

VICTORIA

Auditor-General
of Victoria

**REPORT OF THE
AUDITOR-GENERAL

VICTORIAN
GOVERNMENT'S FINANCES
1998-99**

*Ordered to printed
by Authority. Government Printer for the State of Victoria*

ISSN 1327-6905
ISBN 0 7311 5503 3

Contents

	<i>Page</i>
PART 1	
EXECUTIVE SUMMARY _____	1
Overview • 3	
Summary of major findings • 5	
PART 2	
AUDIT OPINION ON STATEMENT _____	11
<i>Financial accountability framework</i> • 13	
<i>Audit opinion on the Government's Annual Financial Statement</i> • 14	
<i>Auditor-General's Report on the Victorian Government's Finances</i> • 15	
PART 3	
OPERATING RESULT AND FINANCIAL POSITION _____	17
<i>Operating result and financial position</i> • 19	
PART 4	
REVENUE _____	29
<i>Summary of State revenues</i> • 31	
PART 5	
EXPENDITURE _____	47
<i>Summary of State expenditure</i> • 49	
PART 6	
ASSETS OF THE STATE, INCLUDING MAJOR ASSET SALES _____	69
<i>Summary of State assets</i> • 71	
<i>Government asset sales program</i> • 75	
PART 7	
LIABILITIES AND COMMITMENTS _____	155
<i>Aggregate liabilities of the State</i> • 157	
<i>Borrowings</i> • 159	
<i>Unfunded superannuation liabilities</i> • 176	
<i>Other employee entitlements</i> • 182	
<i>Payables and other liabilities</i> • 183	
<i>Contingent liabilities of the State</i> • 185	
<i>Other financial commitments of the State</i> • 194	
INDEX _____	197

PART 1

Executive Summary



**VICTORIAN
AUDITOR-
GENERAL'S
OFFICE**

*Auditing in the
Public Interest*

Overview

This is my first Report to the Parliament as Auditor-General and the Report outlines the results of the audit of the Government's Annual Financial Statement. The Report also includes an analysis of and comment on the operating expenditures and revenues of the State and its assets and liabilities, together with the outcomes achieved from the privatisation of government business enterprises and the sale of surplus and under-utilised properties.

A clear audit report was provided on the Government's Annual Financial Statement. It is particularly pleasing to be able to report on a strengthening of the State's financial condition during the 1998-99 financial year, reflecting the positive impact of the financial management strategies implemented over recent years.

The Statement shows that the Government achieved an operating surplus prior to abnormal items of \$2.7 billion in the year, and an overall operating surplus of \$6.7 billion after taking account of abnormal items, mainly relating to gains associated with the privatisation program. While strong financial outcomes have been achieved from the privatisation program in recent years, there continues to be a need for greater disclosure by the Government of these and other substantial transactions to further strengthen the public accountability process. The Auditor-General's report should not be regarded as a substitute for adequate disclosures of key transactions by the Government itself.

As at 30 June 1999, the State held assets valued at \$78.8 billion (30 June 1998, \$77.1 billion) and liabilities valued at \$41.3 billion (30 June 1998, \$49.1 billion). The improvement in the State's financial position has mainly been brought about by a significant reduction of State debt and unfunded superannuation liabilities, attributable to the application of privatisation proceeds.

During the 1998-99 financial year, the Government continued with the positive action commenced in prior years to facilitate the termination of a number of costly structured financing arrangements which were established in the early 1980s, including certain transport rolling stock leases and the financing arrangements associated with the construction of the Monash Medical Centre and various Police and Court complexes. Once completed, such action should assist in reducing the costs borne by the State for the delivery of associated programs.

My report also signals, even having regard for the improvements referred to above, that the Government still has some way to go before the State's taxation levels can fall into line with the national average. Given that the Government estimates put the level of Victoria's taxation revenues in the 1998-99 financial year at around \$394 million (\$84 per capita) above the national average, there continues to be a need for strong leadership and effective management of State finances if the above aim is to be achieved.

A significant development during the year was the implementation of new Parliamentary Appropriation arrangements, based on accrual accounting principles. While this initiative undoubtedly represents a positive step towards enhanced management of the State's finances, placing the State at the forefront of financial management practices throughout the world, my Report identifies areas where further scope exists to enhance the effectiveness of Parliamentary control over the public purse, and to strengthen administrative arrangements.

Finally, given the recent trend for public services to be delivered through contractors or outsourcing arrangements, and its growing part of State activity, it is important that the future commitments associated with these arrangements be included in annual reports to the Parliament.

Summary of major findings

OPERATING RESULT AND FINANCIAL POSITION

Page 17

- The State achieved an operating surplus prior to abnormal items of \$2.7 billion for the 1998-99 financial year, which was \$755 million higher than the result achieved in the previous year.

Paras 3.1 to 3.5

- The overall operating surplus for the year was \$6.7 billion after taking account of the impact of abnormal transactions during the year, mainly relating to the gains associated with the Government's privatisation program.

Para. 3.4

- As at 30 June 1999, the State held net assets of \$37.5 billion, comprising assets with an aggregate value of \$78.8 billion and liabilities with an aggregate value of \$41.3 billion.

Para. 3.6

- The State's financial condition has further strengthened during the 1998-99 financial year, in that:

- the Government's capacity to maintain existing programs and operations has improved;
- the Government's flexibility in responding to future opportunities requiring increased financial resources has also improved; and
- the State's vulnerability to funding sources not directly within its control has decreased.

Paras 3.7 to 3.11

- The State's total cash and investment holdings increased substantially from \$16.2 billion as at 30 June 1998 to \$17.6 billion as at 30 June 1999, with a net amount of \$4.2 billion held by the Treasury Corporation of Victoria. The Corporation advised that these funds will be applied towards the retirement of debt when it matures, after retaining sufficient investments to meet the State's prudential liquidity requirements.

Para. 3.11

- The introduction of accrual-based appropriation arrangements represents a positive step towards enhancing financial management within the budget sector by ensuring that the resource allocation processes and the accountability arrangements for departments to the Parliament are aligned.

Paras 3.16 to 3.19

OPERATING RESULT AND FINANCIAL POSITION - continued**Page 17**

- It may have been expected that by shifting to accrual-based arrangements, the appropriations would be applied when expenditure was actually incurred and for the actual accrual cost of outputs delivered. The new framework for the operation of appropriations as from 1 July 1998, however, provides that the Treasurer will determine when Parliamentary appropriations will be applied based on a pre-determined price, which is when the Treasurer determines that the particular outputs have been delivered.

Para. 3.20

- In respect of a number of departments, the value of appropriations applied in the year was higher than the value of costs actually incurred, resulting in the generation of departmental profits which, under the established legislative arrangements, are available for future application by the Government without further Parliamentary sanction.

Para. 3.21

- During the 1998-99 financial year, deficiencies were identified in the documentation available to support the appropriations applied. Procedures at the Department of Treasury and Finance need to be strengthened accordingly.

Paras 3.22 to 3.23

- While the quality of financial reporting by departments has improved in recent years, this improvement has not been accompanied by the introduction of explicit requirements on departments for the presentation of audited information to the Parliament in relation to their achievement of output targets and other performance indicators.

*Paras 3.24 to 3.26***REVENUE****Page 29**

- During the 1998-99 financial year, the operating revenues of the State totalled \$26.4 billion, which was \$795 million higher than the revenues raised in the previous year.

Paras 4.1 to 4.3

- Victoria's taxation revenues in the 1998-99 financial year were around \$394 million above the national average, which equates to around \$84 per capita.

Paras 4.4 to 4.7

- There continues to be a need for strong financial leadership and effective management of State finances to achieve the aim of bringing the State's tax effort into alignment with the national average.

Para 4.8

- During 1998-99, State revenues from gambling activities totalled \$1.4 billion, an increase of around \$121 million since the previous financial year, and represented 5 per cent of total State operating revenues.

Para 4.9

- The State received \$6.4 billion from the sale of a number of State-owned enterprises, mainly the State's gas businesses, the Victorian Plantations Corporation and Aluminium Smelters of Victoria Pty Ltd.

Paras 4.39 to 4.45

EXPENDITURE**Page 47**

- During the 1998-99 financial year, the operating expenses of the State totalled \$23.7 billion, some \$40 million higher than the expenditure incurred in the previous year.
Paras 5.1 to 5.5
- The net operating costs incurred by the State on the Formula One and Motorcycle Grand Prix events, relating to the 1998-99 financial year, were \$9.3 million.
Paras 5.13 to 5.20
- Since the inception of the Formula One and Motorcycle Grand Prix events, the net aggregate operating costs incurred by the State have totalled \$36.7 million.
Paras 5.21 to 5.29
- The State has provided operational funding of \$7.2 million from the Consolidated Fund since 1997 to the Melbourne 2006 Commonwealth Games Bid Pty Ltd, the company established to bid for the 2006 Commonwealth Games.
Paras 5.30 to 5.35
- Based on revenue and expenditure projections included in the submission provided by the Melbourne 2006 Commonwealth Games Bid Pty Ltd to the Commonwealth Games Federation, estimates disclose that the company could incur an operating loss of around \$93 million (in 1998 dollars) from hosting of the 2006 Commonwealth Games in Melbourne. In addition, it was projected that the State would incur a cost of around \$102 million from the provision of services associated with the event and would undertake related capital works at a cost of \$97 million.
Paras 5.36 to 5.41
- The cost ultimately incurred by the State in relation to an annuity-based financing arrangement established in the late 1980s over its 12 year term was around \$17 million higher (in nominal dollar terms) than that which would have been incurred on alternative funding sources available at the time of establishment of the arrangement, mainly due to the impact of adverse taxation assessments.
Paras 5.42 to 5.46
- While up to \$85 million was made available by the Commonwealth Government by way of financial assistance to eligible individuals and small businesses effected by the gas emergency in late September 1998, only \$8 million was actually expended by the State, made up of \$6.5 million (81 per cent) distributed to eligible recipients, with \$1.5 million (19 per cent) incurred in advertising and administering the scheme.
Paras 5.58 to 5.63
- The impact of the increased internal capital assets charge within departments during the 1998-99 financial year was to increase by \$1.1 billion the reported cost of service delivery by departments, as reflected in the application of Parliamentary Appropriations.
Paras 5.64 to 5.68
- In any future assessment of the costs to the State of providing public transport services under the new franchising arrangements, compared with the reported costs of these services under Government ownership, due regard needs to be given to the level of the internal capital assets charge built into these costs.
Paras 5.69 to 5.73

ASSETS OF THE STATE, INCLUDING MAJOR ASSET SALES**Page 69**

- At 30 June 1999, assets with an aggregate value of \$78.8 billion were controlled by the Government.
Paras 6.1 to 6.14
- Over recent years, the State has realised around \$30 billion in gross proceeds from the sale of public sector utilities in the electricity, gas, ports, softwood plantations and aluminium sectors.
Paras 6.15 to 6.19
- The State received total gross proceeds of \$6.28 billion for the sale of the 3 “stapled” gas businesses (including the associated Gasmart business) and Transmission Pipelines Australia, which compared favourably with the book value of the assets sold and valuations obtained prior to sale.
Paras 6.20 to 6.73
- As part of the implementation of the Winter 1999 action plan to ensure the continuation of gas supplies, during the 1998-99 financial year GASCOR incurred expenditure of around \$51 million associated with the upgrade of the New South Wales interconnect pipeline, the completion of the south-west pipeline, the installation of certain additional equipment and the performance of certain new gas supply contracts.
Paras 6.74 to 6.78
- In November 1998, the State entered into a number of agreements for the sale and development of an underground gas storage facility in the Port Campbell area for a total price of \$58.5 million, comprising \$31.6 million for the storage facility and \$26.9 million for the rights to the Iona reservoir gas reserves.
Paras 6.87 to 6.92
- The result achieved by the State for the sale of the Ecogen Energy business which included the Newport and Jerralang gas-fired power stations, was around \$100 million higher than the most optimistic valuation placed on the business by the Government’s advisers.
Paras 6.107 to 6.124
- The State obtained sale proceeds of around \$201 million in excess of the book value of the plantation business of the Victorian Plantations Corporation, mainly representing the value placed by the purchaser on the perpetual rights granted by the State in relation to the occupation and management of around 166 000 hectares of Crown land vested in the Corporation for plantation purposes.
Paras 6.126 to 6.142
- After taking account of an amount of \$109 million which was applied by the State to fund the closure of Aluvic’s foreign exchange hedge book and to meet the State’s costs of sale, the net loss to the State from the sale of Aluvic was \$8 million.
Paras 6.143 to 6.161

ASSETS OF THE STATE, INCLUDING MAJOR ASSET SALES – continued**Page 69**

- The State received \$72.9 million from the sale of the net assets of V/Line Freight Corporation. The State has retained ownership of the intra-State rail infrastructure. It has also entered into a lease agreement with the purchaser, under which the purchaser paid \$89.7 million to the State as a prepayment of the future lease rentals over the 45 year term of the lease.

Paras 6.162 to 6.217

- To facilitate the efficient operation of rail transport throughout the State, a number of access agreements have also been established under which the purchaser of the V/Line Freight Corporation is required to provide certain rail operators, such as V/Line Passenger and other private sector passenger service operators, access to the leased railway infrastructure in return for the receipt of related fees.

Para 6.216

- The proceeds of \$16.25 million achieved from the sale of the former Coburg Prison Complex and the adjoining former Newland Secondary College were \$1 million higher than the comparable valuation of the property, but \$12 million below the book value of the complex.

Paras 6.218 to 6.241

- During 1998-99, the State sold a number of de-commissioned hospital sites, including the former Heatherton Hospital and part of the Kingston Centre site, the former Larundel Psychiatric Hospital in Bundoora and the former Preston and Northcote Community Hospital, realising total proceeds of \$41.4 million.

*Paras 6.242 to 6.287***LIABILITIES AND COMMITMENTS****Page 155**

- The liabilities of the State totalled \$41.3 billion at 30 June 1999, a reduction of \$7.8 billion on the previous year, mainly due to the application of privatisation proceeds towards the reduction of State debt and unfunded superannuation liabilities.

Paras 7.1 to 7.6

- The State also has quantifiable contingent liabilities of around \$951 million (1997-98, \$1.4 billion). In addition, various other contingent liabilities existed as at 30 June 1999, which could not be reliably quantified.

Paras 7.7 and 7.105 to 7.108

- The aggregate value of the State's operating lease and capital commitments as at 30 June 1999 was \$2.7 billion (30 June 1998, \$2.9 billion). These do not include all the State's commitments under outsourcing contracts entered into for the provision of services to the public sector, such as health services.

Paras 7.8 and 7.138 to 7.139

LIABILITIES AND COMMITMENTS - continued**Page 155**

- Over the past 3 financial years, the State has incurred a total cost of around \$385 million associated with the termination of the transport rolling stock leasing arrangements that were established during the 1980s and the acquisition of the related assets, including \$9 million relating to premiums and other costs payable upon the early termination of the arrangements.
Paras 7.23 to 7.37
- Though the transport rolling stock leasing arrangements were terminated, the State was required to retain certain taxation indemnities that were provided to the lessors when the arrangements were initially established.
Para 7.37
- As an initial step in facilitating the termination of the financing arrangements associated with the construction of the Monash Medical Centre, the State provided a loan of \$35.5 million to the special purpose company it acquired during the year and applied these funds towards the repayment of its “conventional” borrowings. It is now in the process of negotiating the termination of the remaining complex trust-based financing arrangements with the relevant parties.
Paras 7.53 to 7.55
- The realisable value of bonds, which had been initially issued by a private sector company to finance the construction of properties under the Accelerated Infrastructure Program, and which had been previously purchased by the State at a cost of \$258 million, were written-down by \$122 million in June 1999.
Paras 7.56 to 7.64
- The State Superannuation Fund incurred expenses totalling \$12.5 million, which were initially funded from members’ funds, relating to the establishment of the Government Superannuation Office and VicSuper Pty Ltd. As a result of legal advice received regarding the application of members’ funds for the above purposes, in November 1999 a payment of \$12.5 million was made by the Department of Treasury and Finance to reimburse the State Superannuation Fund for these costs.
Paras 7.86 to 7.92
- Net payments made by the SECV to the aluminium smelters under electricity supply contracts during the 1998-99 financial year totalled \$188 million (1997-98, \$180 million).
Paras 7.99 to 7.102
- Based on Government expectations of future aluminium prices and inflation levels, the estimated net present value of the State's future liabilities under the smelter electricity supply arrangements is \$1.3 billion and the estimated amount receivable is \$1.1 billion from the levy on distribution businesses.
Paras 7.103 to 7.104
- In August 1999 a settlement was reached between the various parties in relation to the Western Link of the City Link Project, with the State agreeing to pay Transurban and the contractors for the Western Link a total of \$10 million as full settlement of claims against the State in relation to works conducted on that section of the City Link.
Paras 7.113 to 7.137

PART 2

Audit Opinion on Statement



**VICTORIAN
AUDITOR-
GENERAL'S
OFFICE**

*Auditing in the
Public Interest*

Financial accountability framework

2.1 The accountability responsibilities of the Government to the Parliament in relation to State finances are set out in the *Financial Management Act 1994*, *Audit Act 1994* and *Constitution Act 1975*. These include the external financial reporting and audit arrangements which operate within the Victorian public sector.

2.2 A key element of the accountability arrangements is the requirement, under the *Financial Management Act 1994*, for the Government to prepare an Annual Financial Statement which must be audited by the Auditor-General and presented to the Parliament each year, together with a Report of the Auditor-General on that Statement. Under the Act, **the Government's Annual Financial Statement must present fairly the transactions of the Public Account, which comprises the Consolidated Fund and the Trust Fund, and the other transactions of the State in respect of the financial year, and the financial position of the State as at the end of the financial year.**

2.3 The Government's Annual Financial Statement is required to be prepared in a manner and form approved by the Minister for Finance. It must include a number of prescribed disclosures which, in the main, relate to the transactions and balances of the Consolidated Fund and the Trust Fund of the Public Account.

2.4 The prescription by the Parliament of the financial disclosures relating to the operations of the Public Account reflects its important role within the State's accountability framework. The Consolidated Fund within the Public Account represents 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 State's accountability framework is the principle that only the Parliament can authorise expenditure from the Consolidated Fund. Accordingly, Appropriation Acts which provide the key means by which parliamentary control is exercised over public finances are prepared annually by the Government and sanctioned by the Parliament.

2.5 The Trust Fund, which also forms part of the Public Account, 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.

2.6 Consistent with the financial reporting requirements of the *Financial Management Act 1994*, the Minister has determined that the Government's Annual Financial Statement is to be prepared in a format which is consistent with the requirements of Australian Accounting Standards and, in particular, Australian Accounting Standard AAS31 *Financial Reporting by Governments*. Accordingly, the Statement represents the consolidated financial report of the Victorian Government and incorporates a statement of financial position, an operating statement, a statement of cash flows and accompanying notes.

Audit opinion on the Government's Annual Financial Statement

2.7 The Government's Annual Financial Statement for the year ended 30 June 1999 has been audited as required by the *Financial Management Act* 1994. The audit has been undertaken in accordance with Australian Auditing Standards and my opinion on the Government's 1998-99 Annual Financial Statement which was issued on 8 November 1999 was as follows:

Audit Scope

The accompanying Annual Financial Statement for the year ended 30 June 1999 of the Government of Victoria (excluding local government bodies and universities), comprising the consolidated operating statement, the consolidated statement of financial position, the consolidated statement of cash flows and the accompanying notes contained in Section 2 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 to the Members of the Parliament, the responsible Ministers and the Secretary to the Department of Treasury and Finance 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 report is presented fairly in accordance with Australian Accounting Standards and other mandatory professional reporting requirements, and complies 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, the results of its operations and its cash flows.

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

Audit Opinion

In my opinion, the financial report presents fairly the financial position of the Government of Victoria as at 30 June 1999 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 complies with the requirements of the *Financial Management Act* 1994.

Scope of the Annual Financial Statement

2.8 The Government's 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 of general purpose whole-of-government financial reports, prepared on the accrual basis of accounting.

2.9 In presenting the Government as a single economic entity, the Government's Annual Financial Statement has been prepared by consolidating the financial statements of government departments, public trading enterprises, government-controlled public financial institutions and not-for-profit public sector entities. Certain entities have not been consolidated, including local government bodies and universities.

2.10 The majority of the State's assets have been appropriately recognised within the financial statements, substantially due to the implementation of the Government's asset identification and valuation program in recent years. The major assets yet to be recognised as at 30 June 1999 include land under roads which, at this stage, is not required to be recognised under Australian Accounting Standards, and the State's share of assets managed by the Murray-Darling Basin Commission which have not yet been valued by the Commission. Further comments on the progress made during the 1998-99 financial year in relation to the valuation and recognition of State assets are included in Part 6 of this Report. The State's liabilities have been recognised within the financial statements and comment on these is included in Part 7 of this Report.

Auditor-General's Report on the Victorian Government's Finances

2.11 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 the Parliament in its 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;
- Revenue;
- Expenditure;
- Assets of the State, including major asset sales; 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 Consolidated Operating Statement discloses the operating result achieved by the State in the year, which is a key measure of the Government's financial performance and represents the difference between the revenues raised and expenses incurred in the year in delivering services to the public. The Statement also presents information on the movements in revenue and expenditure levels since the previous year. This information, when assessed over a number of years, provides an important indicator of the financial impact and sustainability of the Government's financial strategies and policies.

3.2 The Consolidated Statement of Financial Position discloses information on the level and composition of assets and liabilities held by the State as at 30 June 1999, including changes thereon since the previous year. Importantly, the Statement serves as an indicator of the Government's financial strength and of changes in its overall financial position.

3.3 Table 3A presents a summary of the operating result achieved by the State for the year and its financial position as at 30 June 1999, as disclosed in the Government's Annual Financial Statement.

TABLE 3A
STATE OF VICTORIA
OPERATING RESULT AND FINANCIAL POSITION
(\$billion)

<i>Item</i>	<i>1998-99</i>	<i>1997-98</i>
Operating result		
Revenues	26.4	25.6
Expenses	23.7	23.6
Operating surplus for the year before abnormal items	2.7	2.0
Net abnormal items (a)	4.0	2.2
Operating surplus for year	6.7	4.2
Financial position		
Assets -		
Physical assets	56.6	56.1
Cash and investments	17.6	16.2
Other	4.6	4.8
	78.8	77.1
Liabilities -		
Borrowings	14.3	19.0
Unfunded superannuation	11.5	14.9
Employee entitlements	2.4	2.5
Other	13.1	12.7
	41.3	49.1
Net assets	37.5	28.0

(a) Includes the net impact of privatisations of \$4 billion (1997-98, \$1.4 billion), the impact of a write-down in the 1998-99 financial year of \$122 million in the value of certain bonds previously acquired by the Government as part of the termination of the accelerated infrastructure program, and a gain of \$107 million associated with a finance lease liability relating to the Monash Medical Centre, arising from a restructure of the associated arrangements by the State. Further comment on the privatisation program, the accelerated infrastructure program and the Monash Medical Centre financing arrangements is contained in later Parts of this Report.

Operating result for the year

3.4 The Government's Annual Financial Statement discloses that **the State achieved an operating surplus prior to abnormal items of \$2.7 billion for the 1998-99 financial year, which was \$755 million higher than the result achieved in the previous year. However, after taking account of the impact of abnormal transactions during the year, mainly relating to the gains associated with Government's privatisation program, the overall operating surplus for the year was \$6.7 billion (1997-98, \$4.2 billion).** Detailed comment on the Government's privatisation program is provided in Part 6 of this Report.

3.5 The key factors positively contributing to the improved operating result were increased taxation revenues, Commonwealth Government grants and investment income, together with a reduction in interest costs mainly resulting from lower debt levels attained from the application of privatisation proceeds. However, the impact of these items was partially offset by increased expenditure in the year on employee entitlements and supplies and consumables.

Financial position

3.6 The Government's Annual Financial Statement shows that, **as at 30 June 1999, the State held net assets of \$37.5 billion (30 June 1998, \$28 billion), comprising assets with an aggregate value of \$78.8 billion (30 June 1998, \$77.1 billion), and liabilities with an aggregate value of \$41.3 billion (30 June 1998, \$49.1 billion).** The key factors contributing to the improvement in the State's net assets position during the 1998-99 financial year included:

- Increase in the State's asset holdings of \$1.7 billion, mainly comprising an increase in the reported value of physical assets, and increased investment balances (Further analysis of the State's asset holdings is presented in Part 6 of this Report); and
- Decrease in the State's liabilities of \$7.8 billion, mainly comprising a decrease in the level of outstanding debt and unfunded superannuation liabilities (Further analysis of the State's liabilities is presented in Part 7 of this Report).

Analysis of the State's financial condition

3.7 Given that the above analysis of the operating result and movements between years in the level of assets and liabilities, in itself, does not necessarily provide a complete picture of the State's "financial condition", to assist the Parliament in undertaking an informed assessment of the State's financial health and strength, a number of additional indicators were presented in the *Auditor-General's Report on the Victorian Government's Finances, 1997-98*, which focused on:

- **Sustainability** - indicating movements in the degree to which the Government can maintain existing programs and operations, and meet existing creditor requirements without increasing the debt burden on taxpayers;
- **Flexibility** - indicating movements in the degree to which the Government can increase its financial resources to respond to rising commitments, by either expanding its revenues or increasing its debt burden; and
- **Vulnerability** - indicating movements in the degree to which the Government is dependent on, and therefore vulnerable to, sources of funding outside its direct control or influence.

3.8 In recognition of the usefulness of such financial indicators in assessing the financial performance and condition of the State, following the Auditor-General's Report, the Government in its Budget Papers for the 1999-2000 financial year also presented a number of financial ratios aimed at projecting balance sheet performance within the public sector over the 5 year period from the 1998-99 to the 2002-2003 financial years. The Government further presented in its Annual Financial Statement for the year ended 30 June 1999 a number of selected financial ratios, which will assist in assessments of actual performance achieved.

3.9 To facilitate informed assessments of the State's financial health and strength as at 30 June 1999 and trends thereon, Table 3B presents some key financial indicators for the 3 year period, 1996-97 to 1998-99.

3.10 It needs to be recognised that the audit analysis focuses on historical financial information and, accordingly, its scope does not extend to assessments of the effectiveness of government programs and their associated impacts on the State's revenues and expenditures. Also, given that audited whole-of-government accrual-based financial information for the State is only available for the past 3 years, the analysis presented in this Report is necessarily limited to this timeframe. As the base of audited information becomes available over future years, longer-term trend analyses of financial performance and condition will become possible.

TABLE 3B
STATE OF VICTORIA
INDICATORS OF FINANCIAL CONDITION,
1996-97 TO 1998-99 FINANCIAL YEARS

<i>Indicators (a)</i>		<i>1996-97</i>	<i>1997-98</i>	<i>1998-99</i>	<i>Improvement/ (deterioration) over 3 year period</i>
Sustainability of existing operations -					
Operating result - level of surplus/(deficit)	<i>(\$billion)</i>	1.6	2.0	2.7	1.1
Level of borrowings	<i>(\$billion)</i>	19.8	19.0	14.3	5.5
Operating result (before abnormal items) to Victoria's GSP	<i>(per cent)</i>	1.2	1.4	1.8	0.6
Operating result (before abnormal items) to total revenues	<i>(per cent)</i>	6.2	7.7	10.4	4.2
Borrowings to Victoria's GSP	<i>(per cent)</i>	14.6	13.3	9.5	5.1
Total liabilities to Victoria's GSP	<i>(per cent)</i>	36.3	34.2	27.4	8.9
Total assets to total liabilities	<i>(per cent)</i>	142.1	157.0	190.6	48.5
Finance charges to total expenditure	<i>(per cent)</i>	9.0	6.0	4.8	4.2
Flexibility in increasing financial resources -					
Own source revenue to Victoria's GSP (b)	<i>(per cent)</i>	13.1	12.7	12.5	0.6
Own source revenue to total revenue (b)	<i>(per cent)</i>	70.4	71.4	71.2	0.8
Finance charges to total revenue	<i>(per cent)</i>	8.4	5.6	4.3	4.1
Expenditure to Victoria's GSP	<i>(per cent)</i>	17.5	16.4	15.7	1.8
Level of fixed assets to net assets	<i>(per cent)</i>	254.8	200.2	151.2	103.6
Vulnerability to external sources of funding -					
Operating result (before abnormal items) to Victoria's GSP	<i>(per cent)</i>	1.2	1.4	1.8	0.6
Commonwealth revenues to total revenues	<i>(per cent)</i>	29.3	28.2	28.4	0.9
Finance charges to total revenue	<i>(per cent)</i>	8.4	5.6	4.3	4.1
Current assets to current liabilities	<i>(per cent)</i>	104.8	69.9	89.9	(14.9)
Borrowings to Victoria's GSP	<i>(per cent)</i>	14.6	13.3	9.5	5.1
Foreign currency borrowings to total borrowings	<i>(per cent)</i>	28.4	19.6	19.6	8.8

(a) A number of the indicators provide reference to Victoria's GSP. This reference relates to Victoria's Gross Domestic Product which is a measure of the size of the State economy and is sourced from statistics published by the Australian Bureau of Statistics for the 1996-97 and 1997-98 financial years, and estimates provided by the Department of Treasury and Finance for the 1998-99 financial year.

(b) Own source revenue represents total operating revenue less total grants to the State.

3.11 The information contained in the above table highlights that **the State's financial condition has strengthened during the 1998-99 financial year, in that:**

- **The Government's capacity to maintain existing programs and operations has improved**, as indicated by the improved operating result achieved in the year, the reduced level of outstanding borrowings, the lower call on State revenues to meet financing charges, and the reducing proportion of State liabilities compared with the size of Victoria's economy;
- **The Government's flexibility in responding to future opportunities requiring increased financial resources has also improved**, as indicated by the reducing proportion of State expenditures compared with the size of the State's economy and the reducing debt burden on State finances; and
- **The State's vulnerability to funding sources not directly within its control has decreased**, as reflected in the reducing debt burden on Victorian taxpayers and the improved working capital ratio as at 30 June 1999 when compared with the previous year, as reflected in the reducing excess of current liabilities over current assets. This improvement is reflected in the increase of around \$1.4 billion in the level of investments held as at 30 June 1999 when compared with the previous year. In particular, **the State's total cash and investment holdings increased substantially from \$16.2 billion as at 30 June 1998 to \$17.6 billion as at 30 June 1999, with a net amount of \$4.2 billion held by the Treasury Corporation of Victoria.** The Corporation advised that these funds will be applied towards the retirement of debt when it matures, after retaining sufficient investments to meet the State's prudential liquidity requirements.

Consolidated Fund result for the year

3.12 As previously commented on in this Report, in addition to the presentation within the Government's Annual Financial Statement of the State's consolidated operating result, 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. Note 31 to the Government's Annual Financial Statement provides these additional disclosures.

3.13 The Government's Annual Financial Statement discloses that **the overall Consolidated Fund cash-based result for the 1998-99 financial year, funded from borrowings, was a deficit of \$779 million, which was \$521 million higher than budget expectations.** The key factor contributing to this outcome was the repayment of Consolidated Fund debt in excess of the surpluses generated by the Consolidated Fund in the year. Table 3C presents the Consolidated Fund result for the year.

TABLE 3C
CONSOLIDATED FUND RESULT FOR YEAR
(\$million)

<i>Item</i>	1998-99	1997-98
<i>Receipts -</i>		
Operating activities	18 479	17 019
Investing and financing activities	280	126
<i>Total receipts, excluding borrowing transactions</i>	18 759	17 145
<i>Less – Payments (operating and capital transactions) -</i>		
Special Appropriations	1 849	2 133
Annual Appropriations	15 293	13 580
<i>Total payments, excluding borrowing transactions</i>	17 142	15 713
Overall Consolidated Fund surplus, excluding abnormal items and borrowing transactions	1 617	1 432
Add – Net abnormal items (a)	2 824	1 522
Overall Consolidated Fund surplus for year, excluding borrowing transactions	4 441	2 954
Borrowing repayments	(5 220)	(3 263)
Deficit for the year, funded from borrowings	(779)	(309)

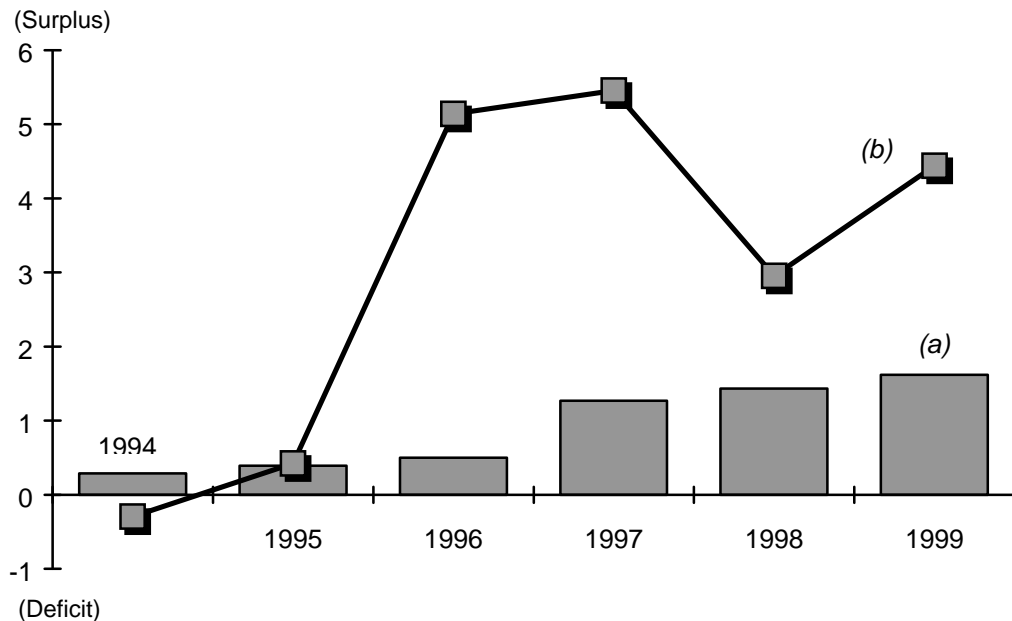
a) Abnormal items mainly include:

- Receipt of \$6.4 billion from the sale of State-owned business enterprises (\$2.1 billion, 1997-98), and costs of \$208 million (1997-98, \$50 million) associated with these privatisations;
- Additional superannuation payments of \$3.4 billion (1997-98, \$490 million) to public sector superannuation funds to reduce the State's unfunded superannuation liabilities; and
- Certain other items impacting upon the 1997-98 result, which were detailed in the Auditor-General's November 1998 Report to the Parliament. These mainly included one-off capital grant payments of \$410 million to rural water authorities, an additional receipt of \$299 million from the Director of Housing representing a part repayment of outstanding advances from the Consolidated Fund, special dividends of \$173 million received from public bodies and a contribution of \$159 million to the Commonwealth Government in relation to its deficit reduction program.

3.14 An analysis of the Consolidated Fund result indicates that the result for the year prior to abnormal items and borrowing transactions was a surplus of \$1.6 billion, compared with \$1.4 billion in the 1997-98 financial year. The improved outcome achieved in the 1998-99 financial year was mainly due to higher taxation receipts and increased grants from the Commonwealth Government which, in part, were offset with increased departmental expenditure. **However, after taking account of abnormal items, mainly relating to proceeds of \$6.4 billion (1997-98, \$2.1 billion) received as a result of the Government's privatisation program and additional payments of \$3.4 billion (1997-98, \$490 million) to reduce the State's unfunded superannuation liabilities, the result for the year, prior to borrowing transactions, was a surplus of \$4.4 billion (1997-98, \$3 billion).**

3.15 Chart 3D illustrates the significant improvement that has occurred over recent years in the Consolidated Fund results achieved by the Government, reflecting the positive impact of major budget and financial management reforms, and the improved economic conditions within the State.

CHART 3D
CONSOLIDATED FUND RESULT, PRIOR TO BORROWING TRANSACTIONS,
1993-94 TO 1998-99
 (\$billion)



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

Financial Management Reform

3.16 The previous year's *Auditor-General's Report to the Parliament on the Victorian Government's Finances* highlighted a number of key initiatives which were introduced during that year as part of the Government's Management Reform Program, including legislative reforms which involved a fundamental shift away from traditional "cash-based" appropriations to "accrual-based" appropriations, and to a greater focus on the delivery of outputs.

3.17 The introduction of "accrual-based" appropriation arrangements represents a positive step towards enhancing financial management within the budget sector by ensuring that the resource allocation processes and the accountability arrangements for departments to the Parliament are aligned.

