximately $95 million**, comprising $63 million for works near Punt Road, which will be undertaken and funded by Transurban, and $32 million for works at the city end of the extension which will be managed by VicRoads and initially funded by the State, for which the State will receive a specified contribution from Transurban.

8.230 **At the date of preparation of this Report, the Authority is continuing to negotiate with Transurban to proceed with the Punt Road end of the Exhibition Street extension project with contractual documentation expected to be executed in late 1997.**

Petroleum resources rent tax dispute settlement

8.231 My previous Reports to the Parliament have commented on a dispute which had developed between 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.

8.232 As previously outlined, GASCOR and Generation Victoria purchased natural gas produced from Bass Strait under supply agreements with ESSO and BHP. In turn, GASCOR supplied this gas to its industrial, commercial and domestic customers, while Generation Victoria utilised the acquired gas in the operation of its Newport and Jeeralang gas-fired power stations.

8.233 Prior to July 1990, the production of gas from Bass Strait was taxed in accordance with the Commonwealth Government's excise and royalty regime which attracted a 10 per cent to 12.5 per cent royalty. This royalty was paid by ESSO and BHP and was implicit in the price of gas supplied to the purchasers.

8.234 However, in July 1990, the Commonwealth Government introduced a PRRT on Bass Strait oil and gas production. The new tax regime imposed a 40 per cent taxation rate on the producers' taxable profit from the extraction of gas and oil. Consequently, ESSO and BHP immediately commenced invoicing the purchasers for the PRRT liability, after allowing for an amount equivalent to that which would have been paid for royalties, as they believed that the gas supply agreements with the purchasers permitted them to pass-on the PRRT relating to gas sold to the purchasers. As a result of the above action, a dispute arose between the purchasers and ESSO and BHP, as the purchasers did not believe that they were liable to pay the PRRT under the existing gas supply agreements and, consequently, did not pay the amounts invoiced.

8.235 **After years of legal dispute, in November 1996, the Government and ESSO and BHP announced that an agreement for the settlement of the long-standing PRRT dispute had been reached. The settlement arrangements between these parties and the Commonwealth Government broadly involved a net after-tax payment to ESSO and BHP, and a new gas supply agreement which superseded the previous supply arrangements between GASCOR, and ESSO and BHP.**

8.236 Under the arrangements, GASCOR made gross settlement payments totalling $1 billion to ESSO and BHP, comprising $692 million in respect of PRRT amounts outstanding in relation to gas sold and delivered between July 1990 and October 1996, a further $327 million in respect of PRRT assessed on gas to be sold and delivered between November 1996 and the date of termination of the new gas supply agreement, which is required to occur by December 2009, and an amount of $5 million on account of the settlement of an associated gas transportation dispute.

8.237 From the gross amounts paid in settlement of the dispute, ESSO and BHP retained a net after-tax payment totalling $392 million, after being required to pay the Australian Taxation Office an amount of $627 million in relation to outstanding PRRT and company tax assessed on the gross settlement payment.

8.238 While the gross cost to the State of the settlement arrangements was $1.1 billion, which included legal and associated costs of $43 million mainly relating to the ongoing dispute and the associated arbitration and litigation processes, consistent with the extensive negotiations between the State and Commonwealth Governments prior to settlement, GASCOR subsequently received the sum of $555 million from the Commonwealth Government. This amount represented a part return of the PRRT and company tax paid by ESSO and BHP as a result of settlement arrangements. Therefore, **the net cost of the PRRT settlement arrangements to the State was $502 million**.

8.239 As previously indicated, further to the monetary settlement arrangements associated with the termination of the PRRT dispute, the arrangements also incorporated a renegotiated gas supply agreement between GASCOR, and ESSO and BHP. While the gas prices established under the new gas agreement are consistent with the prices incurred by GASCOR under the previous supply agreement, the major features of the new agreement were:

- an enhanced ability of the parties to deal with others in the market;
- the adoption by GASCOR of a significant take-or-pay obligation in relation to the annual nominated gas quantity it is required to consume; and
- the provision of regulative exemptions to the respective parties in order to prevent breaches of the *Trade Practices Act* 1994 and the *Competition Code.*

8.240 Detailed comment on the settlement, including the key elements of the new gas supply arrangements, was provided in my May 1997 *Report on Ministerial Portfolios*.

8.241 **As concluded in my previous Report to the Parliament, overall, the PRRT dispute settlement arrangements which cost the State $502 million represented a favourable outcome for the State. However, the State has retained a significant take-or-pay obligation in relation to the annual nominated gas quantity that GASCOR is required to consume, and has retained certain anti-competitive gas supply contractual arrangements which will remain in operation until the expiry of the new gas agreement, which will be no later than December 2009.**

8.242 The settlement was funded by GASCOR borrowing via the Treasury Corporation of Victoria, which has had a direct impact on the State's Budget, through no revenues being received by the Consolidated Fund from GASCOR during the 1996-97 financial year in relation to dividends and State tax equivalent payments.

8.243 The cost to the State of the PRRT settlement has been disclosed as an abnormal item in the Operating Statement of the Government's Annual Financial Statement.