3.18 Under the new arrangements, which came into effect as from 1 July 1998, Parliamentary appropriations provide for the application of Consolidated Fund revenues towards the purposes specified in the relevant Appropriation Acts, based on a purchaser/provider model. Under this model, the Treasurer represents "the purchaser" and is responsible for the application of appropriations to departments, which occurs when the Treasurer is satisfied that the required services have been provided.

3.19 The value of appropriations applied represents the price paid by the Treasurer for the delivery of departmental services based on (but not necessarily equal to) the full “costs incurred” by departments during a financial year in the production of outputs - including both the cash and non-cash components. Accordingly, in any one year, the value of appropriations applied may be higher than the expenses actually incurred by departments in the production of outputs (in which case the departments will record profits which may be applied in future years without further Parliamentary sanction) or, conversely, may be lower than the costs incurred by departments (in which case the departments will record deficits and will need to finance these shortfalls from future efficiency improvements in the production of outputs and therefore such shortfalls will ultimately be funded from future Parliamentary appropriations).

3.20 It may have been expected that by shifting to accrual-based arrangements, the appropriations would be applied when expenditure was actually incurred and for the actual accrual cost of outputs delivered. The new framework for the operation of appropriations as from 1 July 1998 however provides that the Treasurer will determine when Parliamentary appropriations will be applied based on a pre-determined price, which will be when the Treasurer determines that the particular outputs have been delivered. Accordingly, under the new framework, the funding of Government operations will be initially dependent on the provision of advances to enable the incurring of expenditure to deliver outputs.

3.21 For the 1998-99 financial year, the value of appropriations applied was \$949 million greater than the funds issued from the Consolidated Fund. The *Financial Management Act* 1994 provides authority for these funds to be issued in future years. **In respect of a number of departments, the value of appropriations applied in the year was higher than the value of costs actually incurred, resulting in the generation of departmental profits which, under the established legislative arrangements, are available for future application by the Government without further Parliamentary sanction.** These profits form part of the above appropriations applied but not issued from the Consolidated Fund, however the quantum of such profits could not be accurately determined.

3.22 A further feature of the present appropriation framework is the provision of “global” appropriations to departments, generally for the following 3 purposes:

- provision of outputs;
- additions to net asset base; and
- payments made on behalf of the State.

3.23 As indicated previously, the Treasurer determines when Parliamentary appropriations are to be applied. During the 1998-99 financial year, deficiencies were identified in the documentation available to support the application of appropriations for these purposes. **Procedures at the Department of Treasury and Finance need to be strengthened in this regard.**

3.24 The move in recent years towards the use of “global” appropriations has been based on a philosophy of providing greater management flexibility to the Executive Government, with ultimate accountability to the Parliament through reporting processes established for all public sector entities.

3.25 While undoubtedly the quality of financial reporting by departments has improved in recent years, this improvement has not been accompanied by the introduction of explicit requirements on departments for the presentation of audited information to the Parliament in relation to their achievement of output targets and other performance indicators.

3.26 Given the overall effect of the issues outlined above, in my opinion, there remains scope to enhance the effectiveness of Parliamentary control over the public purse.

□ **RESPONSE** provided by the Minister for Finance

The comments in relation to the accrual based appropriations in Victoria touch on matters of policy.

The Parliament has adopted a contractually based appropriation structure in which authority is given for the Consolidated Fund to be appropriated to the extent of the agreed price of the outputs represented in the Budget.

An alternate method of applying appropriations may have been expected had the Parliament endorsed an alternate appropriation structure.

Under the Victorian accrual budgeting structure, annual appropriations for the provision of outputs are applied by the Treasurer when he determines that outputs have been provided as agreed. The application of appropriations therefore represents revenue paid to a department by the government.

This structure means that, in Victoria, application of appropriations is unrelated to the expenses incurred by departments. Departments are not free to incur unlimited expenses, however: it is the responsibility of each Secretary to ensure that his or her department can at all times meet its liabilities from the resources available to it. The amount of appropriation budgeted for each department is based on a price for services that will enable the department to meet all its budgeted expenses as they fall due, but the incurring of the expense is not the trigger for the application of the appropriation.

Each department may draw from the Consolidated Fund an amount of cash up to the appropriations that have been applied in respect of that department. This cash is used to meet liabilities as they fall due. In this structure an appropriation serves two purposes: it is a cash instrument in that it controls withdrawals of cash over time from the Consolidated Fund. An appropriation is also an accrual instrument in the sense that the Parliamentary authority does not terminate at the end of the financial year during which the appropriation was applied and cash may be drawn under that authority over a number of years, without additional reference to the Parliament.

❑ **RESPONSE** provided by the Minister for Finance - continued

At the time of introduction of accrual output-based budgeting and management in Victoria, New Zealand was the only jurisdiction which had accrual-based appropriations. New Zealand had introduced appropriations that were applied by the incurrence of expenses by departments, not the earning of revenue. In the view of the Victorian Department of Treasury and Finance, expense-based accrual appropriations have undesirable features, such as the need to pass supplementary, retrospective appropriation Bills should a department subsequently discover that its expenses have exceeded the appropriations available. It also reduces the incentives for departments to manage the resources under their control in an optimal fashion.

Accordingly, Victoria determined that it would adopt the alternative, revenue-based approach to accrual appropriations. This approach has been the subject of extensive legal advice from the Victorian Government Solicitor to ensure that the revenue-based format conforms with Victorian legislation, principally the Constitution Act 1975 and the Financial Management Act 1994.

PART 4

Revenue



**VICTORIAN
AUDITOR-
GENERAL'S
OFFICE**

*Auditing in the
Public Interest*

SUMMARY OF STATE REVENUES

4.1 During the 1998-99 financial year, the operating revenues of the State totalled \$26.4 billion, which was \$795 million higher than the revenues raised in the previous year. The major items contributing to this favourable outcome were increased collections from State taxation mainly comprising higher revenues from gambling taxes and business franchise fees and revenue replacement payments, increased investment income associated with increased investment holdings and higher grants from the Commonwealth Government in the year. These increases were partially offset by reduced revenues from the sale of goods and services due to the impact of the Government's gas industry privatisation program.

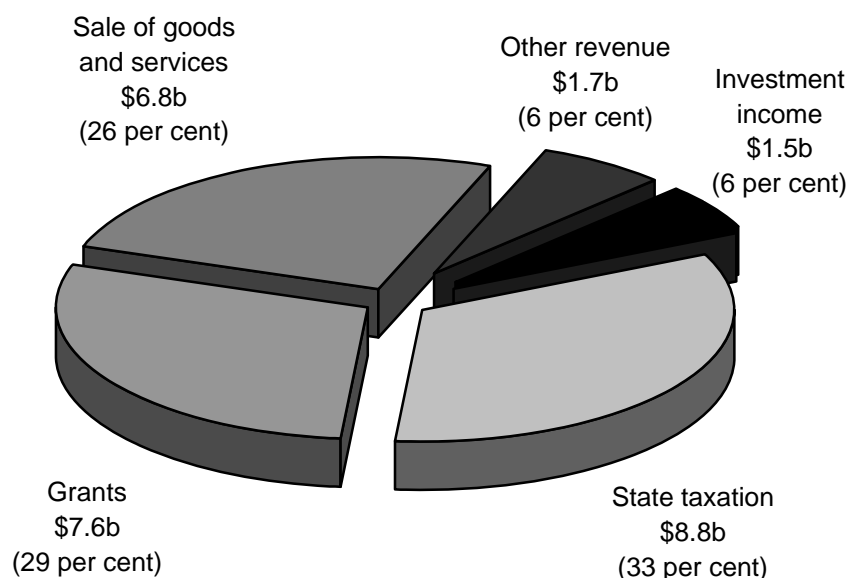
4.2 Taxation collections, grants from the Commonwealth Government and proceeds from the sale of goods and services, represented the major sources of State revenues. Collections from these sources in the 1998-99 financial year accounted for around 88 per cent of total operating revenues before abnormal items.

4.3 Table 4A provides a summary of operating revenue collections for the year, while Chart 4B illustrates the contribution of the major revenue sources to total State collections.

TABLE 4A
OPERATING REVENUES OF THE STATE
(\$billion)

<i>Revenue source</i>	1998-99	1997-98
State taxation	8.8	8.4
Grants	7.6	7.3
Sale of goods and services	6.8	7.3
Investment income	1.5	1.1
Other	1.7	1.5
Operating revenue before abnormal items	26.4	25.6

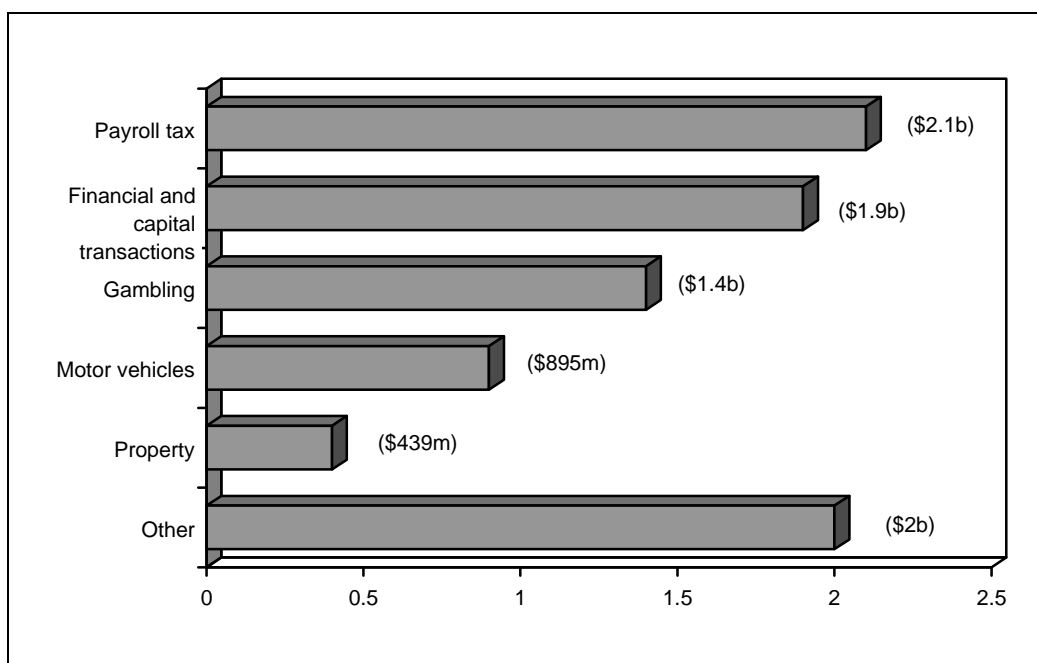
CHART 4B
MAJOR SOURCES OF STATE REVENUE, 1998-99
 (\$billion)



Taxation revenues

4.4 Taxation represents the largest source of State revenues and principally comprises payroll tax, various stamp duties and taxes on financial and capital transactions, property holdings and gambling activities, motor vehicle fees, and other licences and levies. **In the 1998-99 financial year, taxation collections totalled \$8.8 billion, an increase of \$408 million on the previous year.** The major items contributing to the increase in the year were higher revenues from gambling activities, higher collections from business franchise fees and revenue replacement payments, and increased collections from motor vehicle transfers and registration fees. Chart 4C illustrates the key taxation categories.

CHART 4C
TAXATION REVENUES
(\$million)



4.5 In recent years, the Auditor-General Reports to the Parliament and the Government's Budget Papers have highlighted the Government's longer-term aim of reducing the taxation burden on Victorian taxpayers by *bringing the State's tax rates into alignment with the national average*. To assist in the achievement of this aim, which was expected by the Government to enhance Victoria's capacity to attract business investment, over a number of years the Government introduced various tax reduction and expenditure management measures.

4.6 In the 1999-2000 Budget Papers, the Government estimated that based on the 1999 Commonwealth Grants Commission assessment of the relative revenue raising effort of all Australian States, Victoria's taxation revenues in the 1998-99 financial year were around \$394 million above the national average, which equates to around \$84 per capita. They were however \$55 million below the level in New South Wales. To assist in further improving this position, the former Government consequently announced further tax relief in the form of a reduction in the payroll tax rate, which had an estimated full year benefit to taxpayers of around \$97 million.

4.7 In the Budget Papers, the Government indicated that the above tax reduction measure was likely to reduce the gap between Victoria's taxation yield and the national average for the 1999-2000 financial year. However, the ultimate outcome was dependent on the impact of any taxation reduction measures introduced by other jurisdictions. In particular, if taxes in other jurisdictions remained constant, it was estimated that Victoria's revenue raising yield would be \$314 million above the national average in the 1999-2000 financial year.

4.8 The above position represents a substantial improvement for Victorian taxpayers and the State's competitiveness, when compared with the analysis undertaken for the 1993-94 financial year when the State's tax take was estimated to be \$953 million higher than the national average. However, there continues to be a need for strong financial leadership and effective management of State finances to achieve the aim of bringing the State's tax effort into alignment with the national average.

Gambling fees and taxes

4.9 A component of State taxation which has increased in significance in recent years relates to fees and taxes collected in association with 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 1998-99, State revenues from gambling activities totalled \$1.4 billion, an increase of around \$121 million since the previous year, and represented 5 per cent of total State operating revenues.**

"Mirror" State taxes at Commonwealth places

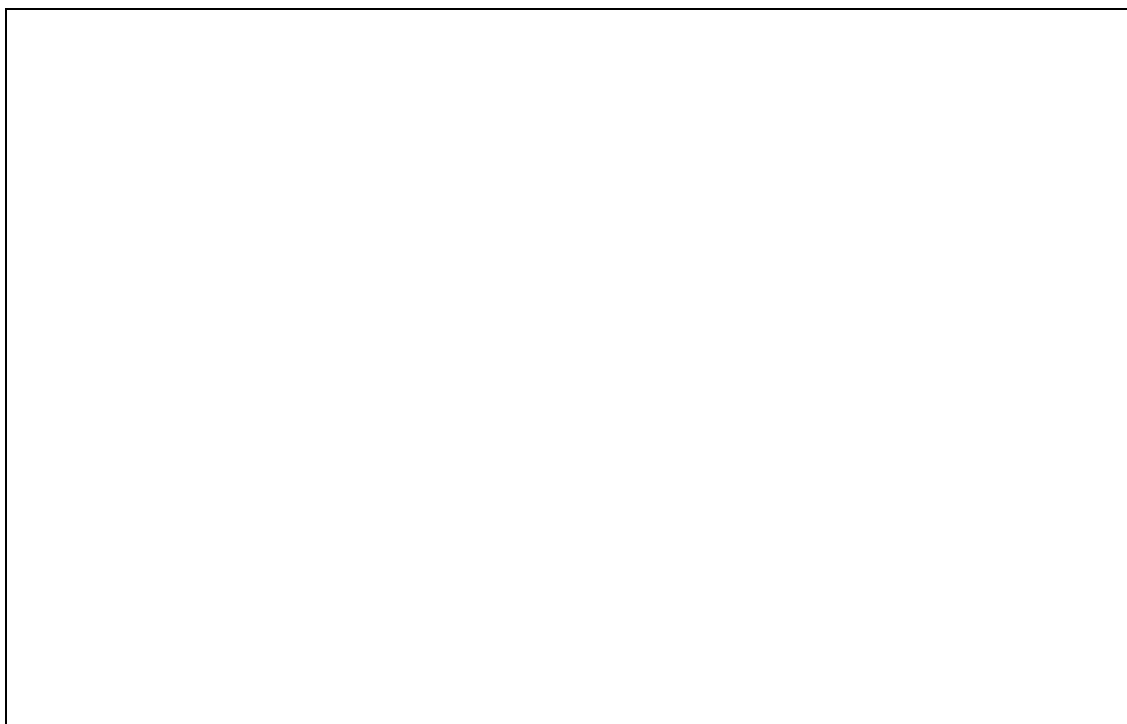
4.10 A High Court ruling in November 1996 raised uncertainty regarding the future collection of State taxes imposed on activities conducted at Commonwealth Government places. Subsequently, legal advice provided to the Commonwealth and State Government's indicated that there was substantial risk of certain State taxes being found to be invalid, in so far as they related to Commonwealth-owned places, including:

- stamp duty on leases, mortgages and contracts of sale;
- business and alcohol licence fees including liquor, tobacco, gambling and petrol;
- financial institutions duty and debits tax;
- property and payroll taxes; and
- local government rates, in so far as those rates amount to a tax rather than fees for service or the use of property or facilities.

4.11 Given the wide-ranging implications of the Court decision and the above advice, the Commonwealth Government subsequently agreed, through the Inter-Jurisdictional Taxation Agreement, to pass legislation which protected State revenues by ensuring that the same obligations apply to Commonwealth places as apply to all other premises and businesses. Such action was also considered necessary to ensure competitive neutrality between private businesses regardless of where these businesses were conducted, and to prevent Commonwealth places from becoming "tax havens" in respect to State taxes.

4.12 Subsequently, the Commonwealth Government announced its intention to pass legislation, with effect from October 1997, to enable the levying of Commonwealth taxes which “mirror” State imposed stamp duty, payroll tax, financial institutions duty and debits tax on businesses operating at Commonwealth places, and return the revenues generated to the States in which the taxes were collected. Furthermore, the Commonwealth announced that it would legislate, as necessary, to apply any other State taxes found to be invalid under the Commonwealth Constitution and to impose a “windfall gains tax” to protect States from refund claims, where refunds are sought on the basis of the constitutional invalidity of previous taxes.

4.13 In April 1998, the *Commonwealth Places (Mirror Taxes) Act 1998* was enacted, with effect from October 1997 to “mirror” the taxes imposed by the States in relation to Commonwealth places, and to ensure that each State would continue to receive revenue equivalent to the taxes that would have been received prior to the High Court ruling.



Commonwealth place, located at the corner of Spring Street and Latrobe Street, Melbourne.

4.14 In order to facilitate the collection of these taxes, in November 1998, the Victorian Minister for Finance approved the establishment of the Commonwealth Places (Mirror Tax Administration) Trust Account within the Public Account as part of the Trust Fund which will record the ‘mirror’ taxes collected by the State on behalf of the Commonwealth and their ultimate on-passing to the Consolidated Fund. In addition, amendments to existing State taxing legislation were introduced in the 1999 Autumn Session of Parliament to facilitate the collection of these taxes imposed under Commonwealth legislation, including amendments to the *Debits Tax Act 1990*, *Financial Institutions Duty Act 1982*, *Payroll Tax Act 1971*, *Stamps Act 1958* and the *Taxation Administration Act 1997*.

4.15 At the date of preparation of this Report, bi-lateral agreements were being developed between the Commonwealth, States and Territories to provide for the operation of the new arrangements and the collection of these “mirror” taxes.

4.16 The Department of Treasury and Finance and the State Revenue Office Victoria have advised that as at 30 June 1999, the Consolidated Fund had not recorded any “mirror” taxes as the associated arrangements had not been finalised due to the need for co-ordinated action by all jurisdictions. However, it was expected that the arrangements will be in place during the 1999-2000 financial year.

4.17 Notwithstanding the finalisation of the “mirror” tax arrangements, the State Revenue Office has continued to collect State taxes on Commonwealth places. The Department has advised that, as the date of preparation of this Report, surveys were being prepared to determine estimates of State taxes collected at Commonwealth places from October 1997 to the date that the arrangements are finalised, with the Commonwealth Government at that time to be nationally credited with these taxes which will be notionally on-passed back to the State.

4.18 The Department of Treasury and Finance has advised that once the arrangements are established, the “mirror” taxes will be ultimately reported as part of State taxation revenues in the Annual Financial Statement and within the financial statements of the Department of Treasury and Finance. This position is based on the view that the proposed disclosure will be consistent with the economic substance of the legislative arrangements, under which the State will continue to have discretion over the taxation rates to be applied and will continue to oversee compliance with the legislation. However, in my opinion, such receipts are more appropriately classified as receipts or grants from the Commonwealth Government, given that these are raised under the authority of Commonwealth legislation.

❑ **RESPONSE** provided by the Minister for Finance

In addition to the points raised by the Auditor-General regarding economic substance, the State is also responsible for all administration and collection costs of the mirror taxes. At the point of collection they are indistinguishable from State taxes.

The nature of the Commonwealth legislation requires that it appropriates the mirror taxes back to the States. In order to assist the Commonwealth in this regard, States have agreed to record the nominal transfer to the Commonwealth and the 'return' of the taxes to the States. At no stage does this include the transfer of cash between the two levels of government.

The recognition of mirror taxes as being substantially State taxes has been agreed by all State governments, the Australian Bureau Statistics and the Commonwealth Grants Commission.

Although potentially mirror taxes can include any tax currently levied by a State government, in effect these include a very wide range of taxes paid by a number of small retailers on Commonwealth properties such as Melbourne Airport. It is the Department of Treasury and Finance's belief that the quantum of these taxes will be immaterial in terms of financial reporting at either departmental or whole of government level.

National tax reform

4.19 In August 1998, the Commonwealth Government introduced a package of major legislative reforms aimed at fundamentally changing the Australian taxation system and Commonwealth-State financial relations. The centrepiece of this package is the introduction of a goods and services tax (GST) and the abolition of the Commonwealth wholesale sales tax and certain indirect State taxes, with revenues raised from the GST to be distributed to the States.

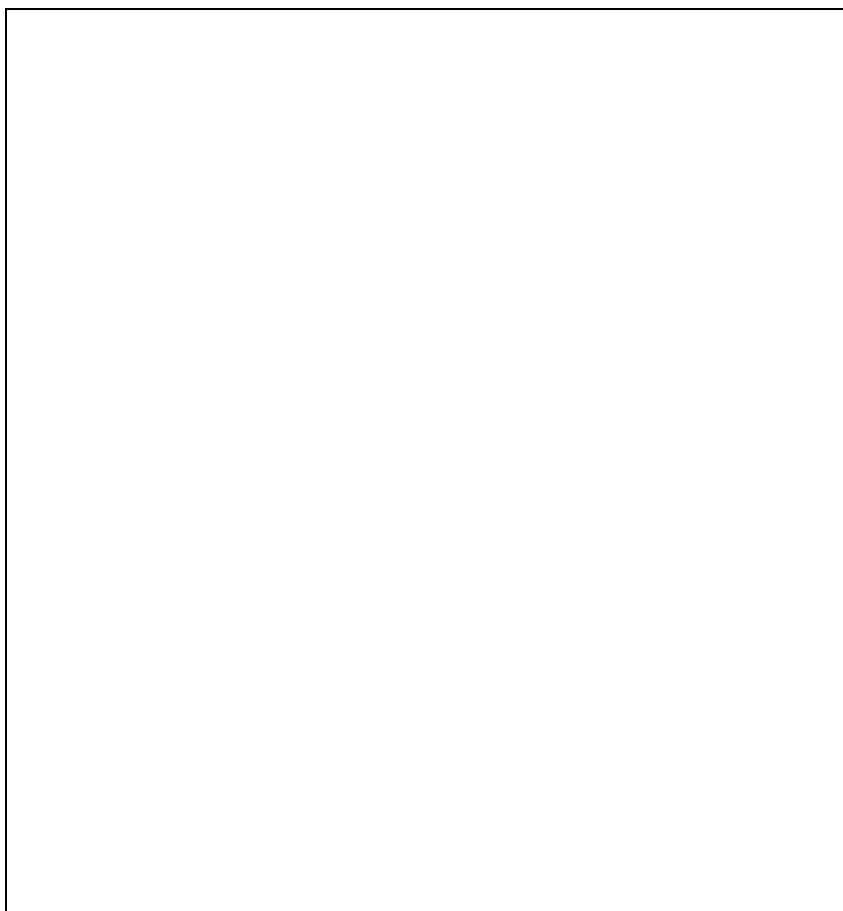
4.20 In the context of the above national tax reform program, in April 1999 the Commonwealth Government and the State and Territory Governments entered into an Intergovernmental Agreement which established the framework which will be implemented to facilitate the reform of Commonwealth and State financial relations. In particular, as from 1 July 2000 a GST (a single broad-based consumption tax) will be introduced which will replace the Commonwealth's wholesale sales tax and certain indirect taxes collected by the States, including financial transaction taxes (such as financial institutions duty and debits tax) and a range of stamp duties.

4.21 Consistent with the terms of the agreement, the States will receive revenues generated by the Commonwealth Government from the GST and the benefit of a Commonwealth Government scheme to provide rebates to off-road users of diesel fuel, which will eliminate the need for the State to continue to provide financial support to off-road diesel users. In return for these benefits, certain indirect taxes imposed by the States will be abolished, together with Commonwealth financial assistance grants and "safety net" revenues from taxation levied on petrol, tobacco and liquor which is collected by the Commonwealth on behalf of the States. Under this agreement, the States were also required to assume responsibility for the funding of the local government sector and a new "First Home Owners" Scheme which is to be established as from 1 July 2000 to provide first home buyers with a specified lump sum payment to offset the net impact of the GST on the prices of new homes.

4.22 Under the new taxation arrangements, the Commonwealth Government has provided an undertaking to the States that the budgetary positions of the States would be not be adversely affected by the reforms. To assist States which are initially adversely impacted by the reforms, the Commonwealth Government will provide a combination of interest-free loans and grants to those States. In addition, those States whose budgetary positions improve as a result of the introduction of the national tax reform package will be required to subsidise other States which have been placed in an adverse position.

4.23 Following the introduction of the GST, Victoria will abolish financial institutions duty and stamp duty on listed marketable securities from 1 July 2001, and, subject to a Ministerial review, will abolish debits tax by 1 July 2005. A Ministerial Council will review by 1 July 2005, the need for retaining a range of other State taxes.

4.24 The Ministerial Council, comprising the Treasurers from the Commonwealth and State and Territory Governments, was established in July 1999 to oversee the operation of the Intergovernmental Agreement.



Document explaining the new taxation system.

Impact of the reforms on the State finances

4.25 The Victorian Government's *Budget Statement, 1999-2000*, which was tabled in the Parliament in May 1999, identified that the implementation of the national taxation reform program as from July 2000 would have an initial estimated negative impact of \$269.5 million on the State's overall budget position.

4.26 However, in June 1999 various changes were made to the reform program, in particular the exemption of basic foods from the GST base, resulting in a number of consequential amendments to the Inter-Governmental Agreement. These included an extension of the timeframes for the abolition of a number of State imposed taxes, including the extension of the abolition date for financial institutions duty from January 2001 to July 2001 and for debits tax from January 2001 to July 2005, subject to review by the Ministerial Council. Furthermore, the revised arrangements included the following elements:

- by the year 2005, the Ministerial Council will review the need for the retention of the remaining business stamp duties, including stamp duties on non-residential conveyances, leases, mortgages, debentures, bonds and other loan securities, credit and rental arrangements, promissory notes and certain marketable securities; and
- the Commonwealth Government will continue to fund the local government sector.

4.27 The revised arrangements also had a significant impact on the estimates provided in the Government's *1999-2000 Budget Papers* of the financial effect of the taxation reforms on the State's finances. The Government's revised estimates, pending agreement between the State and the Commonwealth, forecast the following impacts on future State budgets, over a 3 year period:

- *2000-2001 financial year*, negative impact of \$475 million, resulting in the provision, by the Commonwealth Government, of a grant of \$255 million and an interest-free loan of \$220 million to the State, which will be repaid in the following financial year;
- *2001-2002 financial year*, negative impact of \$92 million. However, as the State will be required to repay the interest-free loan of \$220 million, the overall negative impact on the budget would be around \$312 million, which will be funded by a grant from the Commonwealth Government of \$280 million and a re-distribution of \$32 million from other jurisdictions; and
- *2002-2003 financial year*, negative impact of \$184 million, which will be funded by a Commonwealth grant.

4.28 Under the terms of the established arrangements, the Commonwealth Government will extend the financial support arrangements for any State or Territory beyond the initial transitional period ending in the 2002-03 financial year, if the national reforms have an adverse impact beyond that date and further support is required. However, the modelling which has been undertaken jointly by all jurisdictions indicates that this is unlikely to be necessary for Victoria. The Department of Treasury and Finance advised that the estimates will be under careful and continuous review over the next several years and that the current estimates have indicated a net budgetary gain to Victoria from the national tax reform of \$22 million in 2002-03, and increasing thereafter.

4.29 In addition to the above transitional arrangements, under the Commonwealth-State Housing Agreement, for the period 1 July 1999 to 30 June 2003 the States and Territories will receive GST compensation payments relating to the projected increased cost of public housing to ensure that increases in pensions and allowances payable by the Commonwealth Government will not flow through to increased public housing rents, where the rents are linked to the level of pensions.

4.30 Under the terms of the revised Intergovernmental Agreement, the States and Territories are also required to adjust gambling tax arrangements to take into account the impact of the GST on gambling operators. The nature and amount of the adjustments on gambling imposed taxes was still to be determined by the Victorian Government at the date of preparation of this Report.

Administrative arrangements

4.31 Under the established arrangements, from 1 July 2000 the Commonwealth Government will collect the GST, which will then be distributed to the States and Territories, consistent with a pre-determined formula. This formula takes into account the variations in the capacities of the States to raise revenues and the amounts required to provide certain standards of government service. The States and Territories will be required to compensate the Commonwealth Government for the agreed costs incurred by the Australian Taxation Office in its role in administering the GST.

4.32 The GST will apply to all goods and services purchased, unless such items have been specifically exempt. Those activities deemed to be GST free include services provided in the health and education sectors, municipal rates, water and sewerage charges, as well as any government taxes and charges specifically exempt by the Commonwealth Treasurer.

4.33 The Commonwealth Government has estimated that the increased expenditure by the Victorian Government resulting from the introduction of the GST is expected to be offset by around \$100 million of savings to the State resulting from these reforms. These savings are said to be sourced through reduced costs to Departments and agencies from the abolition of wholesale sales tax and certain State taxes, and the impact of the reforms generally within the economy, which should enable suppliers of services to offer lower prices to the Government.

National Competition payments

4.34 As part of the National Competition Policy Agreement, which was established in April 1995 between the Commonwealth Government and the States and Territories of Australia, Victoria undertook to implement certain micro-economic reforms within an agreed timetable in return for the receipt of additional general purpose grants (known as competition payments) from the Commonwealth Government over a number of years, associated with the implementation of these reforms.

4.35 Consistent with the terms of this agreement, during the 1998-99 financial year the State received \$53.6 million (1997-98, \$52.9 million) from the Commonwealth Government. The Department of Treasury and Finance anticipates to receive further competition payments over future years, with such payments expected to double to around \$108.9 million for the 1999-2000 financial year and then treble by the 2001-2002 financial year.

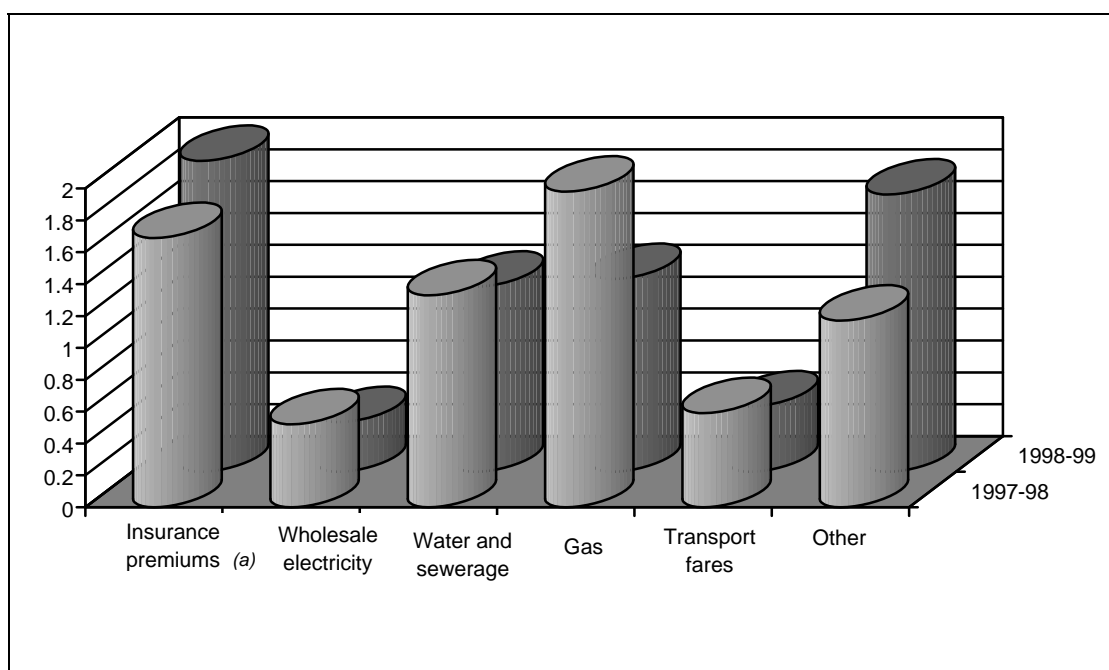
Sale of goods and services

4.36 Revenues from the sale of various goods and services by public sector bodies accounts for around 26 per cent of the State's total operating revenues and mainly comprises insurance premiums, gas sales, water and sewerage charges, transport fares and wholesale electricity charges mainly raised from private sector electricity distribution companies.

4.37 During the 1998-99 financial year, the revenue earnings of the State from the sale of goods and services totalled \$6.8 billion, representing a decrease of \$502 million since the previous financial year. The key factor contributing to the reduced revenues in the year was the privatisation of the gas businesses during the 1998-99 financial year which, in part, was offset by increased premium revenues received during the financial year by the Victorian WorkCover Authority and the Transport Accident Commission.

4.38 Chart 4D illustrates the contribution of the key activities associated with the sale of goods and services.

CHART 4D
REVENUE FROM THE SALE OF GOODS AND SERVICES
(\$billion)



(a) Mainly relates to transport accident charges and workers' compensation premiums.

Summary of Consolidated Fund transactions

4.39 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.

4.40 Given the continuing importance of the Consolidated Fund to 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.

4.41 Table 4E provides a summary of the receipts (excluding borrowings) of the Consolidated Fund for the year.

TABLE 4E
BUDGETED AND ACTUAL CONSOLIDATED FUND RECEIPTS
(\$million)

<i>Item</i>	<i>1997-98 Actual (a)</i>	<i>1998-99 Actual</i>	<i>1998-99 Budget (b)</i>	<i>Variance from Budget</i>	<i>Variance from 1997-98 Actual</i>
Operating activities -					
Taxation (c)	8 678	9 235	8 935	300	557
Grants received	6 071	6 196	6 065	131	125
Public authorities	1 157	2533	953	1 580	1 376
Sales of goods and services	375	442	409	33	67
Other	1 200	2 174	2 027	147	974
Total operating	17 481	20 580	18 389	2 191	3 099
Investing and financing activities -					
Privatisation proceeds (d)	1 717	4 118	-	4 118	2 401
Proceeds from sale of property, plant and equipment	294	124	112	12	(170)
Loan repayments	304	332	53	279	28
Other	-	31	18	13	31
Total investing and financing	2 315	4 605	183	4 422	2 290
Total receipts (excluding borrowings)	19 796	25 185	18 572	6 613	5 389

(a) The 1997-98 comparatives have been adjusted to reflect the re-classification of certain items in 1998-99.

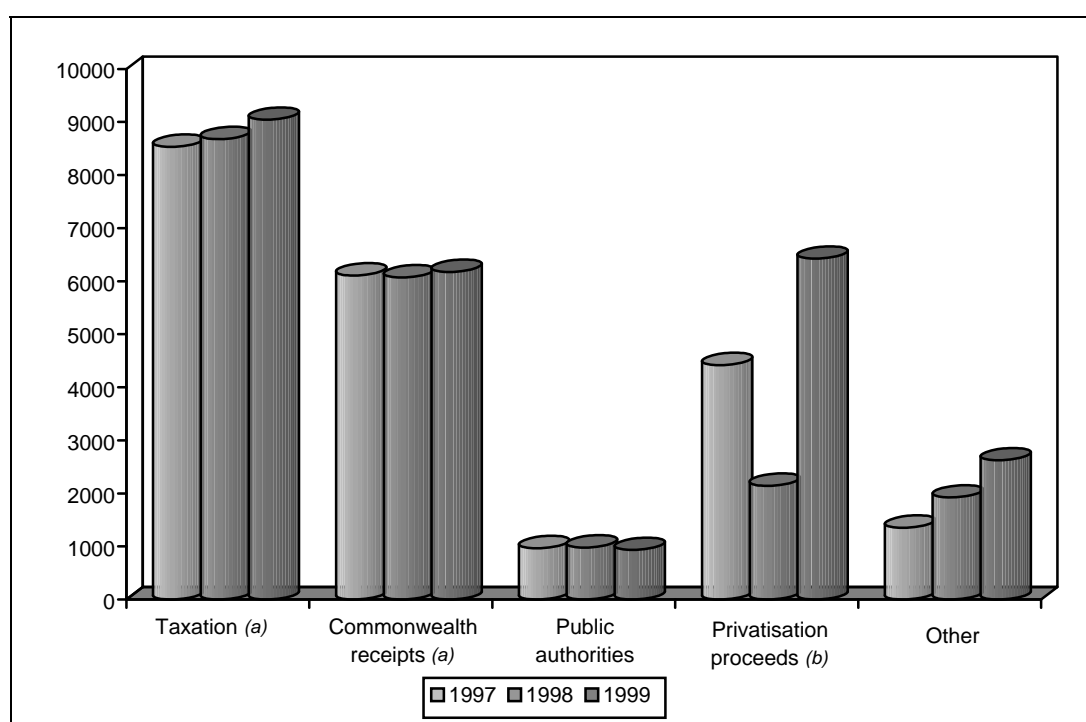
(b) Budget Estimates, 1999-2000 Budget Paper No. 3.

(c) Includes taxes collected by the Commonwealth Government on behalf of the State under the "safety net" arrangements established following a High Court ruling in August 1997 which questioned the power of States and Territories to levy franchise fees.

(d) Does not include the components of privatisation proceeds which are recorded in part of taxation and public authorities receipts.

4.42 The major revenue sources of the Consolidated Fund are taxation receipts, grants and contributions from the Commonwealth Government, dividends and tax equivalent payments from public authorities, and proceeds from business privatisations. Chart 4F shows the contribution from each of these major sources of revenue to the Consolidated Fund over the past 3 years.

CHART 4F
MAJOR SOURCES OF CONSOLIDATED FUND
RECEIPTS, 1996-97 TO 1998-99
(\$million)



(a) Taxation receipts in the 1997-98 and 1998-99 financial years include replacement revenues collected by the Commonwealth Government on behalf of the State following the abolition of franchise fees.

(b) Privatisation proceeds include related public authority contributions and taxation receipts.

4.43 The Consolidated Fund gross receipts for the year totalled almost **\$25.2 billion, which was \$6.6 billion above budget expectations.** The major factor contributing to this positive outcome was the receipt of \$6.4 billion from the sale of a number of State-owned enterprises, mainly the State's gas businesses, the Victorian Plantations Corporation and Aluminium Smelters of Victoria Pty Ltd, which were not fully included in the budget estimates.

4.44 When these privatisation proceeds are excluded, the Consolidated Fund receipts were **\$276 million higher than the budget estimates.** The key factors contributing to this favourable budgetary outcome were higher than expected grants from the Commonwealth Government (\$131 million) and higher collections from public bodies relating to the repayment of loans and advances (\$71 million).

4.45 The year's receipts, excluding the proceeds from privatisation, were **\$1.1 billion higher than the level achieved in the previous year**. This result mainly reflects the impact of the introduction of a revised capital assets charge on departments during the 1998-99 financial year, under which the amount raised by the Department of Treasury of Finance from this internal charge within Government, which was in turn funded from increased appropriations to departments, increased by \$1.1 billion to \$1.4 billion during the year. Further comment on the capital assets charge is included in this Part of the Report.

Receipts from public authorities

4.46 Public authority receipts into the Consolidated Fund mainly represents 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 Government-owned companies.

4.47 During the 1998-99 financial year, the Consolidated Fund revenue from this source was **\$1.6 billion greater than that budgeted and \$1.4 billion greater than the revenue received in the previous year**. Table 4H provides a summary of public authority income received by the Consolidated Fund during the past 2 years.

TABLE 4H
RECEIPTS FROM PUBLIC AUTHORITIES,
1997-98 AND 1998-99
(\$million)

<i>Business enterprises</i>	<i>Actual 1997-98</i>	<i>Actual 1998-99</i>	<i>Budget 1998-99</i>	<i>Variance from Budget</i>	<i>Variance from 1997-98 actual</i>
Electricity sector	293	35	88	(53)	(258)
Gas sector	153	(a) 1 456	452	1 004	1 303
Public financial institutions	175	281	152	129	106
Water sector	363	289	174	115	(74)
Port authorities	26	51	23	28	25
Other	147	421	64	357	274
Total	1 157	2 533	953	1 580	1 376

(a) Does not include an amount of \$207.7 million paid by GASCOR Pty Ltd into the Consolidated Fund during the 1998-99 financial year relating to the part repayment of debt owing to the Fund, which is disclosed as part of receipts from the repayment of loans. Further comment on this matter is provided below.

4.48 The substantial increase in receipts from public authorities during the 1998-99 financial year compared with the previous financial year and compared with budget was mainly due to the receipt of a higher amount of income tax equivalent payments arising from privatisations, particularly within the gas sector. The following additional factors also contributed to this favourable outcome:

- increased dividends from the metropolitan water sector due to the strong profitability of the sector, which was driven from increased revenues arising from dry climatic conditions and increased property development activity in the Melbourne metropolitan area;

- increased dividends from public financial institutions, particularly from the Transport Accident Commission due to increased profits resulting from higher than expected investment returns and higher income tax equivalent receipts relating to the sale of the Commission's assets at Southgate in the 1997-98 financial year; and
- a special dividend of \$26 million paid during the year by the Melbourne Port Corporation.

4.49 These increased receipts compared with budget were, to an extent, offset by lower dividends from the electricity sector, due to the deferral of a dividend payment by the SECV until the 1999-2000 financial year, and a discontinuation of distributions from certain entities such as Aluvic, which have been privatised.

GASCOR capital to debt conversion

4.50 Following the disaggregation of the former Gas and Fuel Corporation of Victoria in 1994, as part of the Government's gas industry reform program, GASCOR was established as a statutory body to manage the gas supply arrangements in Victoria with the gas suppliers, and to perform the gas retail and distribution functions of the former Corporation. In July 1997, the distribution and retail operations of GASCOR were unbundled into 3 "stapled" gas businesses, each comprising a gas retailer and a gas distributor, which were subsequently privatised during the 1998-99 financial year. Detailed comment on the privatisation of the gas businesses is provided in Part 6 of this Report.

4.51 As part of the gas industry restructuring arrangements, in May 1998 the Treasurer approved the conversion of GASCOR from a statutory body to a State-owned company incorporated under Corporations Law. Subsequently, in late December 1998 the Treasurer issued a determination under the *State Owned Enterprises Act* 1992 which declared, inter alia, that \$234.5 million of GASCOR's existing capital would be converted into interest-free debt owed by the company to the State, with re-payment of the debt to be made in a manner specified by the Treasurer.

4.52 During March 1999, the Treasurer issued 3 determinations to GASCOR Pty Ltd requesting the repayment of \$207.7 million of the above debt into the Consolidated Fund, which occurred by late March 1999. The remaining debt of \$26.8 million was paid to the Consolidated Fund upon the issue of a final determination by the Treasurer in August 1999.

PART 5

Expenditure



**VICTORIAN
AUDITOR-
GENERAL'S
OFFICE**

*Auditing in the
Public Interest*

SUMMARY OF STATE EXPENDITURE

5.1 During the 1998-99 financial year, the operating expenses of the State totalled \$23.7 billion, some \$40 million higher than the expenditure incurred in the previous year.

5.2 The key factors contributing to this outcome were an increase in the level of expenditure incurred on employee entitlements, mainly related to salary and wage increases in the year, and increased expenditures on supplies and services which substantially reflected an increase in costs associated with health services and an increase in the level of claims and associated management costs incurred by the Victorian WorkCover Authority.

5.3 However, these increases were to a substantial extent offset by the impact of the Government's privatisation program where a number of major government business enterprises, mainly gas businesses, were sold during the year. Accordingly, expenditure associated with these businesses for the 1998-99 financial year only related to the period up to the date of their sale. Also as a result of the proceeds of asset sales being applied to debt reduction, interest and other financing costs reduced substantially in the year.

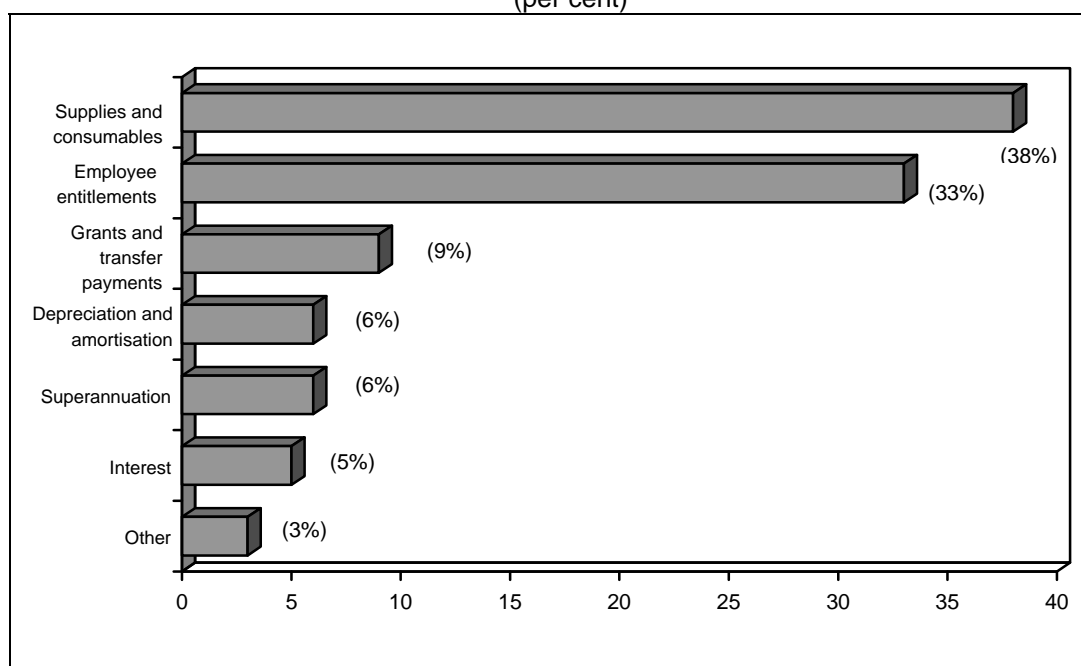
5.4 Table 5A provides a summary of operating expenditures for the year.

TABLE 5A
STATE OPERATING EXPENDITURE
(\$billion)

<i>Item</i>	1998-99	1997-98
Supplies and services	9.1	8.9
Employee entitlements	7.9	7.8
Grants and other transfer payments	2.1	2.0
Superannuation	1.4	1.4
Depreciation and amortisation	1.4	1.4
Interest and other financing costs	1.1	1.4
Other expenses	0.7	0.7
Operating expenses before abnormal items	23.7	23.6

5.5 As shown above, costs associated with employee entitlements including superannuation, the purchase of supplies and services and grants to external organisations account for around 86 per cent of total operating expenses. Chart 5B illustrates the major expenditure categories of the State for the year.

CHART 5B
MAJOR OPERATING EXPENDITURE
CATEGORIES, 1998-99
(per cent)



Summary of Consolidated Fund transactions

5.6 As mentioned previously in this Report, the Consolidated Fund is the Government's main operating account and records revenue received by the State and expenditure incurred by Departments under the authority of parliamentary appropriations to meet programs and meet the financial obligations of the State.

5.7 Table 5C reflects a summary of expenditures by appropriation for the year.

TABLE 5C
1998-99 ACTUAL AND BUDGETED PAYMENTS
(\$million)

<i>Item</i>	<i>1997-98 Actual</i>	<i>1998-99 Actual</i>	<i>1998-99 Budget (a)</i>	<i>Variance from Budget</i>
Special Appropriations-				
Debt repayments	3 230	5 213	-	5 213
Superannuation contributions	496	3 928	879	3 049
Other	(b) 2 047	1 523	1 359	164
	5 773	10 664	2 238	8 426
Annual Appropriations applied in the year -				
Provision of outputs	(c)	14 434	13 861	573
Additions to net asset base	(c)	376	633	(257)
Payments made on behalf of the State	(c)	(e) 1 439	2 098	(659)
Total Annual Appropriations applied in the year (d)	14 332	16 249	16 592	(343)
Less applied Appropriations remaining unspent at year-end	-	(949)	-	(949)
	14 332	15 300	16 592	(1 292)
Total Consolidated Fund payments	20 105	25 964	18 830	(7 134)

(a) Budget Estimates, 1999-2000 Budget Paper No. 3.

(b) Includes a one-off payment of \$410 million to non-metropolitan urban water authorities under the former Government's water industry reform program, for the purpose of accelerating the achievement of water quality and environmental objectives, and to facilitate price reductions.

(c) Due to changes in the classification of transactions during the 1998-99 financial year, comparative figures based on the new classification structure were not available.

(d) In financial periods prior to 1998-99, appropriations were applied on a cash-basis (i.e. as payments were made). However, as from the 1998-99 financial year, under revised legislative arrangements appropriations are applied on an accrual basis, with departments able to make payments in future years against the authority of appropriations applied in the current year.

(e) Includes appropriations of \$15 million applied in the year, relating to contributions made by the State to the Murray-Darling Basin Commission, and grants to cemeteries.

5.8 The table shows that the Consolidated Fund payments for the year totalled almost \$26 billion, which was \$7.1 billion greater than budget expectations. The following expenditures were made in the year under Special Parliamentary Appropriations that were not specifically provided for in the budget:

- An allocation of \$5.2 billion towards the progressive retirement of budget sector debt by the Treasury Corporation of Victoria;
- Additional superannuation contributions of \$3 billion to assist in reducing the State's unfunded superannuation liabilities;
- Increased contributions of \$45 million to the Hospitals and Charities Fund, due to higher than expected collections from gaming activities; and
- Allocation of an additional \$89 million towards health programs mainly due to additional funding received from the Commonwealth Government under the new Australian Health Care Agreement.

5.9 The contributions towards the progressive retirement of budget sector debt and the reduction of the State's unfunded superannuation liabilities were funded from the proceeds received from the privatisation of State-owned enterprises and other surplus moneys held by the Consolidated Fund.

5.10 Departmental expenditure under the Parliamentary authority of Annual Appropriations was \$343 million below budget expectations which, to some extent, lowered the impact of the above additional payments under Special Appropriations. The major factors contributing to this variation were:

- Payments made by the Department of Treasury and Finance on behalf of the State were \$311 million below budget expectations, and a further amount of \$317 million was allocated and utilised by way of Treasurer's Advance mainly for the purpose of output provision by all departments (refer paragraph 5.11 below). This outcome was mainly due to lower than expected expenditure on financing charges resulting from the substantial reduction in State debt during the year and the postponement to the 1999-2000 financial year of certain expenditure associated with the termination of the structured financing arrangements relating to the South Eastern Medical Complex and the World Congress Centre, and the establishment of the franchise arrangements associated with the 5 public transport passenger businesses. In addition, expenditure incurred on the Government's *Winter Power Bonus Scheme* was less than originally budgeted; and
- Payments to departments associated with additions to net assets were below budget by \$257 million. This was mainly due to reduced spending on asset acquisitions and replacements across most departments, including lower than expected spending in the year on road developments and projects associated with the Sports precinct in Melbourne.

5.11 The reduced expenditures as outlined above were offset by the application of additional appropriations (including Treasurer's Advance of \$317 million referred to above) for the provision of outputs of \$573 million compared with the original budget estimates, mainly in the Departments of Infrastructure, Education, Human Services and Justice. The key factors contributing to this out-turn were:

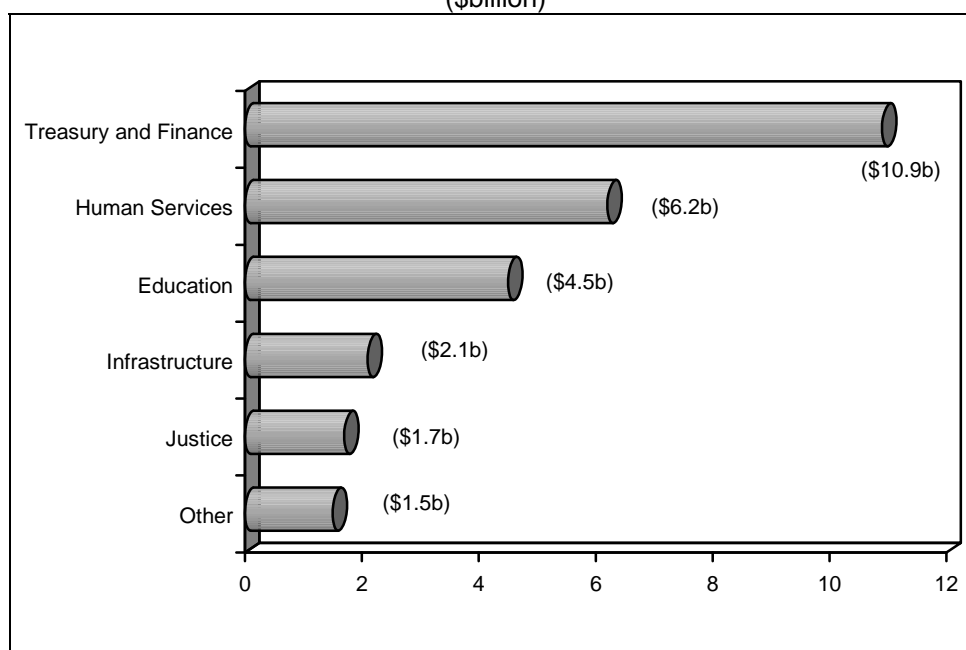
- *Infrastructure* – \$173 million higher than budget, mainly due to increased expenditure associated with the Government's public transport reform program, projects aimed at achieving Year 2000 compliance and costs associated with the Sports precinct in Melbourne. Furthermore, additional funding was provided to VicRoads to finance "blackspot" remediation works and other roadworks;
- *Education* – \$159 million higher than budget, mainly due to increased expenditure on primary and secondary schools, and TAFE colleges resulting from changes in industrial awards, increased expenditure on school cleaning contracts and projects aimed at achieving Year 2000 compliance;
- *Human Services* – \$88 million higher than budget, mainly due to increased expenditure associated with the provision of repatriation services, projects aimed at achieving Year 2000 compliance, and increased salary and wage costs resulting from industrial awards; and

- *Justice* – \$64 million higher than budget, mainly due to increased expenditure associated with industrial awards, the Longford Royal Commission, native title legal costs, and the outsourced traffic camera and fine enforcement operations of the Department.

Major spending departments

5.12 The key portfolios accounting for Parliamentary Appropriations applied in the year were Treasury and Finance, Human Services, Education, Infrastructure and Justice. As illustrated in Chart 5D below, these portfolios collectively represent 94 per cent of total Consolidated Fund appropriations.

CHART 5D
PARLIAMENTARY APPROPRIATIONS APPLIED
BY DEPARTMENTS, 1998-99 (a)
 (\$billion)



(a) Represents gross applied appropriations.

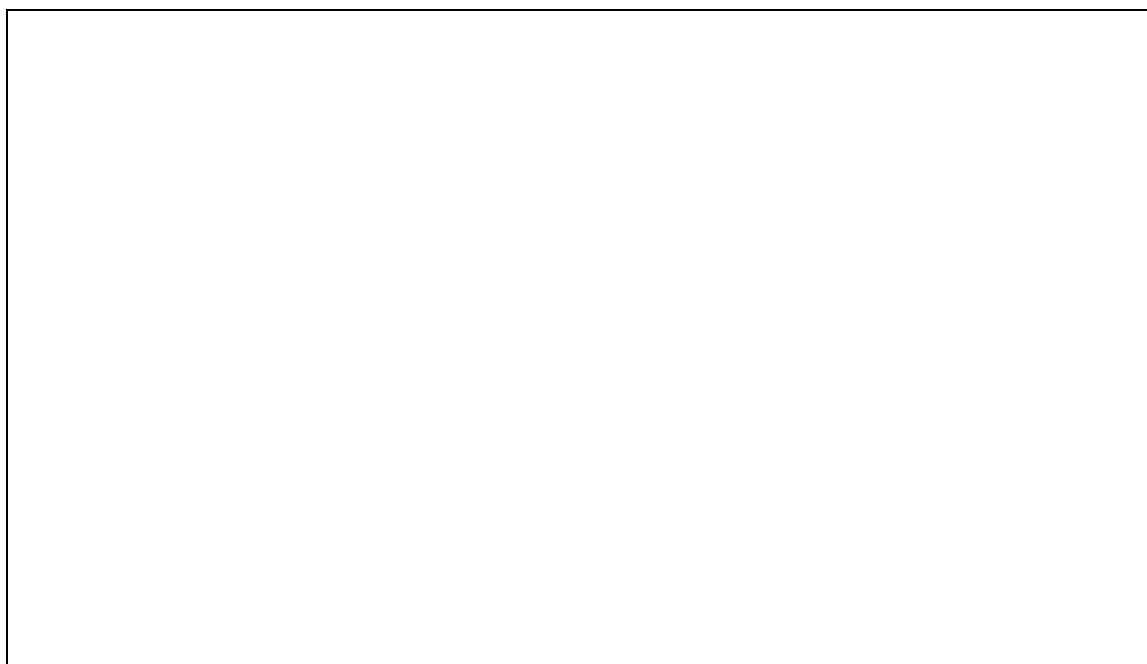
Australian Grand Prix Corporation

5.13 The previous Auditor-General Reports to the Parliament have outlined the State's financial commitments, costs and exposures arising from 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.

5.14 The Australian Grand Prix Corporation was established in October 1994, under the provisions of the *Australian Grands Prix Act* 1994, to stage the Melbourne Formula One Grand Prix event for a period of 6 years to the year 2001. In May 1995, the Government announced that it had also secured the Australian Motorcycle Grand Prix event for Phillip Island, until the year 2001, with this event also to be managed by the Australian Grand Prix Corporation. More recently, in July 1998, the Government announced that, following the successful completion of negotiations between the Victorian Government, the Corporation and Formula One Administration, Melbourne will host the Formula One Grand Prix event for a further 5 years, until the year 2006.

5.15 To facilitate the annual staging of the 2 Grand Prix events, the Government provided an undertaking to underwrite any deficits incurred by the Corporation in relation to the events.

5.16 A study undertaken by a consultant at the request of the Department of State Development to assess the impact of the 1996 Formula One Grand Prix event on the Victorian economy, concluded that substantial economic benefits were provided to the State by the 1996 event, 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 of this study were not subject to scrutiny by this Office. A similar study was not undertaken for the 1997, 1998 or 1999 Formula One Grand Prix events. The Corporation advised that it is not industry practice to conduct such studies on an annual basis.



Formula One Grand Prix.

5.17 A separate evaluation of the impact of the Australian Motorcycle Grand Prix event on the Victorian economy, conducted in May 1995 by a consultant on behalf of the Department of Treasury and Finance, estimated that the 1997 event would provide a \$63 million economic benefit to the State, and \$3.7 million in State Government tax receipts. A further study was undertaken by a consultant engaged on behalf of the Government subsequent to the staging of the 1997 Australian Motorcycle Grand Prix event, which estimated a \$54 million economic benefit to the State, including an estimated regional benefit to the Bass Coast Shire of \$22.6 million and \$3.7 million in State Government tax receipts. The conclusions of these evaluations were also not subject to my Office's scrutiny. A similar study for the 1998 event was not undertaken by the Corporation.

Financial outcome of the Grand Prix events

5.18 The costs incurred by the State in relation to the set-up and staging of the first 3 Formula One Grand Prix events in Melbourne in March 1996, 1997 and 1998, and the first Australian Motorcycle Grand Prix event which was staged at Phillip Island in October 1997, were outlined in the Auditor-General's previous Reports to the Parliament. An analysis of the financial outcome achieved by the Corporation during the 1998-99 financial year, mainly relating to the fourth Formula One Grand Prix event, staged in Melbourne in March 1999, and the second Australian Motorcycle Grand Prix event, staged at Phillip Island in October 1998, is outlined in this Report.

5.19 One of the Corporation's key objectives in relation to Formula One Grand Prix events is to make a direct positive financial contribution to the State, taking into account the taxation receipts generated by the event. In relation to Motorcycle events, one of the Corporation's key objectives is to maximise revenues and minimise expenditure in order to achieve or improve on the budget result as approved by the Government.

5.20 **The net operating costs incurred by the State on the Formula One and Motorcycle Grand Prix events, determined on an accrual basis, relating to the 1998-99 financial year were \$9.3 million.** These costs include depreciation and amortisation of \$1.4 million relating to the utilisation of associated infrastructure and other assets, and net costs of \$275 000 met by public sector agencies in relation to the events, including VicRoads, the Department of Infrastructure and various transport businesses.

5.21 **Since the inception of the events, the net aggregate operating costs incurred by the State have totalled \$36.7 million,** which included set-up and establishment costs of an operating nature of \$4.8 million, and depreciation and amortisation of \$9.6 million.

5.22 Table 5E illustrates the outcome achieved in staging the Grand Prix events for the 1998-99 financial year.

TABLE 5E
COSTS INCURRED BY THE STATE IN RELATION
TO THE STAGING OF THE FORMULA ONE AND MOTORCYCLE
GRAND PRIX EVENTS, 1998-99 FINANCIAL YEAR
(\$million)

<i>Item</i>	<i>Formula One event</i>	<i>Motorcycle event</i>	<i>Total</i>
Operating loss in staging the event, excluding other costs detailed below	3.2	(a) 4.4	7.6
Net operating costs incurred by other public sector agencies (b)	0.2	0.1	0.3
Operating cost, excluding depreciation	3.4	4.5	7.9
Add - Depreciation and amortisation costs (c)			1.4
Total operating cost to the State (d)			9.3

- (a) Reflects the operating loss incurred by the Corporation during the financial year, including components relating to both the October 1998 and 1999 motorcycle events. The overall net loss incurred by the Corporation in relation to the October 1998 motorcycle event was \$4.6 million (October 1997 event, \$5.1 million). At the date of preparation of this Report, the overall net result associated with the October 1999 motorcycle event had not been subject to audit as it related to the 1999-2000 financial year.
- (b) Comprises additional costs of \$71 000 (including \$7 000 for the Formula One events and \$64 000 for the Motorcycle events) incurred by VicRoads in relation to associated road works; \$99 000 incurred by the 2 tram businesses for the provision of additional transport to the Formula One event; and \$105 000 incurred by the Department of Infrastructure towards the promotion of the public transport services to the event.
- (c) Depreciation and amortisation costs have not been apportioned by the Corporation between the 2 events. While the total cost of holding the 2 events is disclosed in the Table, until the apportionment occurs, the full costs associated with holding of the individual events will not be available.
- (d) A further amount of \$575 000 was contributed by public sector agencies relating to sponsorships which were negotiated on a commercial basis.

5.23 The operating loss of \$3.4 million, excluding depreciation and amortisation costs, incurred during the 1998-99 financial year in relation to the Formula One event was substantially higher than the equivalent loss of \$2 million in the previous year. The 1998-99 result was equivalent to that incurred in 1996-97. The Corporation advised that the major factor impacting on the 1998-99 outcome was a decline in corporate attendances and sponsorships which, in part, was off-set from increased revenues from general attendances.

5.24 On the other hand, the operating loss of \$4.5 million, excluding depreciation and amortisation costs, incurred during the 1998-99 financial year in relation to the Motorcycle event, represented an improvement on the loss of \$5.3 million incurred in the previous year. The major factor contributing to this outcome, as advised by the Corporation, was a general reduction in costs, including catering expenditure associated with the event, which was partly offset by a modest reduction in sales revenue, brought about by a change in the mix between grandstand and general admission patrons between the 1998 and 1997 events.

5.25 In addition to the operating costs associated with the staging of the Formula One Grand Prix event, during the 1998-99 financial year capital costs were incurred by the Corporation under licence from Parks Victoria of \$215 000, which was funded by the Government and the related assets transferred to Parks Victoria. Further capital costs of \$385 000 associated with race infrastructure, which is utilised for both events, were also funded by the Government.

5.26 In relation to future Formula One Grand Prix events, as outlined in previous Auditor-General Reports to the Parliament, there are a number of inherent risks that could potentially have an adverse impact on the Corporation's financial projections. These include:

- 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.

5.27 However, consistent with previous years, 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 championship to protect the State's interests in the event.

5.28 Also as indicated in previous Reports to the Parliament, 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. The State's exposure was however mitigated by the Corporation's acquisition of public liability insurance for the 1999 Grand Prix event. Nevertheless, the State retained certain exposures, including claims in excess of the insurance policy limits and certain commercial risks.

5.29 The financial risks in relation to the Australian Motorcycle Grand Prix 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 this event.

Melbourne 2006 Commonwealth Games bid

5.30 In October 1996, the Australian Commonwealth Games Association announced the City of Melbourne as the preferred Australian city to bid for hosting the Commonwealth Games in the year 2006. Following this announcement, an endorsement contract was entered into between the Association and the State for the right to bid for, and if successful, to organise the Commonwealth Games in that year.

5.31 Consistent with the terms of the endorsement contract, the State was required to establish a bidding company to conduct the principal activities associated with the preparation and submission of the bid. Consequently, in January 1997 the Melbourne 2006 Commonwealth Games Bid Pty Ltd (the bid company) was established and was incorporated in April 1997, with the company's primary objective being to secure and promote the Games for the State of Victoria. The two issued shares of the bid company were each held by the Premier of Victoria and the Treasurer. At this time, it was envisaged that the bid company would continue in its current form until the announcement of the successful city by the Commonwealth Games Federation, at which time, if the bid was successful, an organising committee company would be established.

5.32 To support the operations of the bid company, in January 1997 a contract was entered into with the Department of Premier and Cabinet, under which the State agreed to finance the operations of the company from the Consolidated Fund, to a maximum level of \$9 million over a 4 year period. The State also agreed to indemnify the Association against any liabilities arising from the State's bid or organisation of the Games, with the exception of any liabilities arising from the negligence or wilful default by the Association.

Establishment of the organising committee company

5.33 Following the withdrawal of a number of cities which initially expressed an interest in hosting the 2006 Commonwealth Games, the City of Melbourne was the only city to submit a bid in April 1999 for the hosting of the Commonwealth Games. **In the expectation that Melbourne would be selected as the host city, the bid company was placed into voluntary liquidation in July 1999 and the organising committee company, Melbourne 2006 Commonwealth Games Pty Ltd, was subsequently established with a single ordinary share held by the Premier of Victoria. During the period from 30 June 1997 to the time of liquidation of the initial bid company, the State had provided operational funding of \$7.2 million from the Consolidated Fund to that company.**

5.34 In the event of winning the right to host the Commonwealth Games, under the established arrangements, the State is required to underwrite any shortfalls between revenue and expenditure of the organising committee company until the winding down of the company which is to be no later than 18 months following the closing ceremony. In addition, the company is required to make specified progressive payments until July 2005 to the Association in consideration for surrendering its marketing and fundraising rights.

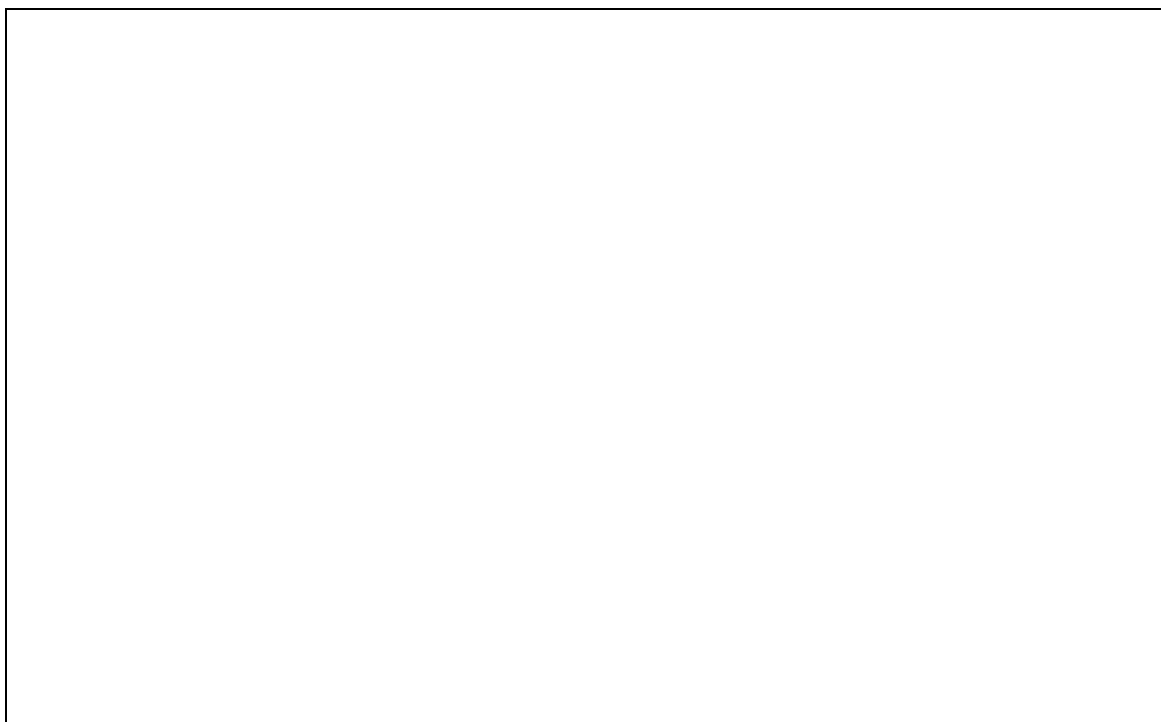
5.35 Upon the winding down of the organising committee company, all the remaining assets and rights after discharging its financial commitments and other obligations to the Commonwealth Games Federation will be transferred to the Australian Commonwealth Games Association. In turn, the Association is required to pay any amount it received to the State, which is to be applied by the State towards the benefit of approved Association sports.

Financial projections

5.36 Based on revenue and expenditure projections included in the submission provided by the former bidding company to the Commonwealth Games Federation, it was estimated that the company could incur an operating loss of around \$93 million (in 1998 dollars) from hosting of the 2006 Commonwealth Games in Melbourne. In addition, it was projected that the State and Commonwealth Governments would incur a cost of around \$160 million from the provision of services associated with the event (the State's share of which is \$102 million) and the State would undertake related capital works at a cost of \$97 million.

5.37 The former Government was committed to "fast track" the capital works program for the required sporting facilities so that all major infrastructure projects required for the 2006 Games would be completed by 2001, mainly including a multi-purpose venue at Melbourne Park (\$65 million), a new State Hockey and Netball Centre (\$27 million) and a new Gymnastics Centre (\$3 million). With the exception of the multi-purpose venue which is to be used as a velodrome for the Games, the former Government stated that the "fast tracked" capital works projects would have been undertaken even if the Games were not held in Melbourne.

5.38 In addition to the above capital works program, \$11 million has been committed in the 1999-2000 Budget by the Department of State Development for the expansion of the Melbourne Sports and Aquatic Centre, to support Melbourne's staging of the Games and to maintain the State's high sporting profile.



Proposed multi-purpose venue for the Melbourne 2006 Commonwealth Games.

Economic impact on the State

5.39 A chartered accounting firm was engaged by the bid company to assess the net economic impact of staging the Commonwealth Games on the Victorian and Australian economies. **The consultants projected that the Games would increase the State's Gross State Product by around \$373 million and increase State taxation revenues by around \$14.5 million. The consultants also projected that Australia's Gross Domestic Product would increase by around \$497 million and Commonwealth taxation revenues would increase by around \$76 million.**

5.40 Further, the report identified that the hosting of the Games would enhance the State's reputation as a tourism destination and Melbourne's reputation as Australia's sporting capital. The hosting of the Games would also provide the opportunity to showcase new facilities, including Federation Square and Docklands, and also establish new world class sporting facilities which would enable Melbourne to hold future events without the requirement to invest large amounts in sporting infrastructure.

5.41 The formal announcement that Melbourne was selected as the city to host the 2006 Commonwealth Games was made in October 1999, at which time a Host City contract was entered into between the organising committee company, the Australian Commonwealth Games Association and the Commonwealth Games Federation. It is intended that the financial obligations entered into by the State under the Host City Contract will be reported in future Auditor-General Reports to the Parliament.

Additional financing costs associated with an annuity and gold loan

5.42 Previous Auditor-General Reports to the Parliament have commented on two financing arrangements established in 1986 and 1987 by the former Victorian Public Authorities Finance Agency (VicFin) to raise funds from a major insurance institution (the investor) through the issue of a 12 year fixed rate *annuity* with a value of \$92 million and a *gold loan*, which mainly comprised floating rate instruments with a maturity date of 2002, to the value of \$200 million. The arrangements were structured to raise funds at a cost below the prevailing market rates, while enabling the investor to receive a required rate of return through the realisation of tax benefits. Under the arrangements, the Treasury Corporation of Victoria (the successor body to VicFin) and ultimately the State guaranteed the after-tax rates of return to the investor.