Pyramid litigation

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

8.245 The State's residual financial obligations associated with the liquidation of the Farrow Group were transferred to the Transport Accident Commission in January 1993, along with the right to receive distributions from the liquidator and any outstanding amounts received from a related petrol levy introduced by the Victorian Government.

Recent legal settlements

8.246 Following the closure of the Group of Building Societies, the former Government established a scheme whereby depositors of the Societies would be paid the amount of their deposit over a period of 5 years. However, this scheme was not extended to the class of investors known as the non-withdrawable shareholders. Consequently, legal action was initiated by the shareholders in 1990 and 1993 to determine their right to participate in the distribution from the liquidation of the Societies.

8.247 In November 1996, the Victorian Court of Appeal provided a ruling which allowed these shareholders to participate in the liquidation of the Societies.

8.248 Subsequently, in late November 1996, the Treasurer in conjunction with the liquidator approved the negotiation of a settlement with the shareholders, and in mid-December 1996 the liquidator and a legal representative acting for the shareholders agreed in-principle to settle the dispute between the State, the Group of Societies and the non-withdrawable shareholders. The settlement provided for these shareholders to participate in the liquidation distributions on the basis of the full value of their investments of $124 million and an entitlement to receive interest for the period from January 1990 until December 1990. **This settlement was approved by the Supreme Court of Victoria in late February 1997 and, under the agreed arrangements, an initial payment of $48 million was made to the shareholders in late June 1997 by the liquidator. Any future payments to these shareholders, similarly to other creditors, will be dependent on the available liquidation distribution proceeds.**

8.249 In April 1997, the Government proceeded with the settlement of other various actions brought by the State and other parties, mainly including those against:

- *the auditors of the Group, Day Neilson Jenkins & Johns* - by the State, the shareholders and the liquidator;
- *the accountants of the Group, Price Waterhouse* - by the State and the liquidator; and
- *the Reserve Bank - the Commonwealth and HSV 7* - by the State and Day Neilson Jenkins & Johns.

8.250 Subsequently, numerous settlement agreements were executed by the Victorian Government Solicitor, on behalf of the State, for the settlement of complicated actions and counter-claims involving the liquidators, the auditors, the accountants, the Reserve Bank, the Commonwealth, the State of Victoria and a small group of depositors.

8.251 The main settlement agreement, approved by the Supreme Court in May 1997, related to the actions brought by the non-withdrawable shareholders, the liquidator, and the State against Day Neilson Jenkins & Johns and Price Waterhouse. The main terms of this agreement included:

- Relevant parties to release each other from the proceedings being litigated before the Court;
- All parties to release each other from the proceedings being brought by the liquidator against the administrator of the Farrow Group in respect of a payment made to Farrow Finance early in the administration period, which was considered to be unlawful and negligent;
- The auditors and the accountants of the Group to pay specified sums to the Societies, a firm of solicitors to pay the Societies a further specified amount at the request of the accountants, and the auditors to pay the depositors a further sum, thereby releasing the auditors and the State from claims for damages;
- The non-prevention by any party from claiming damages against any other party in 2 proceedings that had been commenced by depositors but not yet served against the State. However, such claims against the State became statute barred as from December 1996, being 6 years since either the administrator or the liquidator were appointed; and
- Each party to agree that the amount contributed by the other parties will remain confidential and shall not be disclosed other than where such disclosure is required by law, excluding the Treasurer in his role in reporting to the Parliament and the depositors in receipt of the $1 million from the auditors.

8.252 A further 2 agreements were executed in June 1997 between the State, the Reserve Bank and the Commonwealth, which did not require the prior approval of the Court. Broadly, the agreements allowed the State to withdraw from proceedings with the Reserve Bank and the Commonwealth and required the State to pay a specified sum to these parties to cover part of the legal costs incurred in relation to the proceedings.

8.253 **As at 30 June 1997, the aggregate cost of the State's commitment to Farrow Group depositors and shareholders totalled around $710 million.**

OTHER FINANCIAL COMMITMENTS OF THE STATE

8.254 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 1997, the public sector had financial commitments relating to operating leases and works not performed under existing contracts, valued at $2.6 billion (1995-96, $2.7 billion).

8.255 **However, the above amounts do not include the State's commitments under outsourcing contracts entered into to provide services to Victorian taxpayers.**

8.256 Specific comment follows on a new outsourcing arrangement entered into by the State in July 1997 relating to the lease of information technology equipment.

Information technology equipment lease

8.257 Due the imminent expiry of a previously established lease facility for the provision of information technology (IT) equipment to government departments and budget sector agencies, in January 1997 the Department of Treasury and Finance sought the submission of tenders by April 1997 for the establishment of a new operating lease and asset management facility to facilitate the procurement and management of leased IT equipment and services.

8.258 The Government advised tenderers that the leasing facility must qualify as an operating lease under Australian Accounting Standard AAS17 *Accounting for Leases.* In addition, tenderers were advised that the major evaluation criteria that would be adopted by the Department for the assessment of the tenders would be the financial costs and benefits of each proposal, subject to the satisfactory assessment of each proposal against certain other additional criteria.