Annuity arrangement

5.43 As from 1988, the Australian Taxation Office (ATO) commenced issuing amended taxation assessments to the investor in relation to the annuity financing arrangement which resulted in a potential increase in the associated financing costs of up to \$75 million. To facilitate the payment of the taxation liabilities associated with this financing arrangement for the period from 1986 to 1994, the Corporation advanced interest-free loans of \$55.7 million to the investor, which were funded by the Government, with the balance of taxation assessments held in abeyance by the ATO pending the outcome of an appeal lodged by the investor.

5.44 In July 1998, the ATO rejected the investor's objection to the taxation assessments and, subsequently, maintained this position when considering a further appeal by the investor to the decision. This matter was subsequently settled between the investor and the Commissioner of Taxation and, in February 1999, the investor advised the Department of Treasury and Finance that, based on its calculations, a net amount of \$15.7 million would be refundable to the State.

5.45 In March 1999 the investor paid the Corporation a refund of only \$10.3 million, with the difference of \$5.4 million reflecting the calculation by the ATO of a lower interest sum than was originally expected by the investor. **At the date of preparation of this Report, the Corporation was attempting to recoup the additional \$5.4 million through discussions with the ATO.**

5.46 An audit analysis indicated that the cost ultimately incurred by the State in relation to the annuity arrangement over its 12 year term was around \$17 million higher (in nominal dollar terms) than that which would have been incurred on alternative funding sources available to VicFin in 1986, mainly due to the impact of the adverse taxation assessments.

Gold loan arrangement

5.47 Due to adverse taxation assessments also being issued by the ATO in relation to the gold loan arrangement, in August 1995 the Corporation provided the investor with interest-free loans of \$28.5 million to finance the associated taxation liabilities.

5.48 Subsequently, due to the impact of the taxation rulings on the arrangement, in May 1996 the Treasurer approved the termination of this arrangement, resulting in a termination notice being issued by the Corporation to the investor in June 1996. However, following a dispute with the investor in relation to the value of the required termination payment, the Corporation lodged a statement of claims with the Supreme Court of Victoria against the investor. The claim lodged by the Corporation estimated the termination amount at approximately \$213 million, comprising \$171 million for the repayment of outstanding bank bills and an estimated amount of \$42 million to meet future tax payments if the investor's appeal against the taxation assessments was unsuccessful. However, the investor considered that the estimated termination cost of the financing arrangement would be in the vicinity of \$355 million.

5.49 In September 1996, the Corporation paid the investor \$178.8 million, comprising an amount of \$171 million associated with the maturing of bank bills which were part of the financing arrangement and the remainder relating to scheduled fees and payments under this arrangements. This payment was intended to comprise part, if not all, of the termination value that was in dispute.

5.50 Legal proceedings to determine the termination value of the gold loan arrangement commenced in the Supreme Court of Victoria in February 1998. During the court proceedings, most of the investor's claims in relation to the financing arrangement were abandoned, resulting in the Court decision being limited to an outstanding component of the early termination payment, the treatment of a fee rebate of \$14 million received by the investor in relation to the arrangement and an allegation of misleading and deceptive conduct by a company which arranged the transaction.

5.51 In November 1998, the Supreme Court handed down its decision on the fee rebate issue in favour of the investor, which adversely impacted upon the determination of the final termination amount payable by the Corporation. In relation to the allegation of misleading and deceptive conduct by the private sector company, the court found that while there was evidence of such conduct, given that the Corporation was unable to establish that it had suffered a loss or damage from this conduct, no damages were awarded.

5.52 Subsequently, **the Corporation lodged an appeal to the full bench of the Supreme Court regarding the decision on the treatment of the fee rebate which, if upheld, will reduce the costs associated with this arrangement. The Department of Treasury and Finance anticipates that this hearing is likely to commence in April 2000 at the earliest.**

5.53 Following the Supreme Court judgement, in November 1998 the Corporation paid an amount of \$49.4 million to the investor in relation to the outstanding component of the termination payment, with the intention that any overpayment would be recouped in the event that the full bench of the Supreme Court subsequently rejects the earlier decision.

5.54 In December 1998, the Corporation and the investor (which had then been acquired by another firm) made further claims and counter-claims in relation to the matters under dispute. However, to expedite the finalisation of the termination process, the parties agreed to settle this matter by withdrawing their respective claims, except for the issues subject to appeal.

5.55 A Deed of Settlement was entered into by the parties in February 1999, under which it was agreed to extinguish the outstanding termination amount claimed by the investor. In accordance with the deed, the Corporation is entitled to continue to pursue the matter which is subject to an appeal to the full bench of the Supreme Court.

5.56 As at the date of preparation of this Report, the overall estimated cost of the termination of the gold loan financing arrangement, including the impact of the ATO adverse tax assessments and \$3 million in legal and consultant fees, was around \$252 million. This outcome represents a reduction of some \$103 million on the original estimated termination cost of \$355 million. It was however some \$39 million higher than the Corporation's original estimate of \$213 million.

5.57 Although the aggregate costs to the State associated with the gold loan arrangement were higher than initially anticipated in 1987 due to the adverse taxation assessments and the early termination payments, the actual cost of funds which was ultimately incurred by the State was broadly similar to that which would have been incurred on alternative funding sources available to VicFin in 1987. The Department advised that this was mainly due to the concessions made by the investor during the litigation process and the investor's settlement with the ATO.

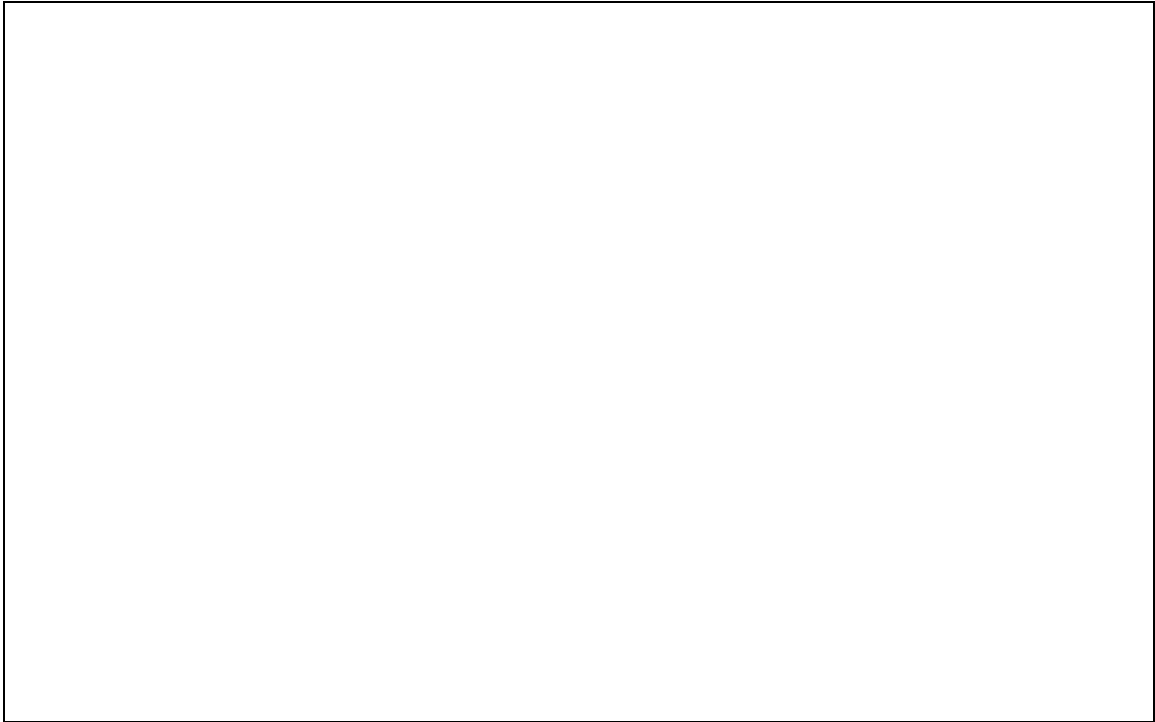
Gas emergency assistance

5.58 Following the explosion at the ESSO/BHP gas processing plant at Longford in late September 1998 and the resultant interruption to Victoria's gas supply, the Commonwealth Government announced that it would provide financial assistance to eligible individuals and small businesses affected by the gas emergency.

5.59 Subsequently, in November 1998 a Heads of Agreement was entered into between the Commonwealth and the Victorian Government under which the Commonwealth Government agreed to provide up to \$85 million in financial assistance to eligible persons within the period mid-October 1998 to late March 1999.

5.60 Under the terms of the above Agreement, the Commonwealth Government provided a sum of \$50 million to the State which was credited to the Gas Emergency Trust Account within the Trust Fund of the Public Account and was administered by the Department of Treasury and Finance. The Department distributed \$6.5 million of this amount in the form of financial assistance to various eligible recipients, including welfare organisations (\$2.4 million), private sector businesses (\$2.5 million) and appliance replacement for individuals (\$1.6 million). Our audit work associated with the preparation of this Report did not extend to an examination of the assessment and payment of claims for financial assistance.

5.61 In addition, direct costs of \$1.5 million were incurred by the respective Departments in advertising and administering the scheme. The unexpended balance of \$42 million was repaid to the Commonwealth on expiration of the Agreement in March 1999.



*Gas emergency at Longford processing plant.
(Photo courtesy of The Age.)*

5.62 While up to \$85 million was made available by the Commonwealth Government by way of financial assistance to eligible individuals and small businesses effected by the gas emergency, only \$8 million was actually expended by the State, made up of \$6.5 million (81 per cent) distributed to eligible recipients, with \$1.5 million (19 per cent) incurred in advertising and administering the scheme.

5.63 Part 7 of this Report includes comment on the legal actions which are currently in process associated with the gas emergency in late September 1998.

Capital assets charge

5.64 To enhance the management of assets within the budget sector, in the 1994-95 financial year the Government introduced an interim capital charge which was levied on departmental capital outlays.

5.65 Up to the financial year ended 30 June 1998, this charge was levied at a rate of 8 per cent of the cumulative value of departmental capital outlays in years subsequent to the introduction of the charge, with departments fully compensated for the charge through budget supplementation to prevent any adverse impact on service delivery.

5.66 To facilitate a wider focus on asset management by departments and enable the cost of capital to be incorporated in the price of outputs delivered by departments, as from July 1998 the above interim capital charge was replaced with a capital assets charge, which is generally levied at a rate of 8 per cent on the written-down value of non-current physical assets controlled by each department. The cost to departments of the capital assets charge forms part of the cost of service delivery funded from Parliamentary appropriations.

5.67 Table 5F shows the total amounts charged by the Department of Treasury and Finance to departments since the 1994-95 financial year.

TABLE 5F
CAPITAL ASSETS
CHARGES,
1994-95 TO 1998-99
(\$million)

<i>Year</i>	<i>Amount</i>
1994-95	79
1995-96	163
1996-97	243
1997-98	339
1998-99	1 431

5.68 The substantial increase in the amount levied on departments during the 1998-99 financial year on account of the capital assets charge reflects the impact of its wider coverage in that year, in that it was levied on the aggregate controlled asset holdings of departments compared with only the cumulative capital outlays since the 1994-95 financial year. It also needs to be recognised that the impact of the increased internal charge within government is to increase by \$1.1 billion the reported cost of service delivery by departments, as reflected in the application of Parliamentary Appropriations.

❑ **RESPONSE** provided by the Minister for Finance

Further to the Auditor-General's comment that the Capital Assets Charge replaced the Interim Capital Charge "to facilitate a wider focus on asset management in departments and to enable the cost of capital to be incorporated in the price of outputs delivered by departments", capital charging is primarily a policy to raise awareness in departments that there is a cost to government to hold assets.

The Auditor-General's comment that the increase observed in 1998-99 for the "Capital Assets Charge reflects the impact of its wider coverage" is not correct. The Capital Assets Charge represents a government introduced asset-based charging policy not a "wider coverage".

As the basis of the Capital Assets Charge is fundamentally different to the basis of the Interim Capital Charge, the data presented in the table may prove misleading. The 1998-99 entry should be visually separated from the prior years.

The Capital Assets Charge provides transparency by reporting the previously hidden cost of capital in assets and therefore does not just represent an increased internal charge.

Public transport

5.69 The Government's 1998-99 Budget Papers indicated that the capital assets charge was generally imposed on the written-down value of non-current physical assets, with the charge generally set at a rate of 8 per cent.

5.70 The financial reports of the various Government-owned public transport entities prior to the commencement of the new franchising arrangements in the 1999-2000 financial year included, as part of operating expenses in their revenue and expense statements, a capital assets charge which equated to around 15 per cent of the written-down replacement cost of the various entities' physical assets. This expense was fully funded by way of Parliamentary Appropriations.

5.71 Table 5G presents the capital assets charge applicable to each of the public transport entities for the 1998-99 financial year, and the differential between the above two rates.

TABLE 5G
PUBLIC TRANSPORT ENTITIES,
CAPITAL ASSETS CHARGE, 1998-99
(\$million)

Entity	Capital assets charge		
	15 per cent	8 per cent	Differential
Public Transport Corporation	367.6	196.1	171.5
Met Train 1 (trading as Bayside Trains)	28.2	15.1	13.1
Met Train 2 (trading as Hillside Trains)	31.3	16.7	14.6
V/Line Passenger Corporation	17.5	9.3	8.2
Met Tram 1 (trading as Swanston Trams)	23.8	12.7	11.1
Met Tram 2 (trading as Yarra Trams)	24.6	13.1	11.5
Total	493.0	263.0	230.0

5.72 According to advice received from the Department of Treasury and Finance, the 15 per cent rate was based on advice received from its consultants, which indicated that the weighted average cost of capital for comparable public transport business around the world (especially the United Kingdom) was around 15 per cent. This rate was based on an after tax cost of equity of 14 per cent, a cost of debt of 7 per cent and a gearing level of 50 per cent.

5.73 In any future assessment of the costs to the State of providing public transport services under the new franchising arrangements, compared with the reported costs of these services under Government ownership, due regard needs to be given to the level of the capital assets charge built into these costs.

Part 6

Assets of the State, including major asset sales

SUMMARY OF STATE ASSETS

6.1 The assets of the State mainly comprise physical assets (including Crown and freehold land, buildings, plant and equipment, roads and other infrastructure), investments, receivables and cash at bank. Assets represent the resources that are controlled by the Government which, together with the resources provided by employees and other service providers, are available for application towards the provision of services and the delivery of programs.

6.2 The Government's Annual Financial Statement discloses that, at 30 June 1999, assets with an aggregate value of \$78.8 billion were controlled by the Government, representing an increase of \$1.7 billion since the previous year. The major factors contributing to the improved reported asset position were:

- \$1.2 billion increase in financial and other non-physical assets, mainly due to increased cash and investment balances held by the Treasury Corporation of Victoria as at 30 June 1999 arising from the Government's privatisation program; and
- \$2.4 billion net increase in land and buildings assets, mainly due to the revaluation of asset holdings by public sector agencies during the year and the first time recognition of certain assets, mainly land conservation reserves and certain other parcels of land managed by Committees of Management which come under the ultimate responsibility of the Department of Natural Resources and Environment. However, the above impact was to some extent off-set by a \$2.1 billion reduction in other physical assets, mainly plant, equipment and infrastructure assets which was predominantly due to the impact of the privatisation program.

6.3 Table 6A presents a summary of the assets controlled by the Government.

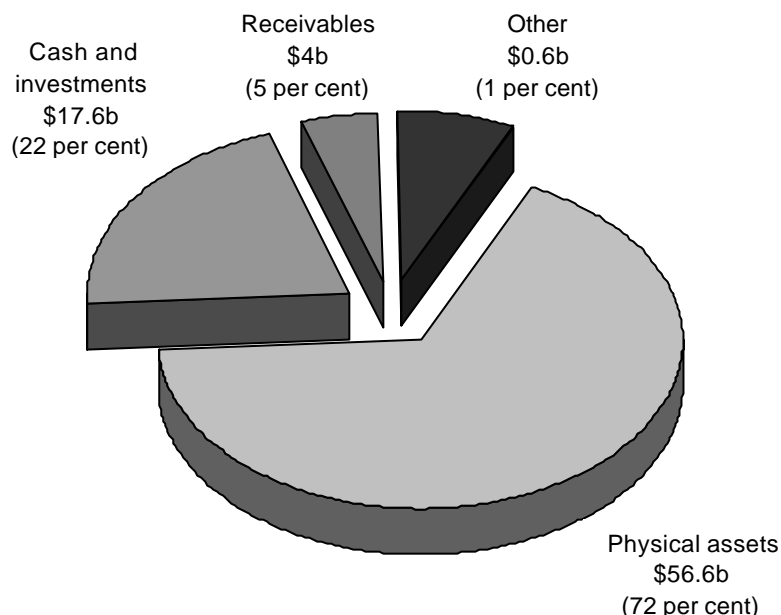
TABLE 6A
SUMMARY OF STATE ASSETS
(\$billion)

<i>Type of assets</i>	1998-99	1997-98
Physical assets -		
Land and buildings	24.3	21.9
Plant, equipment and infrastructure systems	19.3	21.4
Roads and earthworks	11.3	11.3
Other	1.7	1.5
	56.6	56.1
Financial and other non-physical assets	22.2	21.0
Total State assets (a)	78.8	77.1

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

6.4 As shown in the above table, physical assets represent by far the largest asset category, accounting for around 72 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 6B further illustrates the major components of the State's assets.

CHART 6B
COMPOSITION OF STATE ASSETS
(\$billion)



Physical assets

6.5 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, upon which comment has been made in my previous Reports to the Parliament.

6.6 A key part of the former Government's agenda for improving the management and accountability of departments for the total resources they control, has been the implementation of the asset identification, valuation and reporting program. Under this program, the major assets of the State have been identified and recognised in agencies' financial statements and in the Government's Annual Financial Statement.

6.7 During the 1998-99 financial year, the value of certain assets 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:

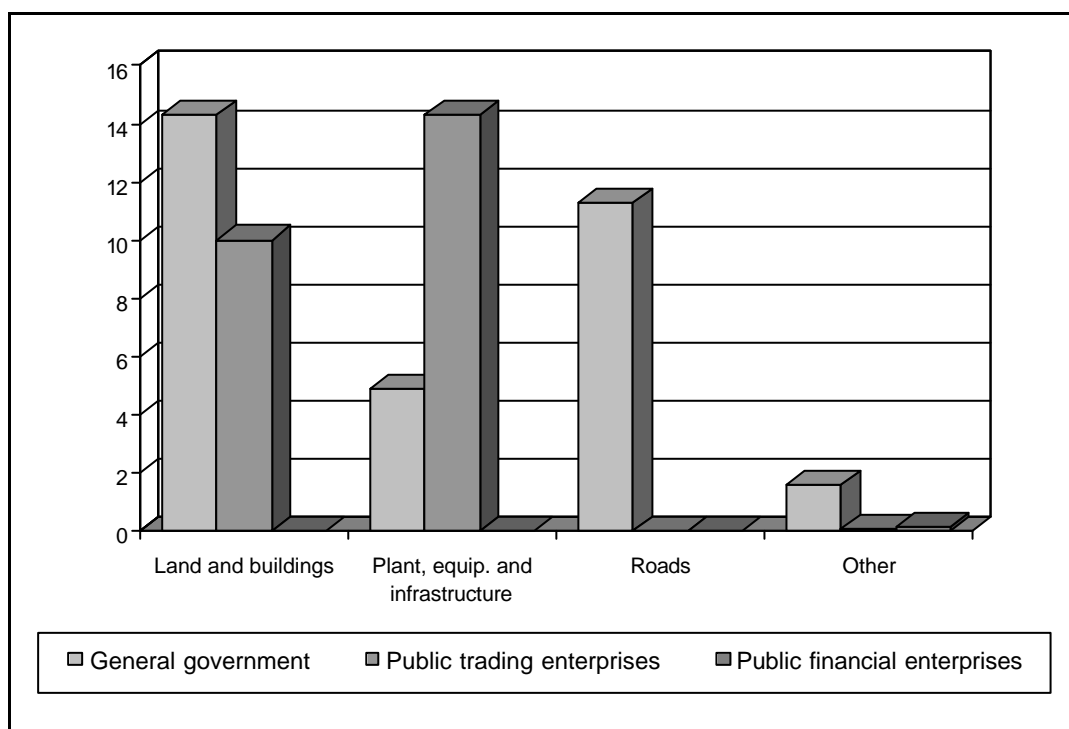
- certain land conservation reserves and other parcels of Crown land managed by Committees of Management which come under the ultimate responsibility of the Department of Natural Resources and Environment (\$257 million); and
- various buildings, roads and other physical assets also managed by the Department of Natural Resources and Environment (\$122 million).

6.8 In addition, the reported value of assets was significantly impacted by asset revaluations performed by public sector agencies during the 1998-99 financial year. The net impact of such revaluations was to increase the reported value of the State's assets by around \$2.3 billion.

6.9 Certain assets of the State are yet to be recognised by the relevant agencies, including the State's share of assets and liabilities managed by the Murray-Darling Basin Commission, and land associated with the State's road network. As at the time of preparation of this year's Government's Annual Financial Statement, the Murray-Darling Basin Commission was in the process of identifying and valuing its assets to facilitate their reliable measurement and recognition in future financial periods. In relation to land under roads, the Australian accounting profession has not yet determined an appropriate valuation approach to be adopted in relation to these assets. Accordingly, consistent with the transitional provisions contained in Australian Accounting Standard AAS31 *Financial Reporting by Governments*, the Government has decided to defer accounting for these assets until such time as the profession develops a position on the associated issues.

6.10 Chart 6C illustrates the value of physical assets recognised in the Government's Annual Financial Statement, attributable to the major government sectors as at 30 June 1999.

CHART 6C
PHYSICAL ASSET HELD BY THE STATE, 30 JUNE 1999
(\$billion)



6.11 The chart shows that, while the general government and public trading enterprises sectors are responsible for the control and management of the vast majority of land and buildings, the majority of plant, equipment and infrastructure assets are held by the public trading enterprises sector, reflecting their role in providing key services to the community, including water and health services.

Level of financial and other non-physical assets

6.12 Financial assets included in the Government's Annual Financial Statement can be broadly described as those assets that can be 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.

6.13 The financial and other non-physical asset holdings of the public sector at 30 June 1999 stood at \$22.2 billion, representing an increase of around \$1.2 billion on the previous financial year. Table 6D shows the composition of these balances as at 30 June 1999.

TABLE 6D
FINANCIAL AND OTHER NON-PHYSICAL
ASSETS OF THE STATE
(\$billion)

<i>Type</i>	<i>1998-99</i>	<i>1997-98</i>
Investments	16.3	14.9
Receivables	4.0	4.3
Cash	1.3	1.3
Other assets	0.6	0.5
Total State assets (a)	22.2	21.0

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

6.14 As previously commented in this part of the Report, the increase during the financial year in the level of the State's financial assets was mainly attributable to higher investment balances held by the Treasury Corporation of Victoria (\$1.1 billion increase in the financial year), mainly on account of privatisation proceeds.

GOVERNMENT ASSET SALES PROGRAM

6.15 In recent years, a major component of the public sector reform program has been the privatisation of government business enterprises and the sale of surplus and under-utilised properties. In particular, the application of privatisation proceeds towards the reduction of State debt has been a major factor contributing to the strengthening of the State's financial position.

6.16 Among the key objectives of the privatisation program, which has resulted in the realisation by the State of around \$30 billion in gross proceeds from the sale of public sector utilities in the electricity, gas, ports, softwood plantations and aluminium sectors, have been the maximisation of:

- efficiency and effectiveness in service delivery;
- competition and consumer choice within the economy; and
- the value to taxpayers from the previously publicly-owned businesses.

6.17 The sale of surplus and under-utilised assets in turn has been focused at improving asset management and the financial performance of the public sector.

6.18 This Part of the Report outlines the major business and property sales undertaken or completed by the Government during the 1998-99 financial year, and up to the date of preparation of this Report. The sales covered in this Report include:

Business sales

- Gas businesses;
- Generation Victoria (trading as Ecogen Energy);
- Victorian Plantations Corporation;
- Aluminium Smelters of Victoria Pty Ltd; and
- V/Line Freight Corporation.

Property and equipment sales

- Prison complex at Coburg, incorporating the Pentridge Prison;
- Health Care Network properties;
- Salmon Street, Port Melbourne; and
- Latrobe Valley land exchange.

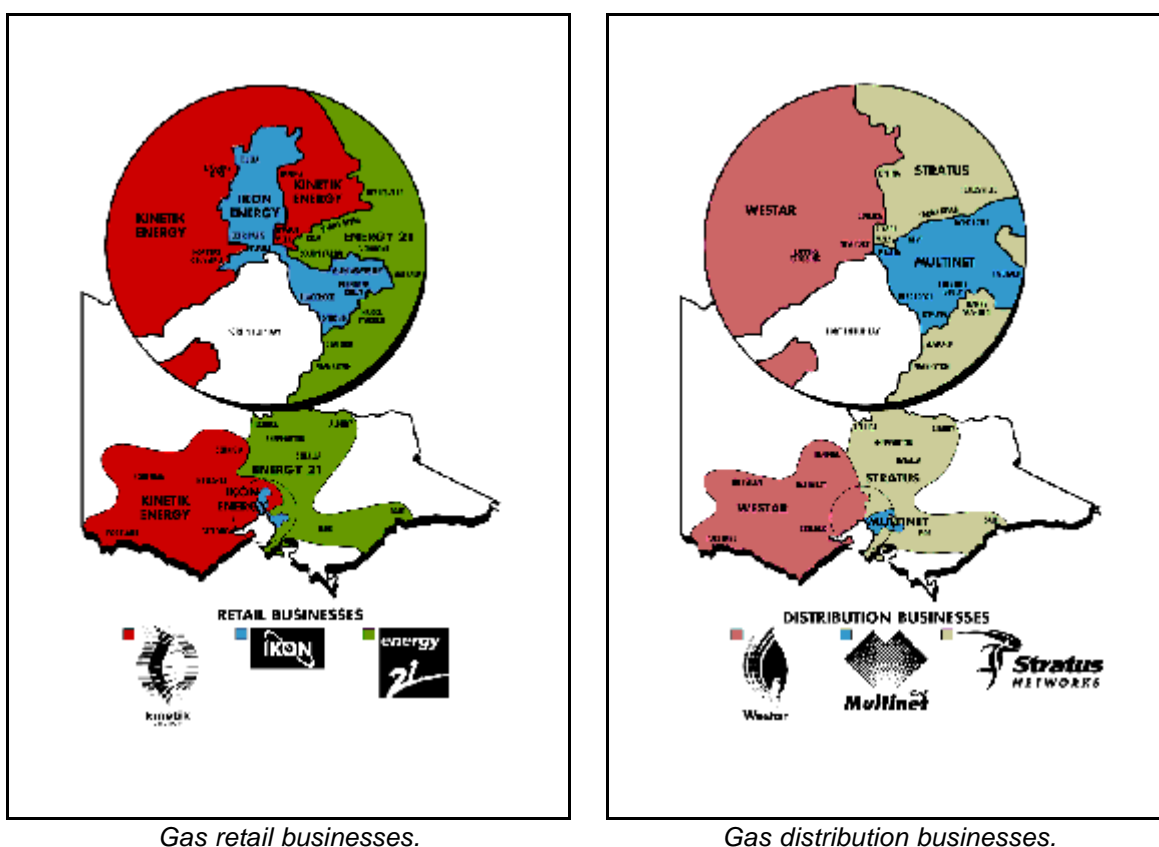
6.19 The franchising arrangements associated with the country and metropolitan public transport system which came into operation subsequent to the 1998-99 financial year will be examined and reported upon in the Auditor-General's May 2000 Report to the Parliament on Ministerial Portfolios.

Victorian gas industry privatisation

6.20 The Auditor-General's previous Reports to the Parliament have provided extensive comment on the reform program for the Victorian gas industry, which commenced in 1994. As an initial step in the reform program, the *Gas Industry Act 1994* was enacted to facilitate the disaggregation of the former Gas and Fuel Corporation of Victoria, through the transfer of the property, rights and liabilities associated with the gas distribution and retail business mainly to GASCOR, and the transfer of the property, rights and liabilities associated with the transmission business to the Gas Transmission Corporation.

6.21 Further reforms were announced in March 1997 which resulted in the distribution and retail operations of GASCOR being unbundled into 3 "stapled" gas businesses. These were established as separate legal entities in December 1997, each comprising a gas retail business and a gas distribution business which initially operated over geographically defined customer areas. Chart 6E illustrates the initial geographic coverage of these businesses.

CHART 6E
INITIAL GEOGRAPHICAL COVERAGE OF GAS BUSINESSES



6.22 Further key elements of the above reform process involved:

- the separation of the ownership and maintenance of the transmission assets of the Gas Transmission Corporation, resulting in the establishment of Transmission Pipeline Australia Holdings Pty Ltd (TPA);
- the establishment of a gas services company to provide centralised services to the new gas businesses, including information technology support, call centre services and certain other technical support functions; and
- the creation of Victorian Energy Networks Corporation (VENCorp) to assume the responsibility for controlling the operation of the transmission system, maintaining system security and managing the wholesale gas market.

Gas supply arrangements

6.23 Historically, around 98 per cent of the State's gas requirements have been supplied by BHP Petroleum (Bass Strait) Pty Ltd (BHP) and Esso Australia Resources Ltd (Esso) from the offshore Bass Strait gas fields located to the south-east of the State.

6.24 The May 1997 Auditor-General's *Report on Ministerial Portfolios* commented on the re-negotiation of the long-standing gas supply arrangements between the gas producers and GASCOR, which resulted in these parties entering into a new *Gas Sales Agreement* in November 1996 for the supply of gas to the State over the period up to December 2009. Under this agreement, GASCOR is entitled to acquire a maximum quantity of gas from the producers, however GASCOR also has certain "take-or-pay" obligations in relation to the purchase of minimum quantities of gas over the term of the agreement. Other key terms of the agreement are as follows:

- GASCOR no longer has a monopoly over the retailing of gas, however, where the gas producers make direct sales throughout Victoria, the agreement provides for adjustments to be made to GASCOR's take-or-pay obligations;
- The gas producers can construct pipelines for the transportation of gas, or contract with another party for this purpose, with GASCOR no longer obligated to source gas solely from the producers;
- The price for gas used in the commercial and industrial market is to be adjusted annually for movements in the consumer price index, with a process of price reviews to be initiated intermittently over the period to December 2009. However, the price of gas used for the domestic market is not to be adjusted during the term of the agreement.

6.25 Under a separate *Agency Agreement* established between the 3 gas retailers and GASCOR, the retailers have been appointed as exclusive agents of GASCOR to supply and sell gas to non-contestable customers up until September 2001. In turn, the businesses are entitled to receive monthly commissions based on the value of the gas purchased. In the event that the gas requirements of the retailers are not satisfied from the gas supplied under the Gas Sales Agreement, the retailers may seek alternative sources of gas supply.

6.26 The 3 gas retailers also entered into *Sub-Sales Agreements* with GASCOR to enable the retailers to satisfy the supply requirements of their contestable customers. Further, a *Master Agreement* was entered into by the parties to the above agreements, which provides the mechanism for allocating gas delivered to GASCOR under the Gas Sales Agreement between the retailers and the Gas Release Co. Pty Ltd (a subsidiary of GASCOR established to sell a small portion of gas sourced through the Principal Agreement to new market entrants), and for allocating GASCOR's take-or-pay obligations between the retailers and the Gas Release Company.

Commencement of the privatisation process

6.27 In April 1998, the Government provided in-principle approval to the privatisation of the gas businesses and, as an initial step towards this process, in May 1998 the Department of Treasury and Finance issued an Information Memorandum to interested parties, inviting bids for one of the "stapled" businesses.

6.28 During this time, draft decisions on the proposed access arrangements to be established in relation to the operation of the gas industry were issued by the Office of the Regulator-General (ORG), which has responsibility for the regulation of the gas distribution businesses, and the Australian Competition and Consumer Commission (ACCC), which has responsibility for the regulation of the gas transmission business. The access arrangements set out the terms and conditions under which gas transmission and distribution services will be provided to users of the systems, and the basis on which future tariffs would be determined by the respective regulators.

6.29 While the majority of the draft decisions of the regulators were acceptable to the Government, the main concern was that the proposed arrangements required a reduction in the rates of return to be applied in relation to regulated gas revenues. The regulators were of the view that the reduced rates of return more accurately reflected the appropriate cost of funds for the gas businesses. Pending the resolution of these matters and other associated issues with the regulators, the Treasurer in July 1998 publicly announced the deferral of further steps to introduce competition into the gas industry and the finalisation of the privatisation process.

6.30 Subsequent to a consideration of further submissions lodged by interested parties, a final decision on the Victorian access arrangements was issued by the regulators in October 1998, which required a rate of return of 7.75 per cent to be applied in setting the regulated gas revenues, compared with a rate of 10.16 per cent proposed by the Government. Subsequently, following the necessary amendment to the initially proposed arrangements, **in December 1998 the regulators provided their final approval to the access arrangements and the Government publicly announced that it would proceed with the privatisation of the State's gas industry.**

6.31 Provided below is a comprehensive assessment of the sale of the 4 major State-owned gas businesses, namely, the 3 "stapled" distribution and retail businesses and the Transmission Pipelines Australia group.

Profile of the businesses

Gas distributors and retailers

6.32 Under the established gas industry arrangements, each of the 3 “stapled” businesses consist of a retail company which acts as an agent for GASCOR in the sale of gas to customers, a distribution company which is responsible for the maintenance of the local distribution and transmission network within designated locations, an asset holding company which owns the physical gas distribution network and leases the associated assets to the distribution company, and a group holding company which owns all shares in the other “stapled” companies within the group. Each of the gas distribution businesses also held a one-third share in Gasmart (Vic) Pty Ltd, a company established in 1991 which retails gas appliances throughout Victoria and provides related installation services to customers.

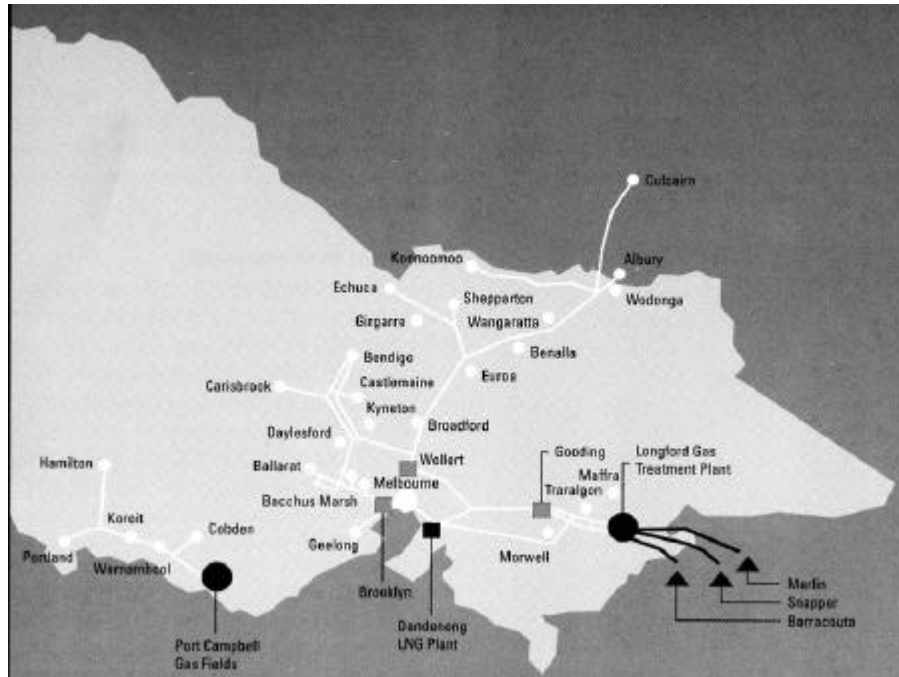
6.33 A profile of the gas distribution and retail companies within each of the 3 “stapled” businesses follows.

TABLE 6F
PROFILE OF GAS DISTRIBUTORS AND RETAILERS

<i>Distribution companies</i>	<i>Retail companies</i>
Multinet Gas Pty Ltd Maintains around 8 900 kilometres of distribution and transmission pipelines and associated assets. The business services approximately 587 000 customers in the inner, outer eastern and south-eastern suburbs of Melbourne.	Ikon Energy Pty Ltd, Sells natural gas on behalf of GASCOR to around 504 000 customers. In addition, the business offers other energy services, including energy audits for businesses and an energy advisory service.
Westar Pty Ltd Maintains approximately 7 500 kilometres of distribution and transmission pipelines and associated assets. The business services approximately 412 000 customers in the western and north-western metropolitan area of Melbourne, together with 19 country localities in central and western Victoria.	Kinetik Energy Pty Ltd Sells natural gas on behalf of GASCOR and tempered liquefied petroleum gas (TLPG) to approximately 398 000 customers. The business is also licensed to retail electricity in Victoria and provides other services such as gas and electricity connections, energy audits for business and appliance repair.
Stratus Networks Pty Ltd Maintains approximately 7 980 kilometres of distribution and transmission pipelines and associated assets. The business services around 404 000 customers in the central business district, the inner suburban, northern and south-eastern areas of metropolitan Melbourne, the Mornington Peninsula and the eastern, central and northern areas of country Victoria.	Energy 21 Pty Ltd Sells natural gas on behalf of GASCOR to around 501 000 customers. The business also provides connection services for natural gas and electricity, and other services such as energy audits for businesses. The Albury Gas company, which distributes gas to Albury and other towns in southern New South Wales, is a wholly owned subsidiary within this “stapled” group.

Transmission Pipelines Australia group

6.34 The Transmission Pipelines Australia group (TPA) owns, manages and maintains the high pressure gas transmission network in Victoria, which consists of approximately 1780 kilometres of pipeline and associated infrastructure such as compressor stations, a liquefied natural gas storage facility, regulator stations, metering stations and laboratory and odorant injection facilities.



The TPA gas transmission network.

6.35 A holding company, TPA (Holdings), was established to hold all the shares of the following 2 subsidiaries:

- *Transmission Pipelines Australia (Assets) Pty Ltd*, which owns the infrastructure assets within the Group; and
- *Transmission Pipelines Australia Pty Ltd*, which leases and maintains the transmission network and associated assets from the above company, and also constructs new network assets as required. The transmission network is made available to VENCORP, which operates the system and maintains system security.

Sale process

6.36 Given the impending privatisation of the State's gas businesses, in early 1998 the Department of Treasury and Finance commissioned a firm of stockbroking consultants to investigate the options available to the Government for the privatisation of the businesses, namely, public float and trade sale. In June 1998, these consultants concluded that there would be sufficient investor demand to absorb a public float of the businesses, however if this option was pursued, it was advised that further consideration would need to be given to various structural and marketing issues, including the timing of the float to optimise the outcome for the State. At this time, the consultants also provided indicative valuations of the businesses, assuming a public float of the entities, which are discussed later in this Report.

6.37 However, based on advice from its financial, legal and accounting consultants, the Government decided that the gas businesses would be sold by way of a trade sale. During this time, a process auditor was appointed by the Department to overview the various stages of the sale process to ensure fairness and objectivity in the sale of the businesses. An evaluation panel, consisting of representatives from the Department and its key advisers was also established to evaluate the tenders submitted by potential bidders for the acquisition of the businesses and to recommend a preferred bidder to the Government for each of the businesses.

Westar/Kinetik group

6.38 In June 1998, the stockbroking consultant engaged by the Department to provide advice on the sale of the gas entities estimated the indicative value of the Westar/Kinetik group of companies, prior to the regulators' final decision on the access arrangements including regulated gas revenues, to be around \$680 million, based on the value that a public offer of shares in the business could be underwritten. However, it was also considered by the consultants that the market would value the business at between \$710 million and \$750 million.

6.39 A further valuation assessment of the business by the Department's financial consultants, taking into account the regulators' final decision of October 1998 on the gas access arrangements, estimated the indicative value of the business to be around \$970 million, based on a trade sale scenario.

6.40 In December 1998, following the calling for expressions of interest by the State for the sale of gas businesses, the Department received 21 initial responses from interested parties. These parties were subsequently issued an Information Memorandum, with indicative bids required to be submitted by mid-December 1998.

6.41 At this time, the Department requested the stockbroking consultant to re-assess the aggregate value of the Westar/Kinetik group of companies. The consultant advised that, based on a public float sale scenario, the estimated value of the business was around \$760 million, however the value could be as high as \$790 million.

6.42 In December 1998, the Department received indicative bids from 6 interested parties with values of up to \$1.33 billion. Following an evaluation of these bids by the Government's advisers, all interested parties were short-listed and notified that the due diligence process could now commence, with final bids to be received by late January 1999.

6.43 During January 1999, the Department performed a review of the short-listed bidders to form a view as to their acceptability as gas utility operators, based on their expertise and past performance, and to identify any potential risks that may arise from participation of the potential bidders in the Victorian gas industry. This process identified that 2 of the bidders were operators of gas pipelines in other Australian States and the remaining 4 bidders were participants in the privatised electricity industry in Victoria. Consequently, it was concluded that there were no existing issues which would adversely affect the final bids when submitted by these parties.

6.44 In late January 1999, the Department received 4 final bids from the short-listed parties, with values of up to \$1.617 billion. Following an assessment of the bids by the evaluation panel, taking into account the bid price, acceptance by the bidders of the proposed terms of sale and the certainty associated with the bidder's financing, the panel recommended the acceptance of the highest priced bid submitted by the Texas Utilities Company. The successful bidder was the owner of Eastern Energy, one of the 5 recently privatised Victorian electricity distribution companies which operates in the eastern suburbs of Melbourne and the eastern part of the State. In addition, the Texas Utilities Company recently acquired the right to build an underground gas storage facility in the Otway Basin, upon which detailed comment is provided later in this Report.

6.45 In January 1999, the Treasurer publicly announced the sale of the first gas businesses, the Westar/Kinetik Energy group of companies, to TU Australia, a wholly owned subsidiary of the Texas Utilities Company (TXU) Group, for \$1.617 billion. Subsequently, in February 1999 the Department's probity auditor reported that the sale process had been conducted in a fair and equitable manner.

Multinet/Ikon and Stratus/Energy 21 groups

6.46 In October 1998, the financial consultants engaged by the Department to assist in the privatisation of the gas entities advised that the indicative valuation of the Multinet/Ikon group, on the basis of a trade sale scenario, was \$1.27 billion while the indicative valuation for the Stratus/Energy 21 group was \$950 million, taking into account the final decision of the regulators on the gas access arrangements including regulated gas revenues.

6.47 In late November 1998, the Government called for expressions of interest for the sale of both the above "stapled" gas businesses. In response, the Department received 28 initial bids, with all interested parties subsequently issued Information Memorandums to assist in the further development of their bids. The potential bidders were provided with an option to either bid for one gas business or for both businesses, however due to pre-established cross-ownership rules, companies could not own more than one of the businesses.

IKON PEOPLE WITH INTEREST

☎ 132 692 - GAS ACCOUNT ENQUIRIES
 ☎ 132 693 - GAS SUPPLY / CONNECTION ENQUIRIES
 ☎ 131 041 - GASLINK - APPLIANCE SERVICE AND REPAIR
 ☎ 1800 645 221 - CALLERS OUTSIDE VICTORIA

Service address: _____ Next scheduled reading: _____ Account number: _____

Total of last account	Processed since last account	Balance brought forward	New charges	Total amount due
\$172.37DR	+	\$172.37CR	=	\$0.00
				\$72.13

Total amount due: \$72.10

Pay total amount by: **03 Dec 1999**

ACCOUNT SUMMARY as at 19 Nov 1999 See over for details

GAS 21 Sep to 19 Nov \$72.13

YOUR AVERAGE DAILY GAS USAGE
 The gas cost per day for this account was \$1.22

Month	Usage (MJ)
Nov 98	133 MJ
Sep 98	112 MJ
Jul 98	308 MJ
May 98	179 MJ
Mar 98	50 MJ
Jan 98	48 MJ
Nov 97	54 MJ

IKON Energy Pty Ltd Trading as IKON Energy/ACH 086 428 760

HOW TO PAY YOUR ACCOUNT

Direct Debit Payment: Convenient account payment by debiting your bank account automatically. To apply, contact 132 692

Paying by Mail: Please detach this payment slip and forward with your cheque made payable to IKON Energy. Mail both to: GPO Box 17850 Melbourne VIC 3001

Phone Pay: Call 1300 303 431 or 1800 652 412 for country callers. Have your Bankcard, Mastercard, or Visa details ready. Remember to write down your receipt number.

In Person: Present this account intact (Cash or Cheque Payments Only) at **POST** or **Gasmart**

Total amount due: \$72.10

Gas: \$ 72.13

Customer gas account.

6.48 In mid-January 1999, the Department received 6 expressions of interest for the purchase of both businesses and one expression of interest for the purchase of only one of the businesses, namely, the Stratus/Energy 21 group. Following an evaluation of the bids by the Government's financial consultants, 4 interested parties were short-listed for the purchase of the businesses, including the bidder that expressed an interest in only one of the businesses. The short-listed parties were advised that due diligence procedures could commence in February 1999, with final bids to be submitted by March 1999.

6.49 As the short-listed bidders for these businesses were also the short-listed bidders for the sale of the Westar/Kinetik group, the Department did not seek to undertake a further review of the suitability of the short-listed bidders as gas utility operators, given that the previous review confirmed this to be the case.

6.50 Given that the previous sale of the Westar/Kinetik group had achieved higher than expected sale proceeds when compared with the valuations obtained, the Department requested its financial consultants to revise the indicative valuations prepared in October 1998 for the remaining gas businesses. Consequently, in February 1999, the consultants revised the trade sale valuation of the Multinet/Ikon group to between \$1.65 billion and \$1.75 billion and the valuation of the Stratus/Energy 21 group to between \$1.35 billion and \$1.45 billion. However, the consultants advised that to achieve such sale results would depend upon ensuring a competitive bidding field. In addition, the Department's stockbroking consultants concluded that there would be strong demand for a public float of both businesses, with the estimated aggregate value of the Multinet/Ikon group being \$1.25 billion and the value of the Stratus/Energy 21 group being \$1.1 billion. These estimates represented the underwritten value of an offer of shares in the event of a public float on the Australian Stock Exchange.

6.51 In March 1999, the Department received final bids for the purchase Multinet/Ikon group with values of up to \$1.97 billion, and bids for the purchase of Stratus/Energy 21 with values of up to \$1.73 billion.

6.52 Following an assessment of the bids received by the evaluation panel, it was **recommended that the highest offer of \$1.97 billion for the Multinet/Ikon group by Energy Partnership Pty Ltd be accepted as the preferred tenderer.**

6.53 Energy Partnership Pty Ltd had also made the highest offer for the Stratus/Energy 21 group, however given the pre-established cross-ownership rules which prevented control by one company of more than one gas business, this bid was not accepted. Following an assessment of the remaining bids, **the evaluation panel recommended the second highest bid of \$1.67 billion by a consortium comprising Boral Energy and Envestra Limited, as the preferred tenderer for the Stratus/Energy 21 group.**

6.54 In March 1999, the Treasurer publicly announced the sale of Multinet/Ikon Energy to Energy Partnership for \$1.97 billion. The purchaser is a joint venture company comprising a 50 per cent ownership interest by Utilicorp United Inc. (a United States-based energy and services company), and a 50 per cent interest by Australian investment manager, AMP Life Limited. The consortium is the existing owner of the privatised Victorian electricity distribution company, United Energy Pty Ltd, which was purchased from the State in August 1995.

6.55 At the same time, the Treasurer also announced the sale of Stratus/Energy 21 to the consortium comprising Boral Energy and Envestra Limited for \$1.67 billion. Envestra Limited has gas distribution interests servicing almost 400 000 customers in South Australia, Queensland and the Northern Territory. Boral Energy currently holds exploration interests in all Australian States, supplying gas to approximately 400 000 customers in the New South Wales, Queensland and South Australian gas markets. The company also supplies building and construction materials in more than 20 nations.

6.56 In April 1999, the probity auditor concluded that the sale process for these 2 "staple" groups had been conducted in a fair and equitable manner.

Transmission Pipelines Australia group

6.57 Following a call for expressions of interest for the sale of the Transmission Pipelines Australia group of companies in late November 1998, the Department received 30 expressions of interest in February 1999. These parties were subsequently issued an Information Memorandum, with indicative bids required to be submitted by March 1999. The Information Memorandum identified that to minimise the risk of gas supply loss to Victoria during the winter of 1999, following the Longford gas plant explosion in September 1998 the following initiatives had been established:

- the accelerated construction of the South-West pipeline, involving the linkage of the State's existing gas transmission system to the Port Campbell gas fields and the South-West gas distribution system in south-west Victoria; and
- the Moomba-Melbourne expansion project, enabling additional gas to flow from the Cooper Basin to the Victorian market through the Interconnect Pipeline which was recently constructed by the business.

6.58 To facilitate the prompt completion of these projects, prospective purchasers were advised that the State was willing to provide funding of up to \$59 million in relation to these projects. Further, the bidders were required to identify within their proposals whether such a financial contribution would be required from the State or whether the bidders themselves would provide the appropriate funding for these projects.

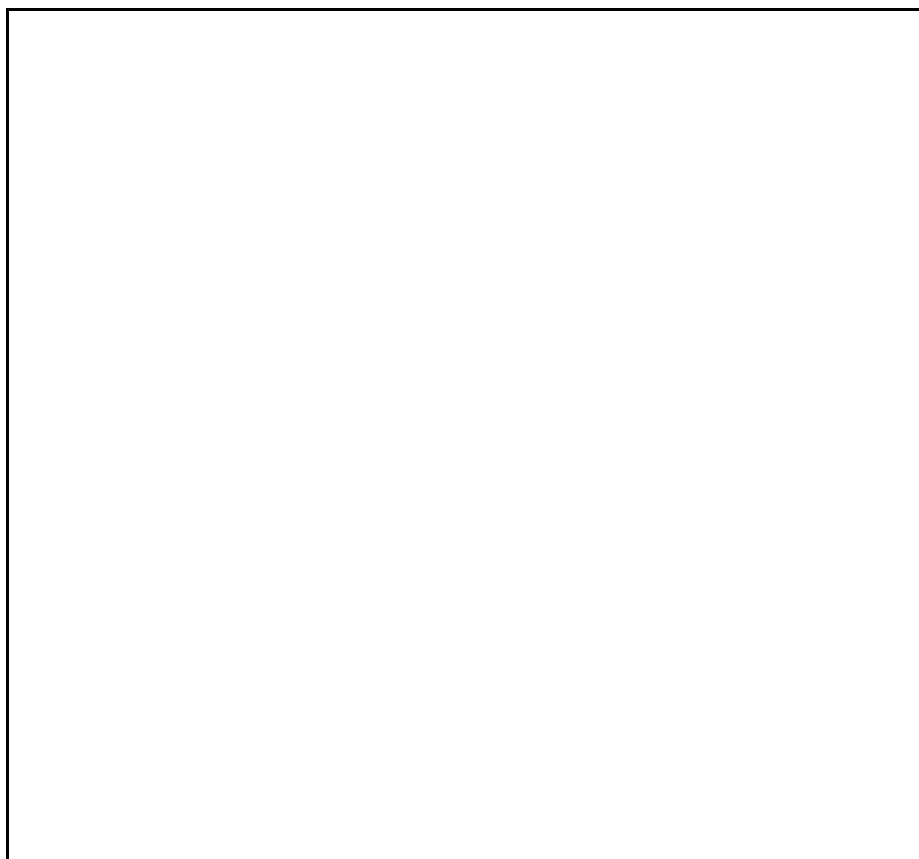
6.59 In March 1999, the Department's stockbroking consultants advised that there would be sufficient demand for investors to absorb a public float of the business and that the indicative valuation of the business was around \$650 million, however could be as high as \$685 million. In an earlier valuation exercise undertaken in October 1998 by the Department's financial consultants, these consultants provided an indicative valuation of \$660 million for the business on a trade sale scenario.

6.60 Following an evaluation of expressions of interest received for the purchase of the business by the Department's financial consultants, in mid-March 1999 the Department short-listed 4 interested parties and these parties were requested to proceed with the due diligence process. During April 1998, the Department undertook a review of the acceptability of the short-listed parties as operators and owners of the State's gas transmission system. It was concluded that all short-listed parties had extensive experience in the management of gas transmission systems around the world, with 2 parties currently providing services to the energy industry in Victoria, and therefore all parties were considered acceptable.

6.61 In May 1999, the Department received 3 final bids from prospective tenderers for the purchase of the Transmission Pipelines Australia group, with price offers of up to \$1.025 billion. **Following an assessment of these bids by the evaluation panel, it was recommended that the highest bidder, namely, GPU Incorporated, with an offer price of \$1.025 billion, be selected as the preferred tenderer. The purchaser accepted the financial contribution from the State to fund the nominated capital works projects.**

6.62 In May 1999, the Government publicly announced the completion of the Victorian gas industry privatisation with the sale of the Transmission Pipelines Australia to GPU Incorporated. The purchaser was already an investor in the Victorian energy industry, previously having purchased the privatised Victorian high voltage electricity transmission business, PowerNet, in October 1997.

6.63 In late May 1999, the probity auditor concluded that the sale process for this sale was conducted in a fair and equitable manner.



Dandenong gas storage facility.

Key terms of the various sale arrangements

6.64 The purchasers of the 3 “stapled” gas businesses individually entered into a number of agreements, with the key agreement being the *Gas Distributor and Retailer Asset Sale Agreement*. For the Westar/Kinetik group, this agreement was executed between the purchaser and the Treasurer, on behalf of the State, in January 1999. The agreements for the remaining “stapled” gas entities were executed between the respective purchasers and the Treasurer, on behalf of the State, in March 1999.

6.65 With regard to the *Gas Distributor and Retailer Asset Sale Agreements* associated with the 3 “stapled” businesses, the key terms common to each sale included the following:

- Until the date of sale completion, the State was required to carry on the ordinary course of business so as to preserve the value of the assets, financial position, and trading position of the businesses;

- The purchasers are required to perform all the obligations under the terms of the allocated business contracts and business licences;
- The purchasers undertook to perform the obligations of the gas retailers, under the gas supply agreements and the agency agreements with GASCOR, relating to the sale of gas to customers;
- The purchasers to endeavour to release the State or any State-owned entity from any guarantees provided by the State or any State-owned entity in relation to the operation of the businesses;
- The purchasers to endeavour to ensure the release of GASCOR from indemnities given under the Blanket Indemnity (dated September 1997) granted by GASCOR to a major bank in relation to certain guarantees, undertakings or bonds previously provided by the bank to the gas retail businesses. In the event that the purchasers are unable to provide such a release, the purchases will indemnify the State against any claim, loss or action taken;
- The State transferred all the employees of the “stapled” businesses to the respective purchasers on and from the date of sale completion, pursuant to the provisions of the *Gas Industry Act 1994*;
- The purchasers agreed not to dispose of, liquidate or allow a change of control of Gasmart within 18 months following the completion of the sale of all the gas distributors and retailers;
- The purchasers undertook not to impede the timely commencement of the Victorian gas market and not challenge the process and timetable for the introduction of contestability in the Victorian gas market, not make any claim or take any action against the State in relation to the introduction of contestability, and ensure that the gas metering installations located within the networks and the communication protocols are upgraded prior to the commencement of the market and maintained to a standard required by VENCORP and the market operating rules;
- The maximum aggregate amount which each purchaser may recover from the State in respect of all claims under the State’s warranties and indemnities specified within the terms of the contract, was limited to a nominal amount of \$1;
- The State was required to pay any stamp duty in excess of the estimated duty payable by the purchasers, which amounted to \$104 million; and
- The purchasers are required to maintain a commitment to the processes established by the State for achieving Year 2000 compliance, which are being co-ordinated through Gas services business Pty Ltd.

6.66 The *Gas Distributor and Retailer Asset Sale Agreements* specifically for the gas distributors and retailers also contained certain other terms which were unique to certain of the businesses, including:

- The purchaser of the net assets of Westar Pty Ltd to be required to construct the necessary pipeline and other infrastructure to enable current tempered liquefied petroleum gas (TLPG) customers in Colac to be supplied with natural gas by the end of June 2001. In addition, the purchaser of Kinetik Energy Pty Ltd to be required by June 2001, at its own cost, to take any action required to convert the gas appliances of current TLPG customers in Colac to operate with a natural gas supply;
- The purchaser of the Stratus/Energy 21 group to indemnify the State against any losses arising from the purchasers' inability to fulfil the requirements of a number of contracts entered into by the State on behalf of the Albury Gas Company Limited. The purchaser of this Group also agreed to continue to participate and support a contestability pilot project being undertaken in New South Wales by Albury Gas Company Limited; and
- The purchaser of the Stratus/Energy 21 group to be required to co-operate with the requirements of the Docklands Authority in relation to the removal or relocation of the gas regulation station located on the site known as the West Melbourne Gasworks site. The cost of the removal of the station is not to be borne by the purchaser.

6.67 The Asset Sale Agreement for the Transmission Pipelines Australia group was entered into by the Treasurer and the purchaser in May 1999. The terms of this sale agreement are broadly consistent to the terms of the sale agreements relating to the 3 "stapled" entities, with the following key exceptions:

- The purchaser undertook to use its best endeavours to ensure that certain nominated initiatives associated with the supply of gas for the 1999 winter were completed as soon as practically possible;
- A sum of \$46.7 million, representing the State's capital contribution to the cost of constructing and expanding the capacity of the Interconnect Pipeline and the costs of constructing the Southwest Pipeline, was required to be paid by GASCOR to the purchaser on the date of sale completion;
- The purchaser was required to execute a deed of novation as soon as possible after the date of sale completion in relation to certain contracts with a New South Wales based utility to which the Transmission Pipelines Australia group is a party. Until the time of such novation, the purchaser is required to perform all the obligations of the State under the terms of the contracts; and
- The purchaser is entitled to nominate a person, subject to the approval by the State, to be appointed as a director of VENCORP.

6.68 In addition, under the terms of a Loan Agreement between the parties, Transmission Pipelines Australia (TPA) agreed to provide an interest free-loan of \$12.3 million to GASCOR, in lieu of an equivalent sum previously paid by GASCOR to TPA. The loan is to be progressively repaid by GASCOR to the purchaser by September 2000.

Adequacy of the sale results for these businesses

6.69 Under the terms of the sale arrangements, the State has received total gross proceeds of \$6.28 billion for the sale of the 3 “stapled” gas businesses (including the associated Gasmart business) and Transmission Pipelines Australia. Table 6G outlines the key components of the cash proceeds received by the State from the sale of these businesses.

TABLE 6G
COMPOSITION OF GROSS SALE PROCEEDS
(*\$million*)

<i>Details</i>	<i>Westar/ Kinetik</i>	<i>Multinet/ Ikon</i>	<i>Stratus/ Energy 21</i>	<i>Transmission Pipelines Australia</i>	<i>Total</i>
Proceeds in excess of book value	928	1 104	993	386	3 411
Proceeds equal to the State's interest in the book value of the business (a)	599	795	622	581	2 597
	1 527	1 899	1 615	967	6 008
Stamp duty	90	71	55	58	274
Gross proceeds	1 617	1 970	1 670	1 025	6 282

(a) Represents the State's interest in the net assets of the businesses, as disclosed in the respective completion accounts.

6.70 The above table discloses that the State received \$6.3 billion for the sale of the 3 “stapled” gas distribution and retail businesses and Transmission Pipelines Australia, which at the effective date of sale had a book value of \$2.6 billion. In fact, this resulted in the State obtaining proceeds of \$3.7 billion in excess of the book value of the businesses, which included \$274 million received by way of stamp duties. However, after taking account of the costs associated with the sales incurred by the Department of Treasury and Finance (\$27.7 million) and a financial contribution provided by GASCOR to the purchaser of Transmission Pipelines Australia on account of certain construction projects (\$47 million), the net proceeds to the State were \$3.6 billion.

6.71 Consistent with the Treasurer's determinations, the cash proceeds from the sale of the businesses of \$6.3 billion were mainly applied towards the retirement of budget sector debt and the reduction of the State's unfunded superannuation liabilities.

6.72 To ensure that reasonable returns were achieved by the State from the sale of the gas businesses, prior to their sale the Government obtained external valuations of the businesses based on both public float and trade sale scenarios. While these individual valuations were previously outlined within this Report, the Department's financial consultants in October 1998 assessed the overall indicative valuation for the businesses, based on a trade sale scenario, at between \$4.1 billion to \$4.25 billion.

6.73 Based on the more recent aggregate valuations for the businesses prior to their sale of between \$4.4 billion and \$4.7 billion, the gross proceeds of \$6.28 billion received by the State from the sale of the businesses compared favourably, resulting in the receipt of proceeds of at least \$1.6 billion in excess of these valuations. The sale of these gas businesses has therefore resulted in a most favourable outcome for the State, compared with the available business valuations.

Underground gas storage project

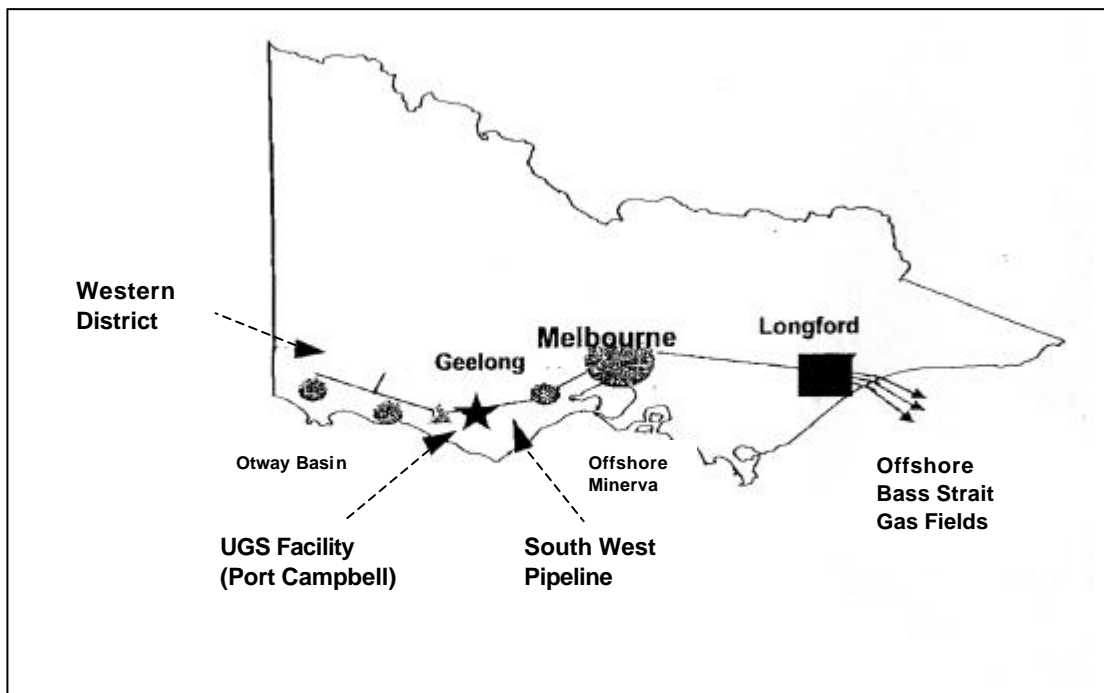
6.74 Given that the Victorian gas supply market has been historically dominated by a single gas producer, namely, Esso/BHP, a key objective of the former Government's gas reform program has been to encourage competition in the gas market. A key strategy aimed at achieving this objective has been the development of alternative sources of gas supply within Victoria and the development of gas transmission pipelines which connect the State's gas transmission system with the gas transmission systems of its neighbouring States. Previous Auditor-General's Reports to the Parliament have identified various initiatives established by the Government to achieve this objective, including:

- *New South Wales Interconnect Pipeline*, involving an expansion of the 150 kilometre interconnect pipeline between Victoria and New South Wales which was previously developed through a joint venture arrangement between the former Transmission Pipelines Australia Pty Ltd and East Australia Pipelines Ltd;
- *South-West Pipeline*, involving the linkage of the State's existing gas transmission system to the Port Campbell gas fields and the south-west gas distribution system in south-west Victoria, through the construction of a new pipeline. This development together with the Underground Storage Project *inter alia* will extend the natural gas supply to towns and cities between Geelong and Port Campbell and provide additional security of natural gas supplies to Warrnambool, Portland, Cobden and Hamilton by connecting the western transmission system by early 2000. This initiative is also intended to promote further development of the gas fields in the Otway Basin; and
- *Underground Gas Storage Project*, involving the storage of surplus gas in underground reservoirs located in the Port Campbell area in the south-west part of the State during periods of low demand, which may be supplied to the gas transmission system through the south-west pipeline at times of high demand or in the case of supply emergencies.

6.75 Consistent with the former Government's objective of encouraging alternative sources of gas supply, the construction of an underground gas storage facility in the Port Campbell area has been a long-term goal of the Victorian gas industry and the Government. The key objectives of this development have been to:

- enhance gas system reliability for all consumers by increasing the security of gas supply;
- free up capacity on the main BHP/Esso plant in Longford, allowing additional gas to be supplied to Victorian or New South Wales markets which will create producer competition and could lead to lower gas prices for consumers;
- encourage gas supply from the Cooper Basin by providing storage for gas supplied to Victoria during off-peak periods; and

- facilitate new developments within the gas industry which would lead to increased competition in the Victorian gas market and lower prices for consumers.



Location of the underground gas storage facility.

Sale and development of the gas storage facility

6.76 Since November 1997, the Department of Treasury and Finance had given consideration to the sale of the State's rights to an underground storage facility in the Port Campbell area. However, until the time of the gas incident at Longford in September 1998 which resulted in the disruption of Victoria's gas supplies over a number of days, the Department's plan was to allow the former Transmission Pipelines Australia Pty Ltd (TPA) to further develop the facility and to then sell the facility in parallel with the sale of TPA.

6.77 In July 1998, the Department requested its financial advisers for the gas privatisation program to undertake an assessment of the likely level of interest from suitable parties within the market for the purchase and development of the gas storage facility. This assessment was intended to form the basis of a decision to be taken as to whether to proceed with the sale of the underground storage facility on an accelerated basis. The advisers subsequently identified that, while the pursuit of an early sale of the facility would provide certain benefits to the Government, there would be additional risks associated with bringing such a sale forward, mainly in terms of the potential to detract potential bidders from the sale of the "stapled" gas businesses and TPA. However, based on the feedback provided from the likely bidders, the advisers concluded that the sale of the storage facility over the subsequent months could be successfully implemented and the above risks managed.

6.78 Following the extensive impact of the September 1998 Longford gas supply incident on the State, an action plan was co-ordinated by the State to ensure the availability of additional gas supplies for the 1999 winter period in the event that the Longford plant was not brought to full operational capacity by that time. **As part of the implementation of the Winter 1999 action plan, during the 1998-99 financial year GASCOR incurred expenditure of around \$51 million associated with the upgrade of the New South Wales interconnect pipeline, the completion of the south-west pipeline, the installation of certain additional equipment and the performance of certain new gas supply contracts to ensure the continuation of gas supplies.**

6.79 As one of the initiatives aimed at enhancing the security of Victoria's gas supply for the 1999 winter, the Government in October 1998 approved the accelerated sale and development of the storage facility by the private sector, on a build, own and operate (BOO) basis. Consequently, the Department sought expressions of interest from parties with an identified interest in acquiring the right to build, own and operate the underground storage facility which was to be located on the site of the partially depleted Iona gas reservoir at Port Campbell and connected to the State's principal transmission system through the 153 kilometre south-west pipeline. The Gas Transmission Corporation had previously completed significant initial development work on this project, including the development of certain assets that could be employed in the construction of the storage facility by potential bidders.

6.80 During that time, the Treasurer approved the transfer of the property, rights and liabilities of the underground storage facility from the Gas Transmission Corporation to a new wholly owned subsidiary of Transmission Pipelines Australia (Holdings) Pty Limited, namely, the Western Underground Gas Storage Pty Ltd (WUGS Pty Ltd).

6.81 In November 1998, the Department received 2 offers for the purchase and development of the facility. Following an evaluation of the offers and the resolution of various concerns by an evaluation panel comprising representatives of the Department, its key advisers and certain representatives from the gas industry, it was recommended that Texas Utilities Australia be selected as the preferred bidder. **It was concluded that the proposal submitted by Texas Utilities Australia was superior in terms of both the price and technical expertise offered, as well as transferring from the State the appropriate level of risk associated with such a development.**

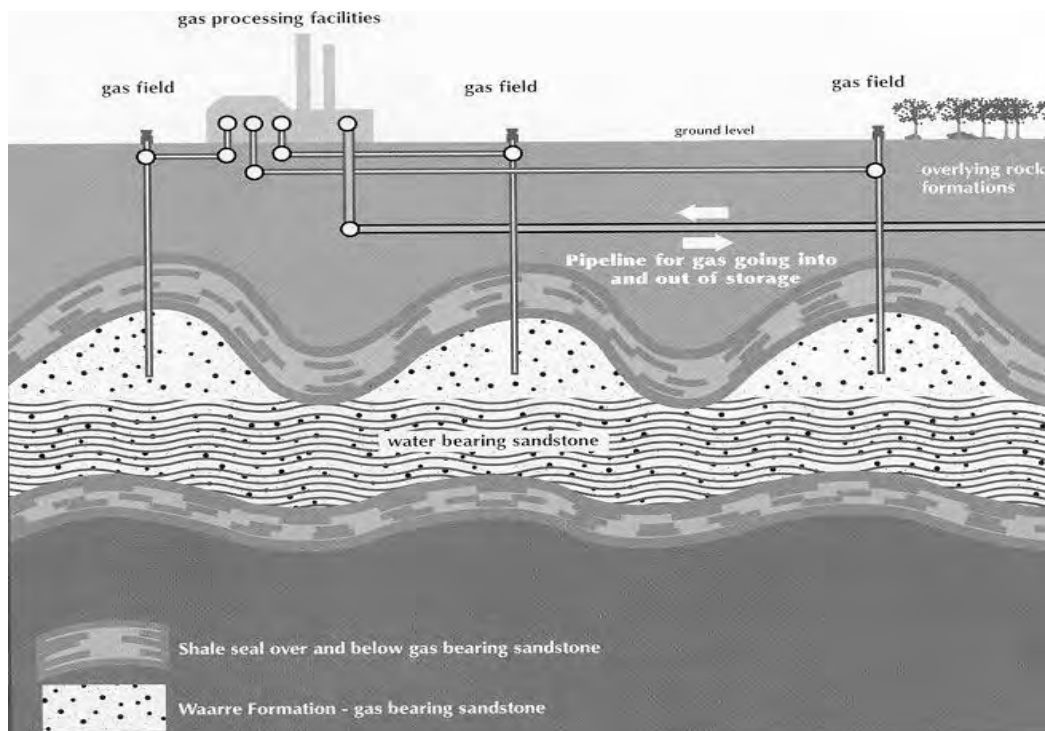
6.82 The Government's financial advisers noted however that a decision to sell the storage facility over a substantially accelerated timeframe created a number of concerns, including:

- an engineering adviser had not been dedicated to this sale to comprehensively assess the proposals; and
- the level of technical requirements within the sale agreements were not as developed as would be expected for a transaction of this nature.

6.83 Notwithstanding these issues, in late November 1998 the Treasurer publicly announced the sale of WUGS Pty Ltd to Texas Utilities Australia Pty Ltd for a sum of \$58.5 million. As at the date of sale, around \$34.3 million had been spent by Transmission Pipelines Australia (Assets) Pty Ltd on behalf of WUGS Pty Ltd towards the part development of the facility, which included \$19.9 million previously spent on the acquisition of the Iona gas reservoir.

6.84 Texas Utilities Australia is a wholly owned subsidiary of Texas Utilities Company which operates 10 natural gas storage facilities and is one of the largest natural gas distribution and pipeline companies in the United States. The company is a major investor in the Victorian energy market, as the owner of the electricity distribution business Eastern Energy and the recent purchaser of one the “stapled” gas entities, namely, Westar/Kinetik Energy.

6.85 Under the established arrangements, the successful tenderer agreed to initially develop a gas processing facility and to supply a specified amount of gas to the State from the partially depleted Iona gas field for the 1999 winter. The second stage of the development is to involve the construction of the entire underground storage facility by the year 2001, while stage 3 mainly involves ensuring that the capacity of the facility satisfies certain enhanced performance criteria. The associated capital cost of these developments was estimated to be approximately \$85 million.



Schematic cross section of proposed underground gas storage facility.