8.259 Following the assessment of 9 initial proposals received by the Department and subsequent negotiations with 3 shortlisted tenderers, in May 1997, a firm of corporate advisers engaged by the Department to evaluate the tender proposals recommended that a consortium comprising Macquarie Bank Ltd (Macquarie) and its sub-contractor, Computer Fleet Management Pty Ltd, be selected as the provider of the leasing facility. It was considered that this consortium provided the most competitive leasing arrangement in financial terms, had a proven IT capability and represented the lowest risk to the Government.

8.260 A subsequent assessment undertaken by the Department of the selected proposal further concluded that:

- although the consortium's funding costs were greater than those of the Treasury Corporation of Victoria (TCV), as Macquarie accepted the residual risk for the equipment, this represented a significant benefit to the State; and
- the lease termination arrangements ensured that any increase in equipment disposal values that resulted from an earlier sale of the equipment was used to reduce termination costs.

8.261 The Treasurer subsequently approved the appointment of Macquarie and Computer Fleet Management Pty Ltd, as the preferred suppliers for the replacement IT operating lease facility and asset management arrangement for Victorian Government agencies. In the public announcement of the new arrangements, the Treasurer stated that the $150 million leasing facility represented the largest IT financing and asset management contract in Australia and had the potential to achieve major cost savings by making the State's IT costs more transparent.

Lease facility arrangements

8.262 **Under the established arrangements, the value of the lease facility is capped at $150 million and the facility is to operate for an initial term of 3 years commencing July 1997, with the State having the option to extend this initial term by one further year.**

8.263 The leasing arrangements for individual parcels of equipment purchased by government agencies under the facility will be for periods of between 2 to 5 years. Macquarie has warranted that these leases will constitute operating leases, in accordance with Australian Accounting Standards, in that the residual risk assumed by the company will be at least 10 per cent of the equipment purchase price and the lease term no more than 75 per cent of the useful life of the equipment.

8.264 The lease arrangements are effectively non-cancellable given that, in the event the State terminates the agreement, it will be required to return the equipment and pay a restrictive termination sum. This termination sum is determined to be equal to the net present value of the rental payments which would have accrued if the lease was not terminated, less a credit for the market value of the equipment as at the date of early termination.

8.265 Under the lease agreements, the State is required to meet quarterly rental payments which are fixed during the term of the agreements. These payments are to be calculated with reference to the following:

- *Benchmark* (interest) *rate*, based on an Australian Financial Markets Association inter-bank swap rate for a term equivalent to the lease period;
- *Equipment purchase price*, representing the net present value of the purchase price of the equipment less the residual risk accepted by Macquarie on the expiration of the individual equipment lease term; and
- The aggregate value of all asset management service fees (payable by agencies for the provision of certain support services), insurance charges and any rental business duty or financial institutions duty.

8.266 Other key terms of the leasing arrangements include:

- If either party commits a material breach of the agreement and fails to remedy such breach within 60 days, then the party not in default may terminate the agreement. A breach will be deemed to be material if it involves a failure to meet a payment in excess of $50 000. If the material breach was caused by the State then the State is required to pay a termination sum as outlined above. On the other hand, the State may also terminate the agreement in the event of Macquarie becoming insolvent;
- Macquarie bears the risk of loss and damage to the equipment from any cause whatsoever, other than loss or damage directly caused by the State's negligence. In the event of such a loss or damage to the equipment Macquarie may be required by the State to replace the equipment, in which case the replacement equipment becomes the subject of the lease agreement. An allowance will be made to the rental payment for the period during which either the equipment or the replacement equipment is unavailable. However, if the State does not require Macquarie to replace the equipment, then the lease agreement will be terminated and the State will pay a termination sum;
- The State is responsible for the cost of repairs of the leased equipment;
- Macquarie will not be liable to the State for any loss of any kind or nature caused directly or indirectly by the equipment, its inadequacy for any purpose, any defect therein or the condition of the equipment; and
- Macquarie must obtain and maintain insurance for the State in respect of the equipment. No additional charge will be payable by the State as the cost will be built into the rental payment. However, the State may elect to obtain and maintain insurance in respect of the equipment, in which case Macquarie requires that the insurance coverage is equal to the greater of replacement value or the termination sum.

Assessment of IT leasing facility arrangements

8.267 **Based on the analysis of obligations of the respective parties under the IT leasing arrangements, it is my view that the arrangements have been correctly classified as an operating lease as the risks and benefits incidental to ownership of the equipment substantially do not reside with the State. Key factors supporting this view are that the residual risk has been assumed by the company and the lease term of the equipment will not exceed 75 per cent of its useful life.**

VICTORIAN AUDITOR-GENERAL'S OFFICE

Auditing in the Public Interest

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
  AUSTRALIA

  Phone: (03) 9651 6012 Fax: (03) 9651 6050
  Internet:
  Email:
  vicaud1@vicnet.net.au
  Homepage:
  http://www.vicnet.net.au/~vicaud1/aghome.htm

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

  Phone: (03) 1300 366 356 Fax: (03) 9603 9920