6.86 In December 1998, the process auditors engaged by the Department concluded that the 2 tenderers were afforded fair and equal treatment during the sale process and that the recommendation of the preferred tenderer was based upon a fair and reasonable assessment of the offers submitted. Furthermore, the Department's financial advisers to the gas privatisation program concluded that the agreements entered into between the parties represented a favourable commercial outcome for the State taking into account the alternatives available, and were consistent with the Government's gas industry reform objectives, including those relating to the supply of gas for the 1999 winter, the enhanced security of the State's ongoing gas supply and the development of a competitive gas market.

Key terms of the sale agreements

6.87 In late November 1998, the State and the purchaser entered into a number of agreements for the sale and development of the underground gas storage facility, for a total price of \$58.5 million. The price comprised an amount of \$31.6 million paid for the acquisition of WUGS Pty Ltd and \$26.9 million for the acquisition of the rights to the Iona reservoir gas reserves.

6.88 The *Underground Gas Storage Share Sale Agreement* between the Treasurer of Victoria on behalf of the State, Transmission Pipelines Australia (Holdings) Pty Limited and its subsidiary WUGS Pty Ltd, GASCOR and the purchaser, represents the key agreement for the sale and development of the facility and includes the following key terms:

- The purchaser is required to remain the ultimate owner of at least 50 per cent of the share capital of WUGS Pty Ltd until the completion of the project;
- The purchaser has undertaken to develop the Iona gas reservoir as an underground storage facility at its own cost, in 3 stages of development. Furthermore, under the terms of the agreement the purchaser is required to provide fully operational facilities which will allow an increasing amount of gas deliverability from the Iona reservoir, a steadily increasing processing and storage capacity and the ability to deliver gas to various delivery points along various pipelines;
- An incentive regime to apply if Stage 1 of the project is completed prior to a stipulated date;
- In the event that the purchaser is unlikely to meet the performance criteria under the agreement, the State must provide written notice to the purchaser to cure or remedy the default. However, if the default has not been remedied by the purchaser within a given timeframe, the State may exercise the right to step-in and remedy the default, with the costs incurred by the State to be reimbursed by the purchaser;
- In the event of any non-performance of the purchaser's obligations due to a force majeure event, such non-performance will not give rise to any liability, losses or damages on the purchaser;
- The maximum aggregate amount which the purchaser may recover from the State under the warranties and indemnities provided within this agreement is a nominal amount of \$1;

- By 31 January 1999, the State was required to nominate the purchaser as a market participant under the provisions of the *Gas Industry Act* 1994. This requirement was met. In addition, the Office of the Regulator-General is required to grant the necessary underground gas storage licences when the operator seeks to become a registered gas market participant. This had not occurred as at the date of preparation of this Report;
- As from October 2000, the purchaser is required to offer to all gas market participants the right to access, under reasonably commercial terms, a minimum level of gas which has not been contracted to third parties; and
- The purchaser is required to grant an easement over certain land in favour of the State for the purposes of providing the South-West Pipeline access to the storage facilities.

6.89 In March 1999, following extensive negotiations with the purchaser, the Treasurer agreed to various amendments to this agreement to provide additional incentives to the purchaser to complete the project as early as possible and to therefore assist the Government in achieving its Winter 1999 objective of ensuring the security of Victoria's gas supply over this critical period in the event that the restoration of the Longford gas plant was not completed by this time.

6.90 In addition to the Underground Gas Storage Share Sale Agreement, various other agreements were also executed between the State and the purchaser, viz:

- *Gas Sales Agreement*, under which for the period from June 1999 to December 1999 GASCOR acquired the right to a specified amount of gas located in the Iona Reservoir for an agreed sum, to ensure that peak demand was met during that period;
- *Underground Gas Storage Services Agreement*, whereby the purchaser agreed to supply gas from the storage facility to GASCOR, representing around 50 per cent of the facility's capacity, at agreed tariffs over the 5 year period commencing from the expected completion date of the facility in 2001 to 2005;
- *Interconnection Agreement*, which provides for the interconnection of the gas processing and storage facility being developed by the purchaser, and the South-West Pipeline being developed by Transmission Pipelines Australia; and
- *The Natural Gas Toll Processing Agreement*, under which the purchaser agreed to process raw gas delivered by GASCOR to enable it to meet its requirements to supply gas to its customers in the Victorian gas market for a period of one year to December 1999.

6.91 In summary, under the arrangements established for the sale and development of the underground gas storage project, the State sold its right to develop, own and operate the project for a net amount of \$24.1 million. As an integral part of the arrangements established between the parties, the security of the State's peak period gas supply security has also been improved through the establishment of requirements for the purchaser to supply specified gas quantities to GASCOR and ultimately to the gas retailers until the year 2005. In addition, the substantial risks associated with the development of the underground gas storage project have been transferred to the purchaser.

6.92 At the date of preparation of this Report, the development of the project was substantially complete.

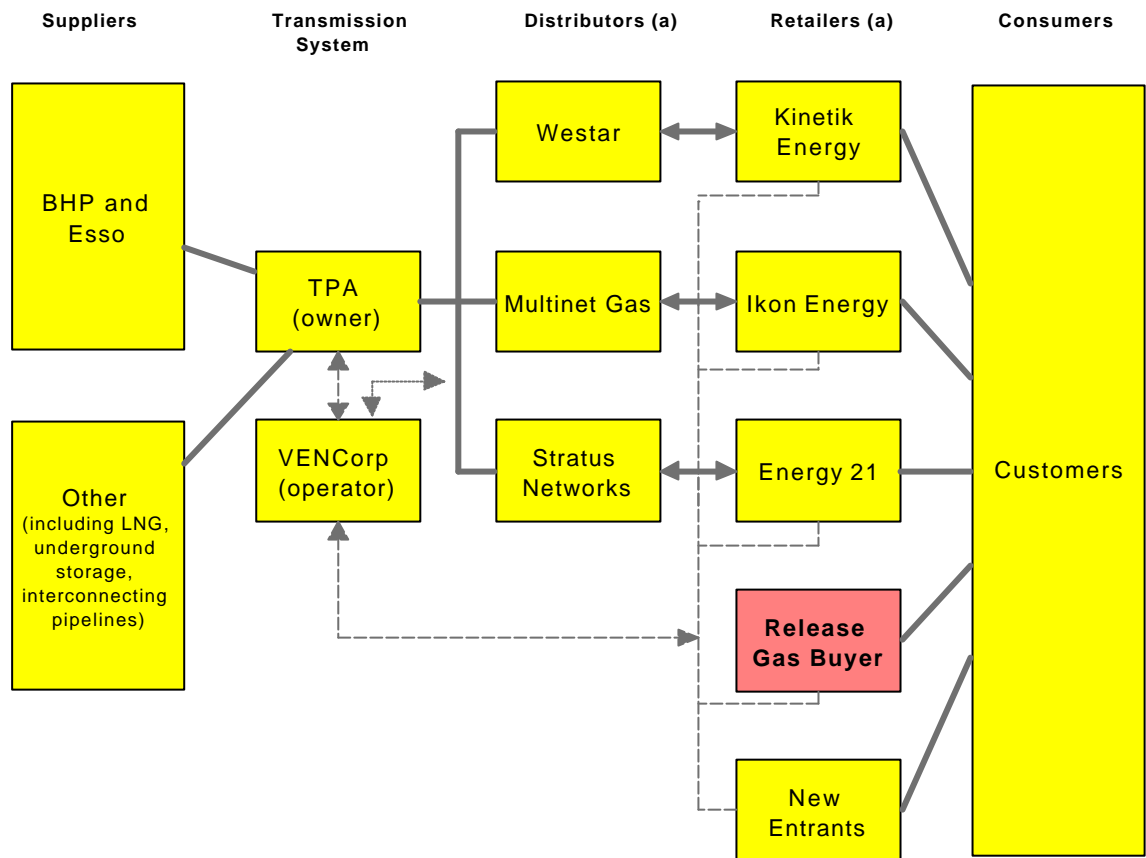
Introduction of new gas retailer through the “Release Gas Program”

6.93 The *Release Gas Program* was developed by the Government to provide an opportunity for a new participant (or participants) to enter the Victorian gas retail market in order to facilitate increased competition within the market and assist in minimising the ongoing exposures of the State to the gas industry.

6.94 Under the Program, GASCOR Pty Ltd was to sell to the new market entrant/s the right to acquire 10 petajoules of gas each year over the period commencing October 1999, when the first tranche of gas customers become contestable, and up until 31 December 2003. Beyond this period, the new entrant/s will be required to negotiate with the other 3 gas retailers for the acquisition of gas, or to purchase gas directly either from the primary gas producers or from other sources. The program was designed to provide the new entrant with a competitively priced supply of gas during the transitional period, which would enable it to establish its gas retail operations in Victoria and to effectively compete with the initial 3 retailers.

6.95 The Gas Release Co Pty Ltd (RCo), a wholly owned subsidiary of GASCOR Pty Ltd, was originally incorporated in June 1997 to facilitate and manage the Release Gas Program. The subsidiary will not have an ongoing involvement in the gas market, other than undertaking an administration role associated with the Program’s contracts. The structure of the Victorian gas industry at the time of the sale of the rights to gas under the *Release Gas Program* is depicted in chart 6H below.

**CHART 6H
STRUCTURE OF THE VICTORIAN GAS INDUSTRY**



(a) Includes 'trading names' of the relevant companies.

Sale process

6.96 As part of the gas industry privatisation process, in January 1999 the Government's advisers presented a report which outlined the proposed design of the *Release Gas Program* and the sale process that should be employed in the impending sale of the rights under the Program. At that time, a probity auditor was engaged by the Department of Treasury and Finance to review the proposed design of the Program and to oversee the sale process.

6.97 In late January 1999, the Treasurer directed the respective Chairpersons of GASCOR and RCo to commence the implementation of the Program in the form recommended by the advisers, by entering into a sub-sales agreement whereby GASCOR would be required to make gas available to RCo for sale to the Program participants. Consequently, in early March 1999 potential purchasers were invited to submit expressions of interest for participation in the Program. Under the established arrangements, the 3 existing retailers and their owners, significant gas suppliers and persons seeking to acquire gas mainly for self-consumption were precluded from participating in the sale process.

6.98 This process resulted in the receipt of 17 expressions of interest that were subsequently evaluated by a panel consisting of representatives from GASCOR and its advisers, RCo and the Department of Treasury and Finance. Subsequently, in May 1999 the potential purchasers were requested to submit a 'qualification statement' which outlined the proposed purchase price and quantity of gas proposed to be purchased under the Program, the bidders experience in the Australian and international gas markets, as well as the legal structure of the proposed purchaser and relevant financial details. The assessment of these statements by the evaluation panel resulted in the short-listing of 7 interested parties for further consideration.

6.99 An Information Memorandum and other relevant documentation which was prepared by the Department of Treasury and Finance was issued to the short-listed parties in mid-May 1999, with final bids expected to be received by mid June 1999. During this time, the advisers to the Government were requested to provide an indicative valuation of the Program based on the marginal cost of market entry, which subsequently concluded that the "one-off" program fee to be payable by the successful purchaser was likely to fall within the range of nil to \$2.2 million. However, the advisers considered that higher bids could be received depending on the bidder's valuation of the business opportunities within the market.

6.100 Final bids were received in June 1999 from 4 potential purchasers, with the proposed one-off program fee to be payable by the bidders with values of up to \$29.25 million. Following an assessment of these bids, the evaluation panel recommended the acceptance of the offer made by Energex which was assessed as superior in terms of both the business strategies proposed by the tenderer and the price offered .

6.101 In late June 1999, the Treasurer formally announced the entry of a new retailer into the Victorian gas market with the sale of the rights to gas reserved by the State under the Release Gas Program to Energex, through its wholly-owned subsidiary Allgas Energy Ltd, for a price of \$29.25 million. The purchaser is a major retailer of energy products and services in the Australian energy market and has obtained licences to retail electricity to contestable customers in Victoria, New South Wales and South Australia.

6.102 The probity auditors concluded that the sale process was conducted in a manner which was fair and equitable to all bidders, and the final bid evaluation was a fair representation of the successful bid selection.

Key terms of sale

6.103 A Release Gas Sales Agreement was entered into between the purchaser, the Gas Release Co Pty Ltd and GASCOR Pty Ltd in June 1999, with the purchase price of \$29.25 million paid to Gascor Pty Ltd at that time. The key terms of this agreement are as follows:

- The Release Gas Program is to commence on 1 October 1999 and either conclude by 31 December 2003 or when the gas contract quantity has been reduced to zero, whichever occurs first. The purchaser is required to receive a maximum quantity of gas in the period between October 1999 to December 1999, with a further specified quantity of gas to be allocated to the purchaser each year thereafter;
- Under the terms of the “take-or-pay” provisions of the contract, in the event that the aggregate quantity of gas delivered to the purchaser in a year is less than 80 per cent of annual minimum quantity for that period, the purchaser is required to pay RCo a deficiency payment which is to be determined by GASCOR;
- The purchaser is prohibited from consuming more than a specified portion of the annual minimum quantity and from selling more than a specified proportion of the gas quantity to other gas retailers;
- The purchaser is required to pay GASCOR specified charges and management fees under the agreement;
- The price of delivered gas may increase to take into account any new taxes imposed by the gas producers (ESSO/BHP) and GASCOR;
- The purchaser has indemnified the State against any liability, loss or damage resulting from any action or claim by any gas producer or third party against the State arising from any default of this agreement by the purchaser;
- In the event of a *force majeure* where the State is unable to perform its obligations under the terms of the agreement, the State is not liable to the purchaser. Similarly, in the event of a *producer force majeure*, the State may reduce the amount of gas to be delivered and must not discriminate against the purchaser or treat the purchaser any less favourably than other purchasers;
- In the event of a default by any party to this agreement which has not cured within the specified period, any combination of the following remedies may be sought by the other parties including:
 - termination of the agreement;
 - suspension of any obligations to the defaulting party until the default is cured; and
 - claim for contractual damages or other available legal remedies.
- The aggregate liability of both GASCOR and RCo for any defaults under this agreement which occur within a contract year is limited to a specified sum;

- Neither GASCOR nor the RCo will be liable to the purchaser for any risks associated with the delivery of gas under the terms of the agreement and, in the event that the gas supply contract between GASCOR and the producers is terminated, RCo may terminate this agreement with the purchaser;
- GASCOR has unconditionally guaranteed the performance of the RCo's obligations under this agreement; and
- GASCOR is required to appoint an independent allocation auditor to review the calculation by Gascor of the daily and monthly delivered gas quantities.

Assessment of the sale result

6.104 Through the payment of a one-off fee of \$29.25 million to GASCOR, the purchaser has acquired the right to enter the Victorian gas retail market by securing access to a specified amount of gas under the Release Gas Program. The fee paid by the purchaser was considerably higher than the valuation provided in June 1999 by the Government's advisers. The net proceeds to the State from this transaction were \$29.1 million, after taking into account the associated costs of \$163 000.

6.105 Under the terms of the sale agreement, GASCOR Pty Ltd will also receive specified management fees and annual charges from the purchaser until December 2003, in addition to the revenue to be derived from the sale of the maximum quantities of gas to the purchaser.

Status of remaining gas industry entities

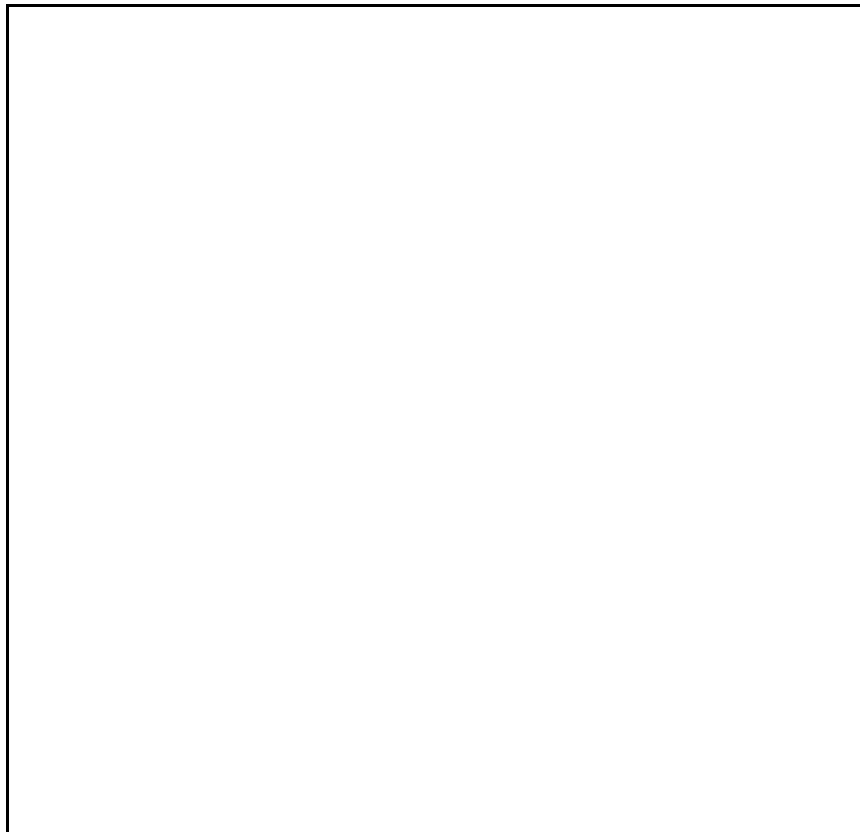
6.106 During the 1998-99 financial year, the State entered into contractual arrangements for the sale of 5 of the 7 business units of the Gas services business Pty Ltd, a State-owned company which provides centralised services under contract to the gas transmission, distribution and retail businesses. A further business was subsequently sold in August 1999. The Department of Treasury and Finance advised that the remaining business unit, Centrecore, will not be sold as a going concern as the purchasers of the retail businesses advised the Department that the service contracts with Centrecore would not be renewed at the end of their current term. Following the expiry of the existing service contracts and the orderly transition of the services to the retailers or new service providers of their choice in December 1999, Centrecore will be liquidated.

Generation Victoria (trading as Ecogen Energy)

6.107 The Auditor-General's previous Reports to the Parliament have provided detailed comment on the Government's extensive electricity industry reform program which commenced in 1994. The program initially involved the disaggregation of the State Electricity Commission of Victoria (SECV) into a new competitive structure, mainly comprising electricity distribution businesses and generation companies and, subsequently, the progressive privatisation of these businesses.

6.108 By the end of the 1997-98 financial year, all the State-owned electricity distribution businesses and generation companies, except for Generation Victoria (trading as Ecogen Energy), were privatised under the reform program.

6.109 Prior to Ecogen Energy's sale in March 1999, it represented the only electricity business remaining in full State ownership and was responsible for maintaining and operating 2 gas-fired power stations, namely, the Newport power station located approximately 6 kilometres south-west of Melbourne, and the Jerralang power station located in the Latrobe Valley, approximately 150 kilometres south-east of Melbourne. The Newport power station began commercial operations in 1980 while the Jeeralang power station was built in 2 stages between 1977 and 1980. The 2 power stations have a combined installed generating capacity of 966 megawatts.



Newport power station.

6.110 Given that Ecogen Energy's 2 power stations are fuelled principally by natural gas, they are more flexible and responsive in their operation than coal-fired plants and hydro power stations. They are therefore well suited as peak and intermediate load generators, taking advantage of periods of high pool prices usually caused by high power demands during the summer period. As the business is also one of few generators in the National Electricity Market with the capability to produce electricity at short notice, it is well placed to offer its generating capacity to electricity retailers, traders and generators to protect them from the risk of high pool prices.

Sale process

6.111 During 1997, the Department of Treasury and Finance commissioned a study to identify any issues which required resolution prior to the sale of this business. The Department's financial and legal advisors subsequently concluded that there were no significant impediments to the sale, however further consideration was required as to whether the business should be sold as a single entity or in a disaggregated form.

6.112 Following a review of the above matter by consultants engaged by the Department, in May 1998 the consultants concluded that:

- the Newport and Jeeralang power stations were not "natural competitors";
- it was unlikely that the disaggregation of the business would promote a more competitive market; and
- the business as a single entity would have the ability to compete more effectively in the provision of energy and capacity contracts than would a disaggregated business.

6.113 Overall, it was concluded that disaggregation for the purposes of sale would result in a reduction in the potential total sale proceeds to the State.

6.114 Following acceptance of the conclusions reached by the consultants, the Department recommended to the Treasurer that the gas-fired generators should be offered for sale as a single entity. Subsequently, in June 1998, the Treasurer provided an in-principle agreement to the sale of the business as a single unit.

6.115 In late December 1998, registrations of interest were sought from interested parties for the proposed sale of the business. Subsequently, in January 1999, the Department issued an information memorandum to 26 potential bidders which previously registered an interest in the business, with interested parties requested to lodge preliminary bids to facilitate a short-listing process.

6.116 In February 1999, the Department received 11 bids from interested parties and, following an evaluation of these initial bids by a financial consultant engaged by the Department, 6 interested parties were selected for short-listing. The high number of short-listed bidders was based on the consultant's advice that the likelihood of certain of the prospective tenderers not proceeding further with the sale process was high, based on previous sale experiences and the complexity of the business.

6.117 In March 1999, the Department received 2 formal bids from the short-listed parties which were evaluated by a panel comprising representatives from the Department and its legal advisors and financial consultants. The evaluation process included consideration of the proposed purchase price, the financial capability of bidders and various risk allocation issues associated with the sale. Subsequently, in late March 1999, the evaluation panel recommended the selection of AES Transpower Pty Ltd, which was assessed as providing the superior offer, as the preferred bidder for the purchase of Ecogen Energy.

6.118 The preferred bidder included in its bid an offer of providing increased consideration to the State for the purchase of the net assets of the business if a long-term electricity hedging arrangement could be negotiated by the Department with Eastern Energy Limited, an electricity distributor, to provide the business with a managed revenue stream from electricity trading. Subsequently, a hedging contract was successfully negotiated between Generation Victoria and Eastern Energy Limited, with the impact of this arrangement factored into the final overall bid price of \$350 million. Subsequently, **in late March 1999, the Treasurer approved the sale of Ecogen Energy to the AES Transpower Pty Ltd for a purchase price of \$350 million.** The purchaser is a subsidiary of the American-based AES Corporation which holds interests in a substantial number of power plants throughout the world.

6.119 The probity auditors appointed by the Department in December 1998 to overview the sale process concluded that the sale process of the business was conducted in a manner which was fair and equitable to all parties.

Adequacy of sale result

6.120 Under the arrangements established for the sale of the business, **the State received total proceeds of \$350.4 million, comprising \$349.4 million for the net assets of the business, \$600 000 for stamp duty payable on the sale transaction and \$430 000 on account of penalty interest associated with a delayed settlement of the transaction.** As the final completion of the sale did not occur in late April 1999 in accordance with the terms of the sale agreement and was deferred to early May 1999, the State received the additional penalty interest on the completion of the sale. The following table outlines the key components of the cash proceeds received by the State from the sale of Ecogen Energy.

TABLE 6I
COMPOSITION OF SALE PROCEEDS
(\$million)

<i>Details</i>	<i>Amount</i>
Proceeds in excess of book value	244.4
Proceeds equal to the State's interest in the book value of the business	105.0
Proceeds from sale of net assets	349.4
Add – Penalty interest resulting from delayed sale completion	0.4
Stamp duty on sale transaction	0.6
External proceeds from sale	350.4
Plus - Cash deposits retained by the State	11.2
Total cash proceeds	361.6

6.121 The table shows that the State received \$349.4 million for the sale of the net assets of Ecogen Energy which, at the effective date of sale, had a book value of \$105 million, which was **\$244.4 million in excess of the book value of the net assets sold.**

6.122 The cash proceeds from the sale of the business have been mainly lodged with the Treasury Corporation of Victoria. The costs of sale incurred by the Department of Treasury and Finance were \$3.3 million, resulting in net sale proceeds from the sale of \$358.3 million.

6.123 The proceeds for the sale of the net assets of the business (not including penalty interest and stamp duty) compared favourably with an indicative valuation provided by the Government's financial advisers in December 1998. The advisers concluded that the value of the business would reflect the investors' views on such matters as the future incidence of high pool prices, the availability of gas and the likelihood of future gas transmission system constraints. In the event that potential investors did not take an aggressive view of the potential of the business in the market, due to its exposure to a number of uncertainties in the electricity and gas markets, the indicative valuation of the business was estimated to be in the region of \$150 million to \$180 million. However, in the event that investors took an aggressive view of the potential of the business, the advisers considered that the value of the business could approach \$250 million.

6.124 Accordingly, the sale result achieved by the State for the sale of the Ecogen Energy business was around \$100 million higher than the most optimistic valuation placed on the business by the Government's advisers.

Key terms of the sale

6.125 In late March 1999, the Treasurer, Ecogen Energy, AES Transpower Holding Pty Ltd (the purchaser) and AES Corporation (the guarantor) entered into a sale agreement for the sale of the business. The key terms of the agreement were as follows:

- All the property, rights and liabilities of the State relating to the business were transferred, assigned or novated to the purchaser at the date of sale, except for certain land which was leased to third parties and the cash deposits held by the Treasury Corporation of Victoria which were retained by the State;
- Prior to the sale completion date, the purchaser was required to use its best endeavours to be registered as a generator under the National Electricity Code;
- The purchaser was precluded from making a claim for any warranty by the State in relation to the emergency declared in respect of the Longford incident or the security of the supply of gas;
- In respect of all claims made under the agreement in relation to the warranties and indemnities provided by the State, the maximum amount which the purchaser may recover from the State was limited to a nominal amount of \$1;
- The purchaser agreed to maintain the Jeeralang power station's gas-fired generators and equipment in working condition at the current site until 31 December 2000 and to maintain the current "Year 2000" compliance program until 31 March 2000;
- The purchaser agreed to indemnify the State and the SECV against any loss incurred by the State in relation to liabilities relating to former employees of the business, environmental or third party liabilities relating to the assets or operation of the assets, and any costs arising from the performance or non-performance of contract liabilities before or after completion date;
- The "guarantor" provided an unconditional guarantee to the State in relation to the performance of the purchaser's obligations under the terms of the agreement;
- The State indemnified the purchaser for any liability or loss suffered resulting from a breach or default by the State under the terms of the agreement;
- The Treasurer, on behalf of the State, guaranteed the performance of the State's present and future obligations under the terms of the agreement. In addition, the State indemnified the purchaser against all liabilities, losses or damages incurred by the purchaser as a result of default by the State in the performance or non-performance of any obligation under the sale arrangements; and
- The purchaser agreed to retain all staff employed by Ecogen Energy at the date of the sale.

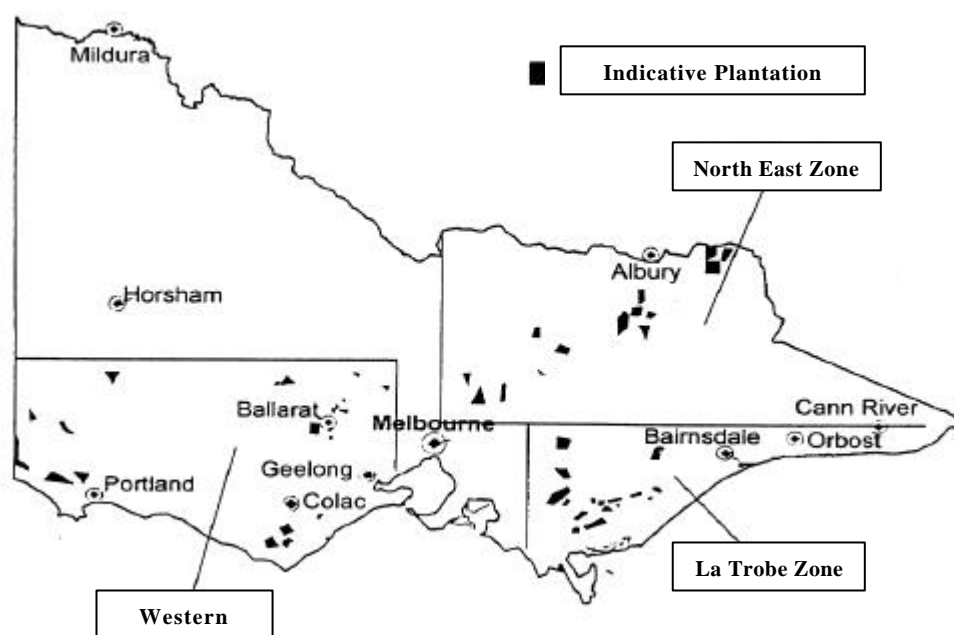
Victorian Plantations Corporation

6.126 The Auditor-General's *May 1999 Ministerial Portfolios Report* provided detailed comment on the sale process undertaken by the Government in October 1998 to divest the State's interest in the Victorian Plantations Corporation (VPC) business and a comprehensive analysis of the associated sale arrangements.

6.127 The VPC managed approximately 108 000 hectares of softwood plantation and approximately 7 000 hectares of hardwood plantation, covering a total land area of around 166 000 hectares. Approximately 93 per cent of the land area managed by the VPC comprised Crown land vested in the Corporation under legislation, with a further 4 per cent representing land managed under leasehold arrangements with other public sector agencies and "share-farming" arrangements with local landholders. The remaining portion of VPC land represented freehold properties purchased by the Corporation since its establishment in 1993.

6.128 The timber plantations were widely dispersed across the State. Chart 6J illustrates the geographical spread of the plantations managed by the VPC.

**CHART 6J
VPC TIMBER PLANTATIONS**



Source: Department of Treasury and Finance.

6.129 The VPC also managed two tree nurseries which supplied planting stock to its plantations and held a one-third interest in a joint venture which exports surplus softwood woodchips sourced from plantations individually owned by the joint venturers.

6.130 The supply of timber from VPC's plantations to the Victorian timber industry and paper industry processors was facilitated under various supply arrangements.

6.131 In March 1998, the Treasurer publicly announced the Government's intention to privatise the VPC business through an international public tender process. Subsequently, the *Victorian Plantations Corporation (Amendment) Act* 1998 was enacted to facilitate the sale of the VPC's assets and associated business interests to the private sector. Under the amendments to the Act:

- the boundaries and dimensions of the plantation land vested in the VPC were clarified;
- the VPC was provided the power to grant or assign to a third party a plantation licence or licences in perpetuity over its vested land; and
- the VPC was empowered to allocate to a new owner its assets and undertakings, including the transfer of VPC's staff.

6.132 In early June 1998, the Department of Treasury and Finance sought expressions of interest for the sale of the VPC's assets and undertakings, through advertisement in major Australian and international newspapers and forestry-related publications. At the same time, the appointed transaction advisers of the Government approached major international timber companies to create an interest in the sale of the business.

6.133 Following a trade sale process involving the receipt and evaluation of competitive bids from prospective purchasers, **in October 1998, the Treasurer approved the selection of Hancock Victorian Plantations Pty Ltd to preferred bidder status to acquire the plantation business of the Corporation, with a public announcement made in November 1998.** The probity auditor engaged by the Department to oversee the integrity of the sale process reported that the process was conducted in a fair and equitable manner.

Assessment of sale result and arrangements

6.134 In October 1998, the VPC, the Treasurer of Victoria and the purchaser entered into a number of arrangements to facilitate the sale or assignment to the purchaser of the various assets, rights and liabilities previously managed by the VPC. Under these arrangements, **the State received gross proceeds of \$550 million during the 1998-99 financial year for the sale of the VPC's net assets and undertakings.** Table 6K outlines the key components of the proceeds received by the State.

TABLE 6K
VICTORIAN PLANTATIONS CORPORATION
COMPOSITION OF SALE PROCEEDS
(\$million)

<i>Details</i>	<i>Amount</i>
Proceeds in excess of book value	201
Proceeds equal to the State's interest in the book value of the assets sold (a)	343
	544
Stamp duty on sale transaction	6
Total proceeds	550

(a) Represents the value of net assets sold as disclosed in the most recently available unaudited financial statements of the business as at the date of sale.

6.135 The above table discloses that the State received \$544 million for the sale of the net assets and undertakings of the Corporation which, at the effective date of sale had a book value of \$343 million. In effect, this **resulted in the State obtaining proceeds of around \$201 million in excess of the book value of the plantation business, mainly representing the value placed by the purchaser on the perpetual rights granted by the State in relation to the occupation and management of Crown land vested in the VPC for plantation purposes.**

6.136 In addition, the cash proceeds from the sale (excluding stamp duty receipts) were \$158 million higher than an indicative VPC business “base” valuation of \$386 million provided in August 1998 by the Government’s financial advisers prior to the sale.

6.137 The costs incurred by the Department of Treasury and Finance and the VPC in relation to the sale totalled around \$7 million, with a substantial part of these costs relating to the engagement of consultants and contractors to advise and assist in the sale process. As indicated in the Auditor-General’s May 1999 Report to the Parliament, in the main, these consultants and contractors were appointed following selective tendering or direct appointment processes, as the Department considered it impractical and inexpedient to undertake public tendering processes given the tight timeframe and circumstances associated with the sale.

Key terms of sale arrangements

6.138 Under the sale arrangements, the purchaser acquired a licence in perpetuity to manage around 166 000 hectares of plantation land forming part of the State’s Crown land estate vested in the VPC, with a restriction placed on the purchaser to use this land only for the purposes of timber production, thereby facilitating the continued development of the plantation industry in Victoria. In particular, the plantation licence issued to the purchaser under the *Victorian Plantations Corporation Act 1993*, confers on the purchaser the perpetual right to establish, maintain and manage timber plantations on the licensed land, and take or convert forest produce on the licensed land.

6.139 An additional limited-term licence relating to the occupation, management and use of certain specified plantation land totalling around 1 600 hectares, covering the period up until 31 December 2010, was also acquired by the purchaser. Under this licence, following the final harvest of the forest produce on the licensed land, the purchaser must treat the land “to a sufficient extent to enable the successful seeding and re-establishment of native species indigenous to the general locality”.

6.140 In relation to any possible land title claims, under the arrangements the State has retained responsibility for meeting any compensation which may be payable to any party “in relation to the passage of the *Victorian Plantations Act* 1993 and the *Land Titles Validation Act* 1993”.

6.141 The other significant terms and conditions of the arrangements are as follows:

- the purchaser entered into three “back to back” contracts as the State was unable to successfully re-negotiate certain supply agreements;
- as the holder of plantation licenses, the purchaser is required to comply with the Code of Forest Practices established under the *Conservation, Forests and Land Act* 1987, ensuring the careful stewardship and responsible management of all forestry activities;
- the exposure of the VPC and the State in relation to any claims made by the purchaser under the Asset Sale Agreement was limited to a nominal amount of \$1;
- the purchaser provided an indemnity to the VPC and the State generally against any claim or liability for property damage or injury or death of any person which arises directly or indirectly out of negligence, a breach of contract or a breach of a statutory duty by the purchaser, including any claim arising from the pollution or contamination of the land or water; and
- the purchaser was required to engage all 120 full-time staff of the Corporation and to honour their leave entitlements.

6.142 With the formalisation of the arrangements relating to the former VPC timber plantations, the statutory responsibility for fire prevention and suppression has been transferred from the VPC and the Department of Natural Resources and Environment to the purchaser and the Country Fire Authority. **Irrespective of these arrangements, the purchaser has no contractual redress against the VPC or the State generally for any financial losses incurred as a result of fire damage to its plantations.**

Aluminium Smelters of Victoria Pty Ltd

6.143 The Auditor-General's *May 1999 Report on Ministerial Portfolios* provided a detailed analysis of the sale during the 1998-99 financial year of Aluminium Smelters of Victoria Pty Ltd (Aluvic), a wholly-owned company of the State through which the State held a 25 per cent joint venture interest in the Portland Aluminium Smelter. Aluvic also held interests in the aerospace aluminium components industries located in France and in the United States of America.

Joint venture arrangements

6.144 A Portland Smelter Joint Venture was established in July 1984, with Alcoa and the State (the participants) initially taking a 60 per cent interest and a 40 per cent interest, respectively. The key arrangements associated with the operation of the joint venture included a participants' agreement and the smelter's electricity supply arrangements.

6.145 The participants' agreement outlined the respective interests of the participants in the joint venture and, in particular, conferred pre-emption rights to the non-State participant(s) in the event of any transfer (sell-down) of the State's participating interest.

6.146 Subsequent to the establishment of the joint venture, the State's 40 per cent was reduced through the following sales:

- *January 1986* - sale of a 5 per cent interest in the smelter to First National Resource Trust, now known as Eastern Aluminium Ltd; and
- *September 1992* - sale of a further 10 per cent interest in the smelter to Marubeni Aluminium Australia Ltd, a company controlled by a Japanese-based organisation, Marubeni Corporation.

6.147 In addition, in 1986 Alcoa's 60 per cent interest in the smelter was reduced to 45 per cent through 2 sales. Consequently, immediately prior to the sale of the State's remaining 25 per cent interest in the joint venture, the equity ownership of the joint venture comprised of:

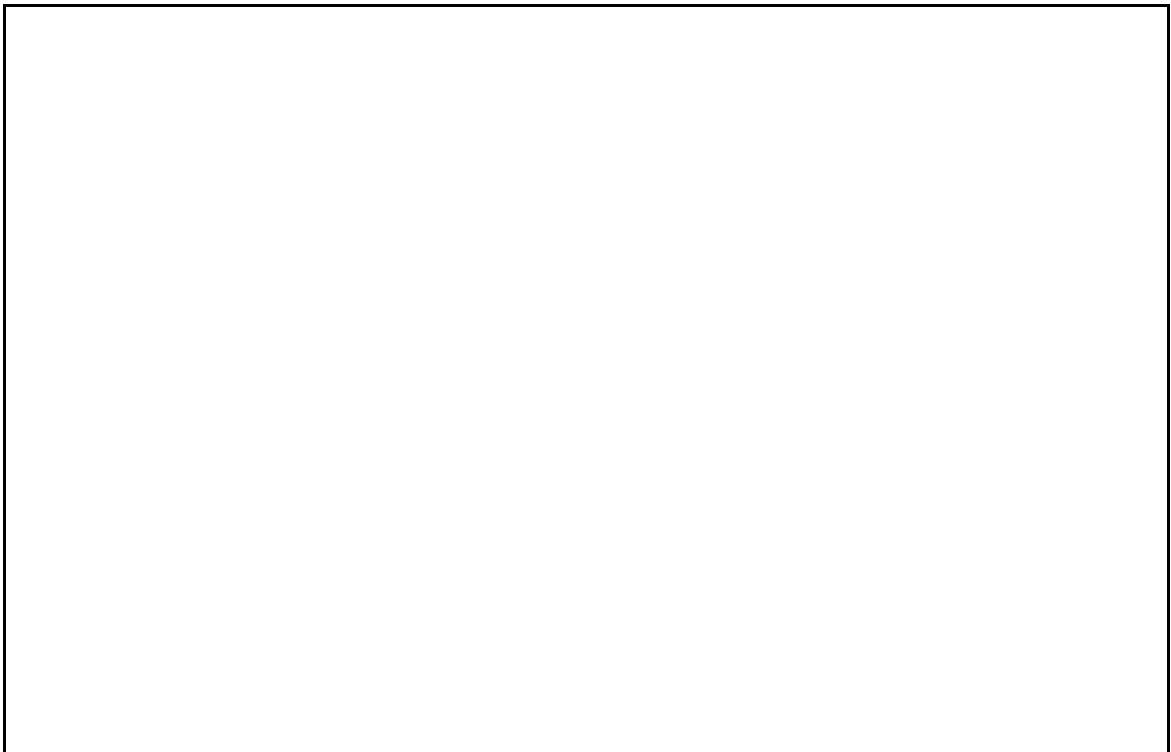
- *Alcoa* - 45 per cent interest;
- *State's interest* through Aluvic Metal Sales Pty Ltd - 25 per cent interest;
- *CITIC Nominees Ltd*, a wholly-owned subsidiary of the Beijing-based China International Trust and Investment Corporation - 10 per cent interest;
- *Eastern Aluminium Ltd* - 10 per cent interest (Aluvic held a 16 per cent shareholding in this company); and
- *Marubeni Aluminium Australia Ltd* - 10 per cent interest.

Electricity supply arrangements

6.148 The previous Auditor-General Reports to the Parliament have commented on the highly complex electricity supply arrangements for the Portland smelter which were established by the Government in 1984. **Although these arrangements have positively impacted on the financial performance of the smelter, they have at the same time imposed a substantial financial burden on the State.**

6.149 Under the arrangements, which extend to the year 2016, the SECV is required to supply a base electricity load of 520 megawatts for the production of aluminium at Portland. Similar arrangements exist for the supply of power to a smelter located at Point Henry, near Geelong, which is also controlled by Alcoa. These arrangements, which include a flexible electricity tariff agreement, require the State, when aluminium prices fall below a stipulated level (a situation that has occurred consistently in recent years) to charge lower prices for electricity supplied to the smelters than it costs the State to acquire the electricity. **Since the 1984-85 financial year, the cost to Victorian taxpayers has been in excess of \$1.45 billion to subsidise lower prices charged for electricity supplied to the aluminium smelters.**

6.150 In September 1997, the Treasurer announced that the Government had reached an agreement with the joint venture participants for the provision of additional power to the smelter. The supplementary power arrangements provided for the supply of up to an additional 120 megawatts to the smelter from January 1998 to December 2002. **The successful completion of the supplementary power arrangements removed what was considered by the Government to be a significant impediment to Aluvic's privatisation which, at the same time, had the effect of adding an estimated \$47 million in value to Aluvic's 25 per cent interest in the joint venture.**



*One of 4 pot-rooms at the Portland Smelter.
(Photo courtesy of ALUVIC.)*

Sale process

6.151 In October 1997, the financial consultants to the Department of Treasury and Finance recommended a privatisation strategy for Aluvic which incorporated a trade sale process to be undertaken in parallel with the encouragement of the submission of proposals for a public float. Consistent with this advice, in December 1997, the Treasurer agreed to a dual trade sale and public float privatisation strategy, which was subsequently ratified by Cabinet in April 1998. However, the Government subsequently decided not to proceed with a float of Aluvic as the market reaction to this proposal was poor.

6.152 In June 1998, as the privatisation of Aluvic gained momentum, the Department was conscious of the significant negative value associated with Aluvic's foreign exchange hedging arrangements due to the decrease in value of the Australian currency and, consequently, sought to unwind the hedging arrangements.

6.153 Following consideration of the available options, in August 1998, the Aluvic foreign exchange hedging arrangements were "closed out" at a total cost of \$101.2 million, including the novation of part of the arrangements to an external party at a cost of \$12.2 million and the novation of the balance of the arrangements to the Treasury Corporation of Victoria at a cost of \$89 million.

6.154 Following the implementation of the trade sale process, which was outlined in detail in the Auditor-General's May 1999 *Report on Ministerial Portfolios*, **in August 1998 the Treasurer approved the sale of Aluvic to CITIC and Marubeni, which were two of the joint venture participants in the Portland Aluminium Smelter, for \$US293 million, which at that time was estimated at \$502 million in Australian dollars.**

Sale results

6.155 Under the sale arrangements, the State received gross proceeds of \$502 million. However, \$109 million of this amount was directed towards meeting costs associated with the assumption and closure of the previously mentioned Aluvic foreign exchange hedge book (\$101 million) and the costs of sale (\$8 million).

6.156 Table 6L outlines the proceeds received from the sale of Aluvic and the proceeds in excess of the book value.

TABLE 6L
SALE PROCEEDS
(\$million)

<i>Details</i>	<i>Total</i>
Gross cash proceeds	502
Proceeds equal to the State's interest in the book value of the business	(a) 401
Proceeds in excess of book value	101

(a) Represents the State's interest in Aluvic's net assets as at the date of sale.

6.157 The above table discloses that the State received \$502 million for the sale of the net assets of Aluvic, which at the effective date of sale had a book value of \$401 million. In effect, this resulted in the State obtaining proceeds of \$101 million in excess of the book value of the business. However, **after taking account of an amount of \$109 million which was applied from the proceeds by the State to fund the closure of Aluvic's foreign exchange hedge book and to meet the State's costs of sale, the net loss to the State from the sale of Aluvic was \$8 million.**

6.158 In placing the results achieved by the State from this sale in context, it is important to recognise that the establishment by the Government in September 1997 of the supplementary power arrangements for the smelter which had the impact of increasing its operating capacity also increased Aluvic's value by around \$47 million.

6.159 The cash proceeds of \$502 million received from the sale of the business compared favourably with the valuations of the business provided by the Government's financial consultants in July 1998 and immediately before the close of bids in August 1998, on the basis of a trade sale.

6.160 Further, it should be noted that while the State has divested its interest in Aluvic, it has retained a substantial financial exposure associated with the flexible electricity tariff arrangements which had an estimated net value of around \$240 million relating to its former 25 per cent interest in the Portland smelter.

Obligations of the State

6.161 Under the sale arrangements, the State has provided certain general indemnities and warranties to the purchasers which give rise to a maximum exposure to the State of \$7.5 million in the event that the purchasers lodge claims within 12 months from the date of sale. The State also provided an indemnity against any liability imposed on the purchasers to pay State equivalent taxation which was not fully provided for in the financial statements of Aluvic for the year ended 30 June 1998. However, in August 1998, the Treasurer directed that income tax not be levied on Aluvic under the State Income Tax Equivalent system for the period 1 July 1998 to 20 August 1998.

Public transport privatisation and franchise arrangements

6.162 The previous Auditor-General Reports to the Parliament have provided extensive comment on the former Government's public transport reform program. As part of this program, the Public Transport Corporation was established in 1989 following the merger of the former Metropolitan Transit Authority and the former State Transport Authority. The Public Transport Corporation initially comprised 5 business units known as Met Trains, Met Trams, Met Bus, V/Line Passenger and V/Line Freight.

6.163 In 1996 the Government commenced the corporatisation of the Public Transport Corporation's business units, facilitated through amendments to the *Rail Corporations Act* 1996. In July 1997, the Government established the V/Line Freight Corporation as a separate corporatised entity with responsibility for the operation of the non-electrified Victorian intra-State rail freight business. Subsequently, in July 1998 certain property, rights, liabilities and staff of the Public Transport Corporation were further transferred to the remaining corporatised transport businesses, including:

- *Met Train 1 (trading as Bayside Trains)*, providing all metropolitan train services to and from Melbourne's northern, western and south-eastern suburbs through a network of 9 rail lines. In addition, this business managed the Stony Point line, which is a non-electrified line;
- *Met Train 2 (trading as Hillside Trains)*, providing all metropolitan train services to and from Melbourne's eastern and north-eastern suburbs through a network of 6 rail lines. All of the train lines within this area are electrified and the business generally does not share its lines with other freight or passenger trains;
- *Met Tram 1 (trading as Swanston Trams)*, providing tram services on 18 routes operating from 4 depots to the north-western and south-eastern suburbs, and the Melbourne central business district;
- *Met Tram 2 (trading as Yarra Trams)*, providing tram services on 10 routes operating from 4 depots, encompassing both the north-eastern and southern suburbs as well as the central business district; and
- *V/Line Passenger Corporation*, providing a network of integrated train and coach services to towns and cities across regional Victoria. The rail network consists of 1 640 kilometres of track over 5 rail corridors of which 1 400 kilometres is controlled by the V/Line Freight Corporation in country Victoria and around 240 kilometres comes under the responsibility of Bayside Trains in the metropolitan area.

6.164 Under the reform program, the Government also established the Victorian Rail Track Corporation in April 1997, which assumed responsibility for the non-electrified track in Victoria and the related train control and signalling operations, together with the maintenance and management of related land and associated infrastructure including railway stations, and the marketing and negotiation of access to the rail network. On 1 July 1999, pursuant to an allocation statement made under the authority of the *Rail Corporations Act* 1996, the Victorian Rail Track Corporation also assumed ownership of the electrified metropolitan track and related train control and signalling assets.

6.165 In August 1997, the Government announced plans to proceed with the privatisation of public transport in Victoria, with the following key objectives:

- secure a progressive improvement in the quality of services to public transport users in Victoria;
- continue to provide users with a high level of safety;
- minimise the long-term costs of public transport to taxpayers;
- transfer the risk to the private sector; and
- secure a substantial and sustained increase in the number of passengers using the public transport system.

6.166 A Transport Reform Unit was formed within the Department of Treasury and Finance to oversee the public transport privatisation program. The Unit reported jointly to the Treasurer and the Minister for Transport, and comprised staff of the Department of Treasury and Finance and the Department of Infrastructure, supported by a range of consultants and other seconded specialist staff.

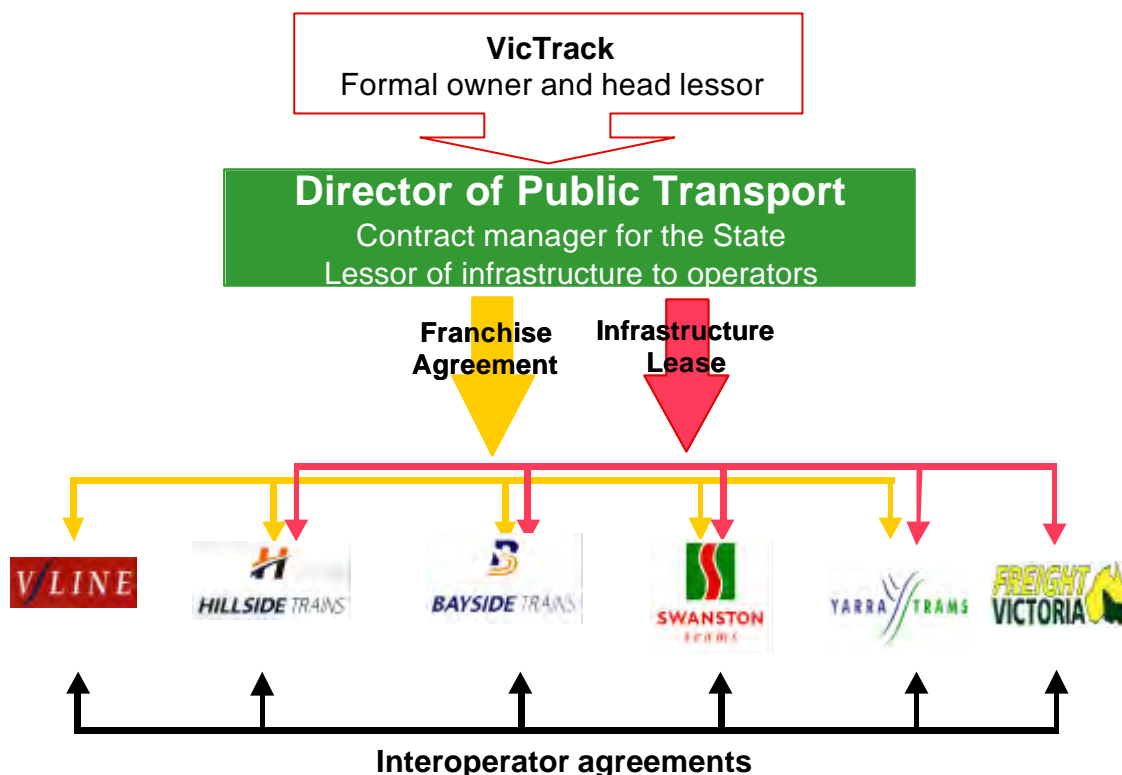
6.167 Following the completion of a comprehensive sale preparation process, **in February 1999 the Government announced the sale of the first public transport business, namely, the V/Line Freight business, to a consortium known as Freight Victoria. A detailed assessment of this sale is presented later in this Report.**

6.168 Subsequently, in June 1999 and July 1999, the Government announced the finalisation of sale and associated franchise arrangements for the remaining transport businesses, with the respective franchise terms varying from 10 to 15 years. Under the established arrangements, the franchisees acquired the respective rolling stock of the businesses, consisting of trains and trams, and are required to lease the track and associated infrastructure to provide the necessary transport services. In turn, the franchisees receive a subsidy from the Government to operate the transport services to a minimum prescribed level and to invest in new rolling stock and infrastructure, as required, to operate the services. **It is intended that detailed comment on these arrangements will be presented in subsequent Auditor-General's Reports to the Parliament.**

6.169 Under the new public transport arrangements, the Victorian Rail Track Corporation owns and leases the railway infrastructure to the Director of Public Transport, who in turn sub-leases the infrastructure to the various business operators. The Director of Public Transport is responsible for the administration of the franchise contracts and the infrastructure leases, and represents the key public sector “player” in the relationships established with the private sector providers. In addition, Victorian Rail Track Corporation’s (known as VicTrack) role is primarily confined to property management, the identification and development of commercial opportunities on sites adjacent or ancillary to the rail network, air rights above rail stations and certain advertising opportunities.

6.170 Figure 6M below illustrates the core agreements and contractual relationships between the Director of Public Transport, on behalf of the State, and the various public transport service operators.

**FIGURE 6M
OVERVIEW OF CONTRACTUAL ARRANGEMENTS FOR
THE NEW PUBLIC TRANSPORT BUSINESSES**



Courtesy of the Transport Reform Unit, Department of Treasury and Finance.
V/Line refers to the V/Line Passenger Corporation.

6.171 As illustrated above, the franchise and infrastructure agreements represent the cornerstone of the new public transport arrangements which contain the key terms and conditions established between the State and the respective private sector operators associated with the provision of public transport services during the nominated franchise periods. In the main, the franchise agreement specifies the minimum service requirements and performance standards to be achieved by the individual franchisees or business operators. In addition, the agreement regulates the maximum fares payable by the transport users and provides for the payment of subsidies and certain fare supplements by the State to the operators. Incentive and penalty payment regimes for operational performance, passenger growth and customer satisfaction are also established within this agreement.

6.172 The infrastructure leases set out the terms and conditions for the use of the railway network infrastructure (essentially track, overhead electricity supply and signalling) by the respective parties. In particular, all passenger services, with the exception of V/Line Passenger, were required to enter into infrastructure leases with the Director of Public Transport. However, V/Line Passenger has entered into an access agreement with Freight Victoria Limited, the purchaser of the V/Line Freight business, which in turn has an infrastructure lease with the Director of Public Transport. In addition, various other industry agreements were entered into between the private sector operators, the Director of Public Transport and the Victorian Rail Track Corporation for a range of services such as access arrangements, maintenance, track control and signalling and resourcing requirements.

Sale of V/Line Freight Corporation

6.173 In May 1996, consultants engaged by the Department of Treasury and Finance to examine the reform options for the public transport system recommended that V/Line Freight (VLF), a business unit of the Public Transport Corporation, be established as a separate corporatised entity. In addition, the consultants recommended that:

- the track infrastructure and the train control function of VLF be separated from the entity, however the necessary staff and assets required to undertake the ongoing rail vehicle maintenance function should form part of the structure of VLF;
- the business should not be structured to be overly reliant on debt, and should aim to eliminate its operating losses within 3 years of corporatisation and generate a return on assets of around 7 per cent by the 2000-2001 financial year;
- the Government should accept responsibility for the funding of any unfunded superannuation liabilities together with outstanding financing arrangements (mainly for locomotives) at the time of corporatisation, as well as redundancy payments for the first 2 years; and
- pre-existing arrangements with the Public Transport Corporation regarding the provision of services for passenger lines by VLF should not continue as a right and, consequently, VLF should be invited to bid for the services on the same basis as other contenders.

6.174 An important element of the proposed corporatisation of VLF was the recommendation by the consultants to establish a separate statutory authority, namely the Victorian Rail Track Corporation (VRT) which, as mentioned previously, was established to administer and maintain the Victorian rail network and the train control function. In addition, the consultants identified that as the rail freight business was heavily dependent on grain transportation with two major customers, there was a significant risk that the financial viability of the business would be affected with such contracts becoming contestable over time and increased competition from road transportation.

6.175 The Department subsequently engaged a private sector accounting firm to provide further commercial and accounting advice in relation to the corporatisation of VLF. In particular, the firm was requested to provide advice on an appropriate capital structure for VLF and to provide an opinion as to the commercial viability of the business, and an indicative business valuation of the corporatised entity.

6.176 In October 1996, the accounting firm concluded that VLF, in its current structure, was not commercially viable. However, the firm indicated that if the business ceased providing services to V/Line Passenger, another business unit of the Public Transport Corporation, and reduced its business costs within the following 3 to 4 years, the business would be capable of generating sufficient cashflows to fund the capital expenditure required to develop the business. It further identified that, although it would not be prudent to establish the business with a debt structure, in the absence of a subsidy by the Government, debt would be required to finance initial losses and capital expenditure. Consequently, the accounting firm recommended that some level of agreed subsidy for up to 3 years be provided to meet the re-structuring costs of the business which would avoid the initial need to borrow funds and would improve the overall viability of the business.

6.177 At the time, the accounting firm estimated the indicative valuation of the business to be between \$50 million and \$80 million, which was significantly less than the net assets of the business as recorded in the Public Transport Corporation's accounts of \$190 million as at 30 June 1997. These assets mainly comprised \$65 million of land, buildings and work in progress and \$110 million in respect of rolling stock. The valuation adopted by the firm was based on the net present value of estimated future cash flows of the business.

6.178 Based upon the recommendation of the accounting firm and the consultants, the Government established VLF as a statutory corporation under the *Rail Corporations Act* 1996, with the business commencing operations in July 1997 following the allocation of the necessary assets and liabilities from the former Public Transport Corporation. Furthermore, the Government determined that community service obligation payments would be made to VLF in respect to its "fast-track" operations, which include the delivery of small parcels.

6.179 In June 1997, the accounting firm revised its indicative valuation of the business to a range between \$48 million and \$60 million, with a mid-point of \$54 million. The downward revision was primarily due to the poor performance of the business, compared with forecast, and a slower than anticipated progression towards achieving best practice cost levels. However, the firm indicated that the achievable sale price would mainly reflect the extent to which management exercised strategies to improve the profitability of the business prior to privatisation and the prospective purchaser's own assessments of business profitability resulting from any synergistic or integration benefits to be derived from the sale.

6.180 At the same time, the accounting firm valued the Victorian Rail Track Corporation business at between zero and negative \$14 million on the basis that the Corporation would not continue to receive Government subsidies.

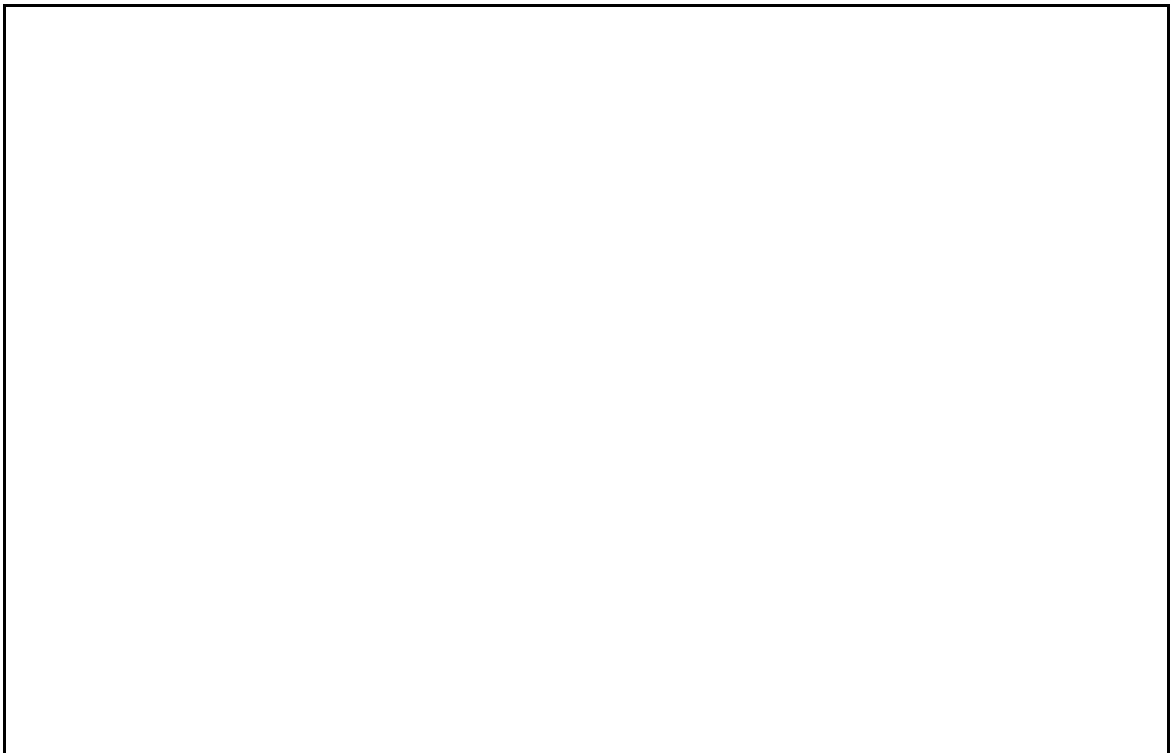
6.181 On the basis that the purchaser of the V/Line Freight business would also be required to assume the significant risks and obligations associated with the non-electrified track business of the Victorian Rail Track Corporation, the accounting firm assessed the mid-point valuation of the rail freight business at around \$47 million.

Sale process

6.182 Following consideration of the above advice, the Government provided an in-principle approval for the sale of the business, with the key objectives being to:

- maximise the sale proceeds and minimise any associated long-term costs to taxpayers;
- transfer the risk of operations to the private sector;
- facilitate the development of an expanding rail freight industry in Victoria as a viable alternative to road transport; and
- secure a progressive improvement in the quality of services available to freight customers in Victoria.

6.183 Subsequently, in April 1998 the Government announced that it would offer the business for sale, including its rail fleet comprising 107 locomotives and over 2 600 wagons, together with a long-term lease over the associated railway infrastructure within the State. Under the lease arrangement, which formed an integral part of the privatisation arrangements, substantial commercial risk and opportunity associated with the rail infrastructure, including responsibility for the maintenance of track, was to be transferred to the private sector. The infrastructure lease was to cover an initial lease term of 15 years with an option to extend the lease period for 2 further terms of 15 years.



V/Line Freight locomotive.

6.184 In September 1998, through public advertisement, interested parties were invited to tender for the business. However, any freight operator which was either wholly-owned or partially-owned or controlled by any Government within Australia was excluded from acquiring an equity interest in the business or controlling any activities of the business, without the prior approval of the Treasurer.

6.185 During this time, an independent engineering firm commissioned by the Transport Reform Unit of the Department of Treasury and Finance **in September 1998 identified that 43 per cent of the business's locomotives were in a good condition, 38 per cent were in a fair condition and the remaining 19 per cent were in poor condition. With regard to the wagons, 12 per cent were assessed to be in good condition, 62 per cent in fair condition while the remaining 26 per cent were considered to be in poor condition. The consultant also determined that the railway infrastructure was 'fit for purpose', however, a backlog in maintenance of the railway lines was identified in each corridor, with 'catch-up' works of around \$23 million required on the freight and passenger lines.**

6.186 Following the advertisement of the proposed sale of the business, 16 parties expressed an interest in the business and were issued an Information Memorandum to assist in their preparation of indicative bids. Subsequently, in October 1998, the Transport Reform Unit received 5 indicative bids and an evaluation panel consisting of representatives from the Unit and representatives from the accounting firm and legal and financial advisers recommended that 4 of the 5 bidders be allowed to proceed to the next stage of the sale process. The other bid was assessed to be non-conforming as it failed to meet certain elements of the selection criteria.

6.187 The key criteria applied by the evaluation panel in assessing both the indicative and final bids included the following:

- the net present value of the proposed sale proceeds, adjusted for expected redundancy costs and the proposed lease payments over the 45 year period;
- the extent of proposed amendments to the sale and infrastructure lease agreements by the bidder;
- the extent of any risk transfer to the State, while considering the State's ongoing exposure to residual risks and liabilities associated with the business;
- any conditions relating to the bid;
- the ability of the prospective tenderer to operate and develop the business; and
- the financial capacity of the bidder.

6.188 In late January 1999, the Transport Reform Unit received further submissions from the prospective bidders and, following the closing of the tenders, one tenderer was eliminated from further consideration as the proceeds it offered the State were significantly less than the other bidders, with the 3 remaining bidders invited to review their bids to take account of certain changes to rail access standards and changes which were made subsequent to the preparation of the Information Memorandum. Following a detailed assessment of the revised final bids, a further tenderer was eliminated from final consideration as again the net proceeds it offered the State were significantly lower than the remaining 2 bids.

6.189 The final bids received from the remaining 2 parties had net present values of up to \$163.1 million, including a component relating to the leasing of the track infrastructure. **Following a detailed assessment of the bids, the evaluation panel concluded in February 1999 that Freight Victoria Limited should be selected as the preferred bidder for the purchase of the freight business for a total price of \$163.1 million. This was accepted by the Government.**

6.190 Under the established arrangements, the purchaser has acquired the rolling stock and associated equipment, including the rights to use the track infrastructure, and has assumed the associated maintenance obligations and risks for a period of up to 45 years. The purchaser is also required to provide track access to third parties on reasonable terms. Freight Victoria Limited is an Australian company, incorporated in Victoria specifically for the purpose of bidding for V/Line Freight and V/Line Passenger. At the time of the bid, Freight Victoria Limited was 100 per cent owned by Macquarie Bank, however consistent with the bid proposal it is now fully owned by RailAmerica Inc., a United States railway operator which operates a number of railways in the United States and Canada, and also has a major interest in a railway in northern Chile.

6.191 In February 1999, the probity auditor appointed by the Department to oversee the sale process concluded that all bidders received fair and equitable treatment, there were no issues of probity outstanding and that the proposals were evaluated and ranked fairly against agreed selection criteria.

Sale agreement

6.192 In February 1999, a Sale of Assets Agreement was entered into by the former V/Line Freight Corporation (VLF), Freight Victoria and RailAmerica Inc. for the sale of the assets of the business for \$73.4 million, with a deposit of \$30 million paid to V/Line Freight Corporation at that time, and the balance to be paid in April 1999.

6.193 The assets sold mainly included plant and equipment, rolling stock, debtors and intangible assets including goodwill, with the purchase price subject to the adjustment on the following grounds. If the purchaser identifies assets which were listed in the Sale of Assets Agreement or assets used solely for the business with a written-down value greater than \$25 000 which were not properly transferred to the purchaser, the purchaser may lodge a claim advising the State of the disputed assets. The purchaser is able to lodge a maximum of two such claims in the 12 month period after the completion date of the sale. The State's exposure to such claims is limited to the extent that the written-down value of the disputed assets exceeds \$2 million, and the exposure capped at \$3 million.

6.194 Under the infrastructure leasing arrangements, which are commented on later in this Report, a further amount of \$89.7 million was paid by the purchaser in April 1999, representing prepaid lease rentals over the full 45 year lease term relating to the rail infrastructure.

Obligations of the purchaser

6.195 Under the terms of the sale agreement, the key obligations of the purchaser are as follows:

- where former VLF employees are engaged by the purchaser and continue to be active members of either the State Superannuation Fund or the Victorian Superannuation Fund, the purchaser is required to meet the required employer superannuation contributions;
- from the date of sale completion, the purchaser is required to assume the rights and obligations of the State in relation to the performance of all business contracts and any other contracts, and must indemnify the State against all liabilities which may be incurred by the State in relation to any breach of, or failure to fulfil, any contract obligations occurring after completion;
- RailAmerica Inc. agreed to unconditionally guarantee to the State the performance of the obligations of the purchaser under the terms of the sale agreement; and
- the purchaser undertook not to dispose, grant or transfer any right or interest in any undertakings or assets of the business to any government agency or entity prior to 30 June 2001, without the prior written consent of the Treasurer.

Obligations of the State

6.196 Under the terms of the sale agreement, the key obligations retained by the State included:

- Responsibility for the unfunded superannuation liabilities of the business as at the date of sale;
- Provision of specified contributions to the purchaser in respect of community service obligations associated with the provision of the “fast-track” operations until June 2000. This contribution totalled \$4.6 million for the year ended 30 April 1999; and
- In the event that the purchaser makes a claim against VLF within one year of the sale completion date, any such liability for breach of any representation, condition or warranty by the State is limited to a nominal amount of \$1, other than in respect of any assets not properly transferred to the purchaser (as mentioned earlier in this Report).

Adequacy of sale result

6.197 A key feature of the tender arrangements established by the Government in relation to the sale of the V/Line Freight business and the transfer of the risks and responsibilities associated with the rail infrastructure to the purchaser, was the provision of flexibility to all bidders to determine what component of the total sale proceeds would be attributed to the acquisition of the net assets of the business and to the infrastructure lease. From a whole of State perspective, the total bid value was assessed, rather than its allocation between the above two components.

6.198 Table 6N presents the composition of the proceeds received by the State of \$163.1 million under the sale and lease arrangements associated with the V/Line Freight Corporation.

TABLE 6N
COMPOSITION OF SALE PROCEEDS
(\$million)

<i>Details</i>	<i>Amount</i>
Book loss on sale of assets	(1.3)
Proceeds equal to the State's interest in the book value of the business (a)	74.2
Proceeds from sale of net assets	72.9
Stamp duty on sale transaction	0.5
Prepaid present value of future lease rental fees	89.7
Total cash proceeds	163.1

(a) Represents the State's interest in the net assets of the business, as disclosed in the completion financial statements of the business as at 30 April 1999.

6.199 The table shows that the State received \$72.9 million for the sale of the net assets of the V/Line Freight business which, at the effective date of sale, had a book value of \$74.2 million, resulting in the State incurring an accounting book loss of sale of \$1.3 million. However, as mentioned earlier in this Report, the purchaser has also assumed substantial commercial obligations and risks associated with the intrastate infrastructure over a 45 year period, which are not reflected in the book value of the assets sold.

6.200 Nevertheless, the total proceeds of \$163.1 million received by the State can be assessed for adequacy against the indicative valuation provided by the Government's financial advisers in June 1997, which estimated the value of the business sold, including the infrastructure lease, at around \$47 million.

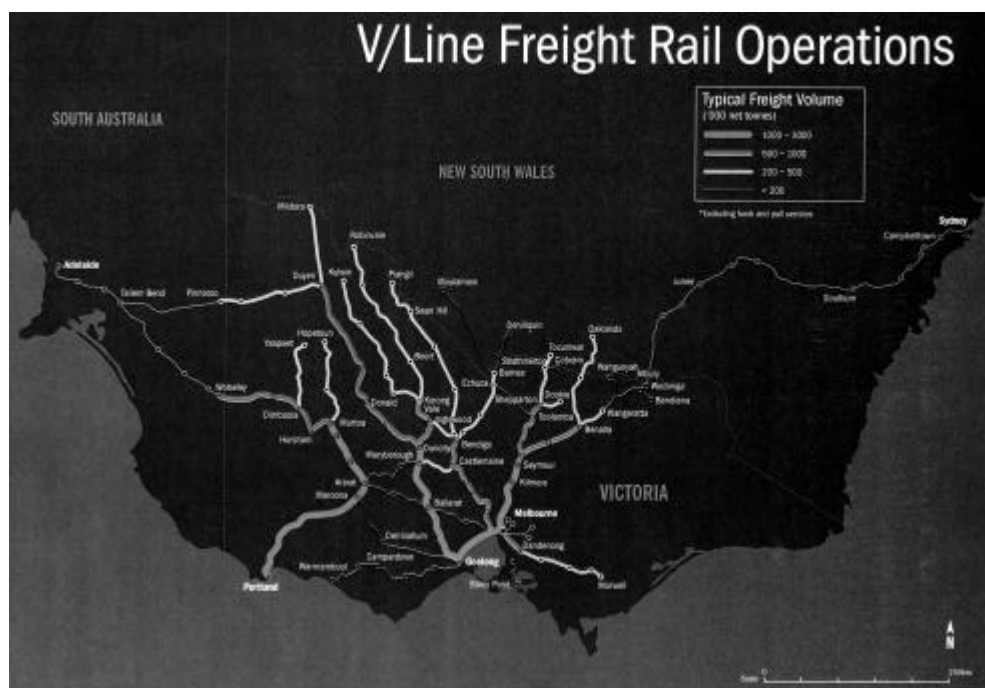
6.201 While the Department of Treasury and Finance's accounting records did not enable the ready identification of the actual costs associated with the sale, the Department has estimated these costs to be around \$10 million, based on the total costs incurred on the reform of all public transport businesses.

6.202 As at 1 July 1999, the V/Line Freight Corporation was abolished, with the Public Transport Corporation "shell" becoming its successor in law, thereby assuming any residual obligations of the former business.

Intra-State and Inter-State Infrastructure Leases

6.203 As mentioned previously, under the public transport reform arrangements the Victorian Rail Track Corporation assumed ownership responsibility for the railway infrastructure throughout the State. The Corporation leases the land upon which the track infrastructure is located to the Director of Public Transport, who in turn, sub-leases the land to the various transport operators. The lease agreement between the Director of Public Transport and the operators, including Freight Victoria as purchaser of V/Line Freight, sets out the terms and conditions of access to the railway infrastructure. Figure 6O below indicates the V/Line Freight rail network leased by Freight Victoria.

FIGURE 60
VICTORIA FREIGHT RAIL NETWORK



6.204 The key agreements associated with the use of the rural track infrastructure by the respective operators include the **Primary Intra-State Infrastructure Lease Agreement**, the **Direct Country Passenger Network Agreement** and the **V/Line Passenger Access Agreement**. Certain other access agreements have also been established, mainly with the Victorian Railway Company (trading as West Coast Railway) in relation to the Melbourne to Warrnambool corridor and Hoys Roadlines Pty Ltd in relation to the Melbourne to Shepparton corridor. To facilitate the transportation of freight nationally, the interstate (standard gauge) lines in Victoria are being leased by the Victorian Rail Track Corporation through the Director of Public Transport to the Australian Rail Track Corporation, which in turn has access agreements with several freight operators.

6.205 Access agreements in relation to the metropolitan track infrastructure have also been entered into with the respective purchasers of the public transport businesses. Comment on these agreements will be included as part of the reporting on the metropolitan transport arrangements in subsequent Auditor-General's Reports to the Parliament.

6.206 Comments follow on the key agreements associated with the V/Line Freight business.

Primary Intra-State Infrastructure Lease

6.207 The purchaser of V/Line Freight, as the lessee, has entered into an Intra-State Infrastructure Lease Agreement with the Director of Public Transport in relation to the land and rail infrastructure upon which all non-electrified intra-state rail track is installed and erected (with the exception of the Stony Point line), as well as the line between Pakenham and Warragul. The lease agreement provides that the land and rail infrastructure is only to be used for railway operations. As consideration, the State as part of the total purchase price has received prepaid rentals of \$89.7 million for the lease of these assets for a 45 year period.

6.208 Under the lease agreement, the lessee is required to maintain, repair, replace or install new railway infrastructure required for the business relating to the handling, storing and transporting freight and passengers by rail. Other key provisions of the agreement are as follows:

- A specified minimum amount of insurance is required to be maintained by the lessee in the joint names of the Victorian Rail Track Corporation, the Director of Public Transport and the lessee in relation to railway infrastructure, public liability, professional negligence, worker's compensation, motor vehicle and any other insurance category as determined necessary by the Director;
- In the event that any part of the railway infrastructure is damaged or is unfit for use during the term of the lease, the lessee must, unless otherwise agreed in writing by the Director, reinstate or repair the damage within a reasonable time;
- The Director of Public Transport may refuse to re-new the lease, where the lessee has committed repeated material breaches of access agreements, within a 5 year period immediately preceding the expiration of the lease term;
- The Director of Public Transport may terminate the lease agreement under a number of specified circumstances, including:
 - where the lessee fails to fulfil its financial obligations under the lease;
 - a material failure by the lessee to comply with the "new works and electrification" provisions of the lease;
 - failure to maintain accreditation as an operator of rolling stock and as a manager of railway infrastructure under the *Transport Act 1983*; and
 - failure to effect and maintain the required insurance coverage under the lease.
- At the termination of the lease term, the infrastructure must be returned to the Director of Public Transport in the condition which will enable the operation of the rolling stock and infrastructure in accordance with operational requirements. In addition, an environmental audit is to be conducted at the time of termination to determine whether the purchaser is liable for any contamination directly attributable to the operations of the lessee;

- The State must indemnify the lessee for a period of 10 years from the date of commencement of the lease term, up to an aggregate sum of \$1 million, for the cost of complying with the requirements of any noise control notice issued by the Environment Protection Authority, requiring the lessee to reduce the level of noise caused by its activities at the Tottenham Yard, provided that the cost of the abatement of any one noise control notice exceeds \$50 000;
- If any part of leased lines is not being used in connection with railway operations for a continuous period of 24 months, the Director of Public Transport may issue a notice to the lessee requiring the surrender of part of the land to the Director, unless the lessee demonstrates it requires the land. The lessee, may at any time, surrender land which it no longer requires;
- Subject to certain conditions, the lessee may surrender a rail line after the first 3 years of the lease term by giving notice to the Director of Public Transport of its intention to do so. However, the Director may exercise an option to require the lessee not to surrender the line, in which case the lessee will be required to continue to perform its obligations under the lease in respect of that line and, in return, the Director will be required to pay the reasonable costs and expenses of the lessee. The Director also retains the right to keep open or re-open a rail line which has been surrendered and may either directly operate the line or engage another party to do so;
- The lessee is required to submit to the Director of Public Transport a maintenance plan which details the repair, maintenance and renewal works proposed to be undertaken each year during the remaining 5 years of the lease term. All works vest with the Director and form part of the railway infrastructure which ultimately rests with the Victorian Rail Track Corporation;
- The Director of Public Transport may undertake works, with the State meeting the cost, on any part of the leased land for the purpose of upgrading or replacing the existing infrastructure or constructing new infrastructure. To the extent that any new works undertaken form part of the existing infrastructure, those works will be deemed to be part of the leased assets and the lessee will be compensated for any financial loss or damage which directly results from the works;
- The lease acknowledges that the Director proposes to undertake the necessary works and incur the associated costs required for the de-electrification of the Pakenham to Warragul line. Furthermore, the Director may elect to extend the metropolitan railway system, at its own cost, by undertaking the necessary works on the leased land for the purpose of electrifying any part of the infrastructure leased to the lessee. Upon completion of any electrification works, the land upon which the electrified lines are located must be surrendered by the lessee to the Director. If part of the land surrendered is within a 120 kilometre radius of Melbourne, the Director will not be liable for any loss or damage suffered by the lessee. However, if the surrendered land is beyond this point, the Director will be liable to pay compensation to the lessee; and

- Upon termination of the lease, the purchaser must co-operate with the Director of Public Transport to ensure that the Director will be in a position to operate, or to permit others to operate rolling stock on the intra-State track in accordance with the operational criteria existing prior to the termination, and to comply with any access agreements continuing in effect after termination. Furthermore, upon the request of the Director, the lessee must novate or assign all agreements to the Director or the Director's nominee without payment, and the Director has a right to claim compensation from the lessee.

Direct Country Passenger Network Agreement

6.209 Freight Victoria also entered into an agreement with the Director of Public Transport to provide access and certain services to various intra-State country passenger operators including West Coast Railway, Hoys Roadline, and Great Northern Railway Services in relation to the provision of access to these operators to the rail network. Under the terms of this agreement, Freight Victoria must:

- Enter into, and comply with its obligations under access agreements with nominated intra-State country passenger operators;
- Operate the system involved in the monitoring of train performance, including arrival and departure points, with this information required to be provided to the Director of Public Transport within a specified timeframe;
- Neither increase or delete services to operators' scheduled train paths without the prior approval of the Director;
- Provide the Director with asset management plans and any other plans relating to repair, maintenance, upgrading and renewal works. Freight Victoria is also required to provide the Director with the results of track auditing tests and other tests undertaken on the quality of railway infrastructure and work plans to be conducted as a result of the tests; and
- Not terminate, rescind or suspend access agreements in the event that the country passenger operators are not in default.

V/Line Passenger Access Agreement

6.210 Under this agreement, Freight Victoria as the network access provider, is required to provide V/Line Passenger (VLP) access to the intra-State network for the purposes of providing rail passenger services, including the delivery of small parcels, medical and like supplies, in accordance with the established passenger service timetable. This agreement is to expire on the later of July 2006 or the date of the expiry or termination of the VLP franchise. The key terms of the agreement are as follows:

- The access provided to VLP must be in accordance with the agreed timetable, with passenger trains having priority over freight trains where train paths can be temporarily varied. However, any permanent changes to VLP scheduled timetables are required to be approved by the Director of Public Transport;

- VLP is required to pay Freight Victoria an access charge based on the kilometres travelled by locomotive-hauled trains and sprinter trains, adjusted for movements in the consumer price index and interest payable on overdue payments. The access charge is to be re-negotiated every 5 years over the term of the agreement, with expert determination provided by the Office of the Regulator-General in the event of a dispute;
- Freight Victoria is obligated to maintain the track in a condition which would allow VLP to operate trains in line with pre-determined train paths at certain speeds for specified sections of the rail line. In addition, Freight Victoria is required to monitor the track geometry at least 4 times a year over the term of the agreement and to demonstrate to the Director of Public Transport and the operator that minimum condition levels have been met;
- In the event that the required track condition levels have not been met, VLP may require Freight Victoria to restore the track to the required standard. Where 4 consecutive breaches have been made, VLP may carry out the works necessary to restore the track to the required standard and demand reimbursement from Freight Victoria;
- Freight Victoria is required to prepare an asset management plan identifying the works to be carried out over the following 5 years, with consultation required with VLP over the timing of the works;
- Both Freight Victoria and VLP are required to insure against public liability for death or injury, and damage and destruction of any property; and
- Both parties are required to make "lateness payments" to each other for variances against specified performance targets, based on an agreed formula.

Other service and leasing agreements

6.211 The respective parties, including the Director of Public Transport, the Victorian Rail Track Corporation and Freight Victoria, have also entered into numerous agreements associated with the provision of other services mainly relating to train and operational control, maintenance facilities, signalling, vehicle engineering, trade mark licences and intellectual property, telecommunications, accommodation and information technology services.

6.212 The use of railway stations is also subject to a leasing agreement between the Director of Public Transport and Freight Victoria. Similar to the requirements associated with the Primary Intra-State Infrastructure Lease arrangement, these stations are owned by the Victorian Rail Track Corporation, with a sub-lease established between the Director and the specified operators which defines the terms and conditions of their use. In particular, Freight Victoria has agreed to lease stations at Shepparton, Warrnambool, Wodonga, Ballarat, Bendigo, Colac, Dimboola, Donald, Maryborough, Mildura, Murtoa and Echuca, commencing in May 1999 and terminating at the expiration of the Primary Intra-State Infrastructure Lease. Under this agreement, the purchaser is required to pay the Director of Public Transport a nominal annual rental of \$10 per station and is required to meet all outgoings including maintenance costs, administration and management costs, security costs, and insurance cover relating to these station buildings. Any alterations made to the station buildings by Freight Victoria, at its own cost, require the prior approval of the Director of Public Transport.

6.213 Finally, Freight Victoria has also entered into numerous agreements directly with the passenger service operators covering such issues as staff secondments, station car parking and hiring of rolling stock.

Overall summary of arrangements

6.214 In summary, under the established arrangements associated with the sale of the V/Line Freight Corporation, the State received \$72.9 million for the sale of the net assets of the business, mainly rolling stock, plant and equipment, debtors and intangible assets such as goodwill. The State has retained ownership of the intra-State rail infrastructure, however the Director of Public Transport has entered into a lease agreement with the purchaser of the business, Freight Victoria, under which the purchaser has agreed to lease the required infrastructure over a 45 year period. Under this agreement, the purchaser paid an amount of \$89.7 million to the State as a prepayment of the future lease rentals over the full term of the lease.

6.215 The infrastructure lease agreement between the purchaser and the Director of Public Transport contains the key terms and conditions relating to the management and operation of the leased infrastructure (mainly track and signalling), and requires the purchaser to repair and maintain these assets at its own cost. The infrastructure assets, including any works undertaken by the purchaser, are required to be returned to the State on the termination of the lease term. The Director of Public Transport is entitled to undertake works, with the State meeting the cost, on any part of the leased land for the purpose of upgrading or replacing the existing infrastructure.

6.216 To enable the efficient operation of rail transport throughout the State, a number of access agreements have also been established under which the purchaser is required to provide certain rail operators, such as V/Line Passenger and other private sector passenger service operators, access to the leased infrastructure in return for the receipt of related fees.

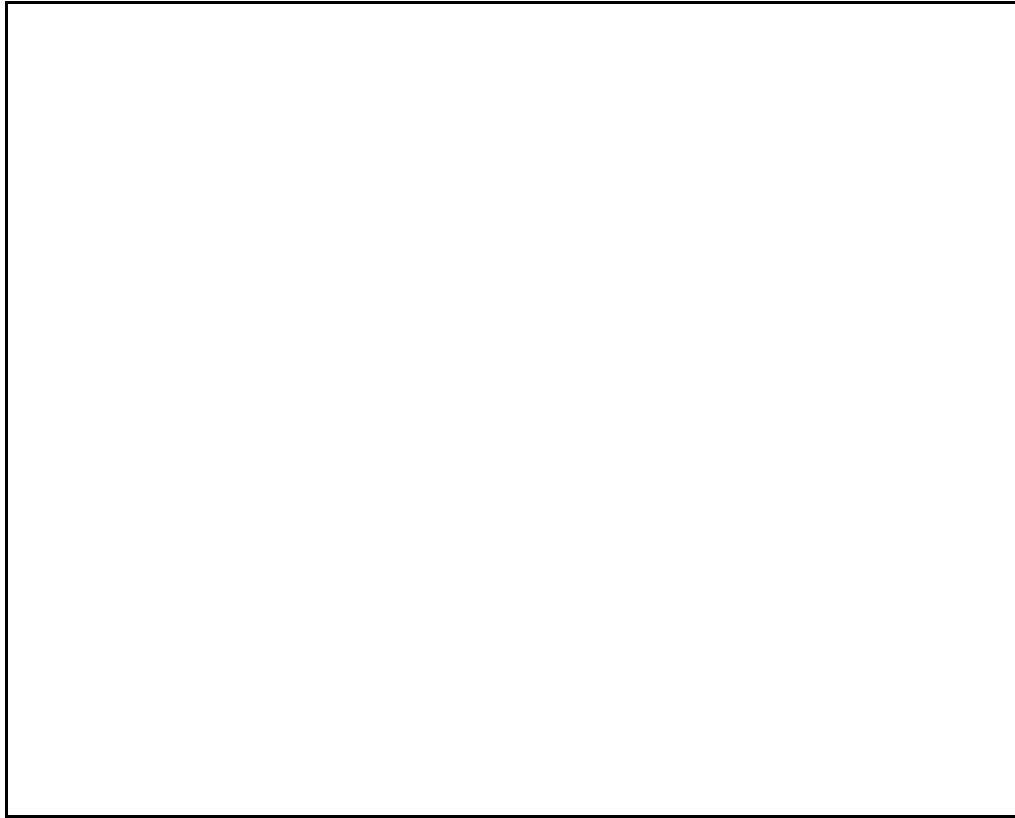
6.217 Finally, under the arrangements associated with the sale of the V/Line Freight Corporation, the State's financial exposures associated with the future operations of the rail freight business and the operation and maintenance of non-electrified rail infrastructure within Victoria were terminated. However, the State has agreed to make community service obligation payments to the purchaser to subsidise the "Fast Track" operations which mainly include the delivery of small parcels, until June 2000.

Prison complex at Coburg, incorporating the Pentridge Prison

6.218 The former Coburg Prison complex was established in 1850 and, until its closure in late 1997, had been the cornerstone of Victoria's correctional system for almost 150 years. The complex represented one of the State's largest prison facilities and was located on a 29 hectare site, with access to Murray Road and Sydney Road, and frontages to Urquhart Street and Champ Street in Coburg.

6.219 The complex incorporated the Pentridge Prison, a maximum security facility able to accommodate up to 1 000 male prisoners, and the Metropolitan Reception Prison, a remand and holding centre for male prisoners. As the population of prison inmates grew and as prison management objectives changed over the years, various buildings and facilities were added to the complex, including a woollen mill, a tannery, a wire netting and a carpentry factory. In 1980, the most modern electronic high security facility in Australia at that time, namely “Jika Jika”, was constructed within the complex. However, this facility was de-commissioned in October 1987, following a fire which claimed the lives of 5 prisoners.

6.220 In December 1993, the then Minister for Corrections announced the planned closure of the complex by November 1997. To facilitate the implementation of this decision, all prisoners within the complex were progressively transferred to other correctional facilities within the State, mainly to the newly privately constructed and operated Port Phillip prison located at Laverton and the Fulham Correctional Centre at Sale.



Plan of the former Coburg prison complex.

6.221 Following the announcement of the planned closure of the complex, the Department of Treasury and Finance engaged a number of consultants from varying disciplines to advise on issues associated with the sale of the site, including the available options for its redevelopment, given the historic significance of the complex and various economic, environmental and traffic issues within the area of the prison.

6.222 In August 1996, a heritage consultant was jointly engaged by the Department of Treasury and Finance and the Moreland City Council to undertake an assessment of the soon to be closed prison complex. This consultant subsequently recommended that 19 of the 164 buildings examined within the complex, including the bluestone walls and the “Jika Jika” facility, should be designated as “areas of primary significance”. It was also considered by the consultant that many sites, including the burial site of the prisoners previously executed at the complex, should receive appropriate recognition. In contrast, Heritage Victoria, a unit within the Department of Infrastructure which maintains the Victorian Heritage Register, indicated that it would favour registering the entire complex on the Victorian Heritage Register.

6.223 When considering the recommendations of the above consultant, the Department of Treasury and Finance estimated that the cost of refurbishing the significant historical buildings to their original condition would be around \$4.5 million, compared with a cost of around \$3.9 million for the demolition of a number of the buildings and the refurbishment of certain of the other buildings. In both instances, these estimates did not include any costs associated with upgrading the buildings to meet current industry regulations and standards.

6.224 In July 1997, a further consultant was appointed by the Department to conduct a geo-technical and contamination investigation of the prison complex and the adjacent former Newlands Secondary College site. This investigation subsequently identified a number of contaminated sites, including the existence of a former quarry which was filled with industrial and domestic waste, sewerage sludges, contaminated soil and building rubble. The consultant estimated that the remediation costs in relation to the contaminated soil identified at the complex was estimated at \$740 000 where the future use of the site was for industrial/commercial purposes, or \$2.1 million where the future use of the site was for residential purposes.

6.225 In addition, the investigation identified the existence of underground storage tanks associated with emergency power generators and a former service station, and contaminated soil associated with hazardous chemicals storage in the area of the Pentridge Prison. The consultant estimated that the cost for the removal of the underground storage tanks and the contaminated soil would be between \$59 000 and \$79 000.

6.226 A separate consultant investigation undertaken in June 1998 to identify the quantum of soil contamination on the site estimated the cost of remediation at between \$1 million to \$6.8 million, depending on the type of development proposed for the site.

Sale process

6.227 In July 1998, the Coburg Prison Complex and the adjacent former Newlands Secondary College site were declared to be surplus of the Government's operational requirements. Consequently, in early July 1998, the Department of Justice and the Department of Education transferred control of the respective properties (total area of around 34.4 hectares) to the Department of Treasury and Finance.

6.228 Subsequently, in September 1998, the Minister of Finance publicly announced that the Government would seek expressions of interest for the sale and redevelopment of the above sites. While not imposing onerous prescriptive restrictions on the development, proposals presented by prospective tenderers were required to address the following development objectives:

- recognition of the historic significance of the property in the development of the Coburg community, including any heritage aspects relating to the historic buildings, and the utilisation of other existing buildings wherever possible;
- integration of the property into the local community, including the improvement of the road infrastructure by designing rational traffic management systems, providing new opportunities for pedestrians and public transport links;

- creation of an environment which would make an economically viable contribution to the State and the City of Moreland, including the attraction of new business and technological enterprises to the area which will create opportunities for residents;
- provision of an integrated network of parkland, open space and public amenities between the Upfield corridor and Merri Creek; and
- delivery of affordable residential options which enhance the local character with an emphasis on energy conservation and quality design.

6.229 In November 1998, expressions of interest were formally sought by the Minister for Finance from interested parties, with a closing date of early December 1998. At this time, 13 initial proposals were submitted, including prices ranging from \$3 million to \$18 million.

6.230 Following an assessment of these proposals by a tender evaluation panel comprising representatives from the Department of Infrastructure, Heritage Victoria, the Department of Treasury and Finance, and its legal advisers, 6 interested parties were short-listed. These parties were invited to lodge formal tenders by March 1999 for the purchase and redevelopment of the former prison complex and the adjoining school site.

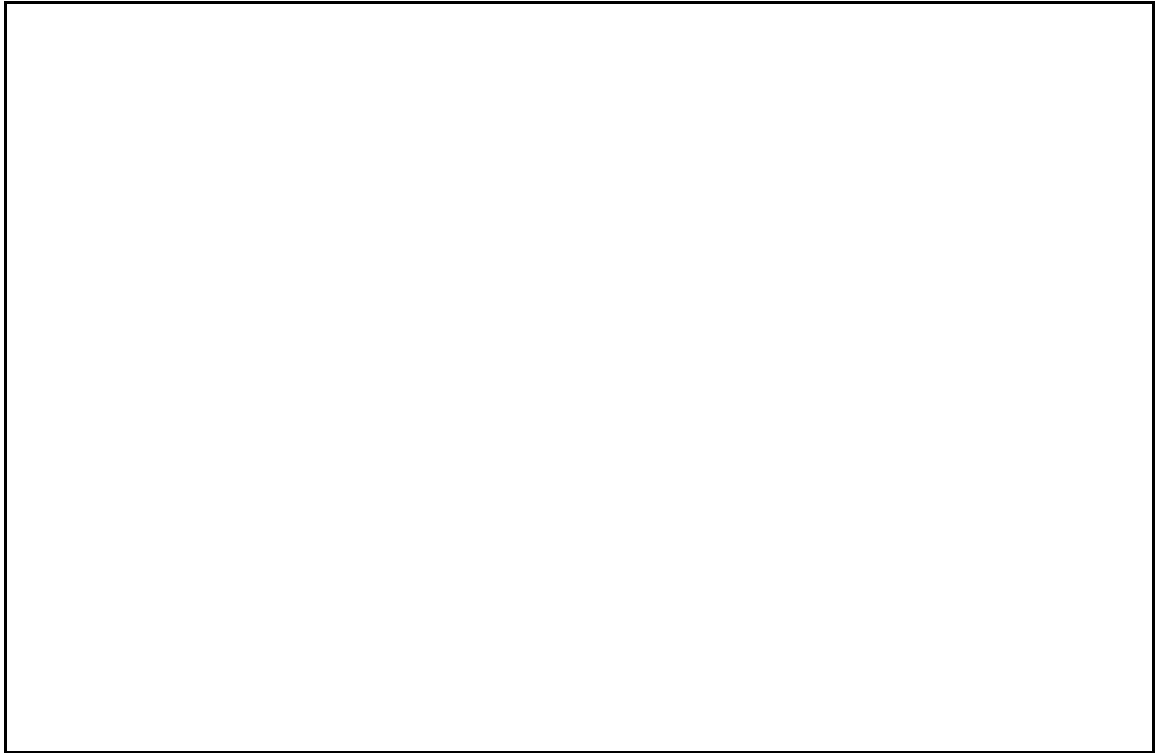
6.231 In March 1999, the Department of Treasury and Finance received 5 formal bids, with tendered purchase prices ranging from \$3.2 million to \$16.25 million. The bids were assessed against the key development objectives previously established by the Minister for Finance and the tendered price, and also took into account other factors such as the financial capacity of the tenderer to undertake the development and the willingness of the tenderer to accept complete responsibility for land remediation and future claims relating to the contaminated sites.

6.232 Based on these criteria, the bid submitted by Stock Constructions Pty Ltd was assessed as providing the best development proposal and offered the highest financial return for the State. Consistent with this assessment, **in April 1999, the Minister approved the sale of the site to Stock Constructions Pty Ltd for \$16.25 million.**

6.233 The successful bid proposed a \$250 million redevelopment of the former Coburg Prison Complex and the adjoining former school site, to include:

- theme tourism area, including a prison history museum;
- residential, commercial, and small office precinct;
- business district for larger employers;
- residential district with low and medium density housing lots; and
- residential apartments, a retirement home and a “3 to 4 star” hotel.

6.234 Under the proposal, 10 of the 19 assessed historical features and buildings on the site are to be retained, including “Division F” of the former Pentridge Prison established in 1850 and sections of the bluestone walls on the perimeter of the former prison site. The remaining features will be either modified or demolished.



Former Pentridge Prison entrance and external wall.

Property valuations

6.235 Prior to the assessment of the final bids, in January 1999 the Department of Treasury and Finance commissioned 2 valuations of the former Coburg Prison Complex and Newlands Secondary College sites based on the following development options for the site:

- *Option 1*, market value of the total site based on an urban design plan developed by the Department's consultants, proposing a combined residential, commercial, light industrial, retail, tourism and community-based development;
- *Option 2*, market value of the total site based on the urban design plan developed by the Department's consultants, excluding the tourism precinct and a mixed use (civic) area; and
- *Option 3*, market value based on a development strategy prepared separately on behalf of the City of Moreland.

6.236 Table 6P outlines the valuations subsequently provided to the Department by the 2 valuers.

TABLE 6P
VALUATIONS OF FORMER COBURG PRISON COMPLEX
AND NEWLANDS SECONDARY COLLEGE SITES
(\$million)

<i>Development option</i>	<i>Independent valuer (a)</i>	<i>Valuation and Survey Services (b)</i>
Option 1	13.0	(c) 20.0
Option 2	11.0	(a) 18.6
Option 3	9.9	(d) n/a

(a) Valuations do not take account of the impact of site contamination.

(b) Formerly known as the Office of the Valuer-General.

(c) After taking account of the estimated impact of land contamination and the associated remediation costs. However, in March 1999 this valuation was revised downwards to \$15.25 million.

(d) No estimate was provided by the valuer as it was considered that the proposed plan lacked certain essential information that was required to make an assessment.

Key terms of the sale

6.237 As mentioned previously, in April 1999, the Minister for Finance approved the sale of the former prison complex and the adjoining former school site for \$16.25 million. Under the terms of the sale, a deposit of \$1.625 million was paid into the Consolidated Fund at that time, with the balance of \$14.625 million paid in late July 1999. The sale was conditional upon the approval of appropriate planning scheme amendments to facilitate the proposed development of the property. This approval was provided in June 1999.

6.238 Other key terms of the sale included:

- The State did not give any warranty as to the completeness or accuracy of various consultancy reports provided to the purchaser for information purposes during the sale process, including the geo-technical and soil contamination assessments, infrastructure reports, and redevelopment plans;
- The purchaser was required to assume all risk of loss, damage or liability resulting from the existence or previous existence of any underground storage tank or the presence of any contaminant on the land. In addition, the purchaser cannot claim compensation resulting from the existence of any contaminant on the land; and
- As certain buildings within the complex are registered under the *Historic Buildings Act and Heritage Act 1995*, separate approval will be required to be obtained from the Heritage Council of Victoria for any alteration or demolition thereof.

6.239 In mid-June 1999, the purchaser advised the Department that due to certain adverse site conditions identified on the property, the proposed development plans submitted in the tender would need to be altered, resulting in a delay in the settlement date for the sale to mid July 1999. **The Department accepted the delayed settlement proposal, including the waiver of penalty interest payable by the purchaser under the contract of sale, estimated at \$120 000.**

6.240 Following the settlement of the sale in late July 1999, the Department was advised by the purchaser's legal counsel that the settlement of the property had been made under protest and that the purchaser reserved the right to claim compensation and damages in respect of the ground conditions at the property, which differed substantially from those presented within the tender documents.

Assessment of sale result

6.241 An analysis of the sale result of the former Coburg Prison Complex and the adjoining former Newland Secondary College site indicates that:

- the purchase price of \$16.25 million was \$1 million higher than the comparable valuation of the property provided by the Valuation and Survey Services Unit of the Department of Natural Resources and Environment in March 1999;
- the purchase price was \$12.05 million below the book value of the complex of \$28.3 million as at 30 June 1998, as recorded by the Department of Justice; and
- the net proceeds for the State, after deducting \$466 000 in costs associated with the sale of the site, was \$15.8 million.

Health care network rationalisation

6.242 A *Plan for Metropolitan Health Care Services* was developed by the Government in 1996. It provides the framework for the future delivery of health services to the community within the Melbourne metropolitan area, and is to be implemented over a 7 year period at an estimated overall cost of \$900 million. A key reform in the delivery of health services in Victoria under this plan has been the move from institutional-based health services to a community-based setting, including the establishment of integrated health networks within the State.

6.243 A major component of the reform program also involves the redistribution of health services from the inner city to the outer metropolitan suburbs to enable their greater accessibility to the community. This will involve major new capital developments, including the establishment of 3 new hospitals and 6 new integrated care centres, the redevelopment of 8 existing hospitals and the de-commissioning of a number of pre-existing hospital sites.

6.244 Consistent with the objectives of reform program, the State has de-commissioned a number of hospital sites which were considered to be surplus to its service delivery requirements. Provided below are comments on the sale of a number of these de-commissioned hospital sites, including the former Heatherton Hospital and part of the Kingston Centre site, the former Larundel Psychiatric Hospital in Bundoora and the former Preston and Northcote Community Hospital.

Sale of the former Heatherton Hospital and part of the Kingston Centre site

6.245 The former Heatherton Hospital was situated in the south-eastern Melbourne suburb of Heatherton, some 20 kilometres from the central business district of Melbourne. The Hospital was fully de-commissioned in 1997 and the associated site, which included 30 buildings, some of which dated back to the early 1900s, have remained unoccupied since that time.

6.246 In February 1997, the Department of Human Services advised the Department of Treasury and Finance that the Hospital site and some surrounding land associated with the Kingston Centre, which provides aged care services in the area, was surplus to its requirements and could be disposed of under the Government's Asset Sales Program.

6.247 As the Kingston Centre was located on Crown land that was permanently reserved for use as a "benevolent asylum", the Department of Treasury and Finance sought advice from the Victorian Government Solicitor regarding the status of this site. In doing so, the Department identified that, given the contemporary trend towards the de-institutionalisation of mentally ill patients, there was no reason to continue the existing reservation on the under-utilised land and that the land should either be made available for other purposes or be sold.

6.248 The Victorian Government Solicitor subsequently advised that before any part of the site could be used for another purpose, it would be necessary to revoke or otherwise remove the land reservation, with the passing of relevant legislation providing the most appropriate method of achieving the desired outcome. Consequently, to allow the sale of the land to proceed, legislation was passed in the 1997 Spring session of Parliament to revoke the permanent reserve status on the entire Kingston Centre site. In addition, a temporary reservation of the Hospital site for "hospital purposes" was also revoked in June 1997.

Initial disposal of part of Heatherton Hospital site

6.249 In February 1997, the Kingston Heath Golf Club re-affirmed a long standing interest in purchasing part of the former Hospital site which adjoined the Club's western boundary. The Club proposed to use this site to provide additional parking spaces and marquees together with an extension to the Clubhouse, which would assist in ensuring the preservation of the Club as an Australian Open-rated golf course for future golf tournaments. The Club had also previously purchased a 2 hectare parcel of the former Hospital land in 1992.

6.250 At this time, the Department of Treasury and Finance expressed concern over the Club's ability to protect an area of native tree growth during the redevelopment of the site. However, it was determined that it was unlikely that another form of development would be found which would allow for its preservation and, after consideration of this matter, in March 1997 the Minister for Finance approved the commencement of negotiations with the Golf Club for the sale of approximately 1.4 hectares of the former Hospital site. The land area was subsequently revised down to 1.05 hectares, following a land survey conducted by the Surveyor-General in April 1997.

6.251 A valuation of the revised land site conducted by the Valuer-General in May 1997 estimated the market value of the site at \$500 000. The Minister for Finance subsequently approved the sale of the site located at 66-72 Kingston Road, Heatherton to the Kingston Health Golf Club for \$500 000.

6.252 In June 1997, a sale agreement between the purchaser and the then Acting Minister for Finance was executed, with the full amount paid by the purchaser into the Consolidated Fund at this time.

Disposal of balance of the Heatherton Hospital site and part of the Kingston Centre site

6.253 In November 1998 real estate agents were engaged by the Department of Treasury and Finance to market and sell the balance of the Heatherton Hospital site and the part of the Kingston Centre site which was surplus to requirements, a total area of around 32 hectares, through a public sale process with advertisements for the sale placed in December 1998. An Information Memorandum was subsequently distributed to interested parties in January 1999, with tenders closing in March 1999.

6.254 In February 1999, an independent valuer estimated the value of these properties at \$9.5 million and concluded that the highest and best use for the land would be a mixed site development comprising a residential sub-division and a retirement village development. A further valuation undertaken in March 1999 by valuers engaged by the Valuation and Survey Services Unit of the Department of Natural Resources and Environment estimated the value of the property at \$14 million and concluded that the highest and best use for the land would be residential development.

6.255 In mid-March 1999, the Department of Treasury and Finance received 9 tenders for the purchase of the site, with conforming tender proposals ranging between \$14 million and \$20.2 million. Later that month, **the Department approved the sale of the Heatherton Hospital site and the surplus land at the Kingston Centre site to Mirvac Victoria Pty Ltd for a price of \$20.2 million.**

6.256 In accordance with the terms of the contract of sale, a deposit of \$202 000 was paid into the Consolidated Fund in March 1999 and the balance of \$19.9 million was paid into the Consolidated Fund in June 1999.

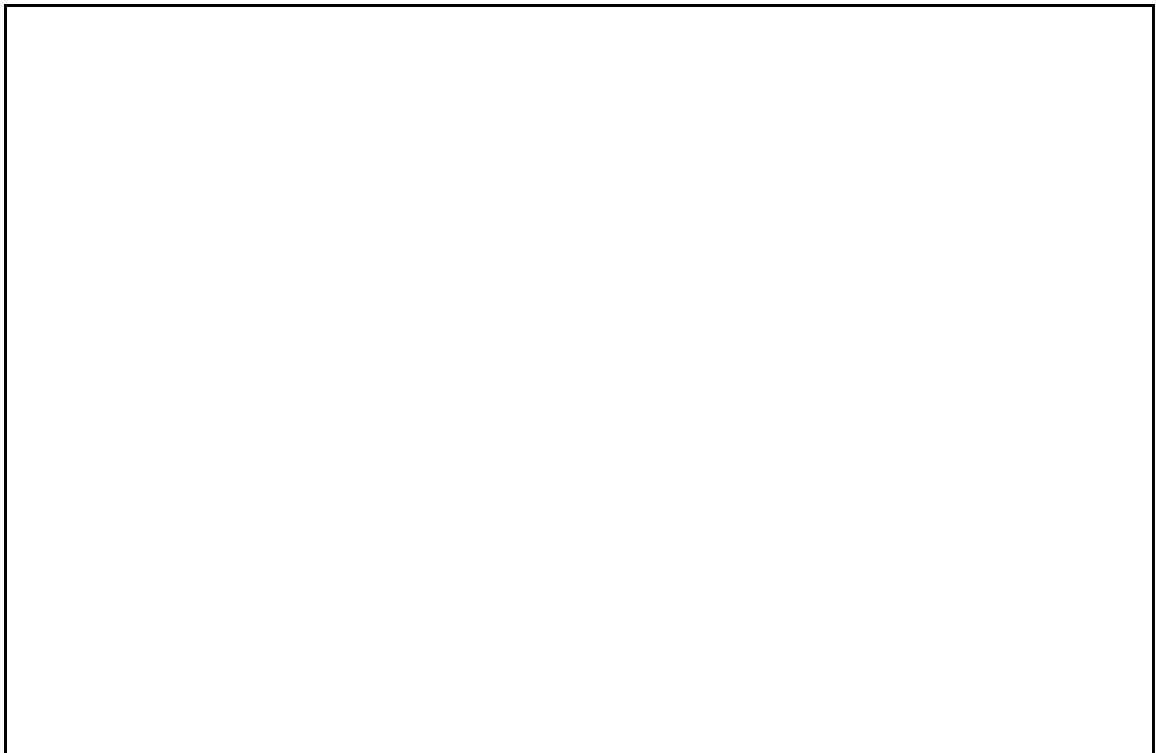
Assessment of sale result

6.257 An analysis of the result achieved from the sale of the former Heatherton Hospital site and surplus land at the Kingston Centre indicated that:

- in relation to disposal of the major part of the former Hospital site and the surplus Kingston Centre land, the sale proceeds of \$20.2 million were \$6.2 million greater than the valuation obtained for the site;
- the proceeds of \$500 000 relating to the initial sale of part of the former Hospital site were consistent with the valuation obtained for this site;
- the proceeds were \$10.5 million higher than the recorded book value of the properties at the time of sale; and
- the net proceeds of the sale were \$20.05 million, after taking into account associated costs of sale of around \$150 000.

Sale of the former Larundel Psychiatric Hospital

6.258 In May 1997, the Department of Human Services declared the Larundel Psychiatric Hospital as surplus to operational requirements, with the Hospital planned to be de-commissioned over a period of 18 months commencing from that date. The Hospital site was located on Plenty Road, Bundoora, approximately 15 kilometres from the central business district of Melbourne and covers an area of approximately 25.1 hectares, comprising several hospital buildings and surrounding vacant land.



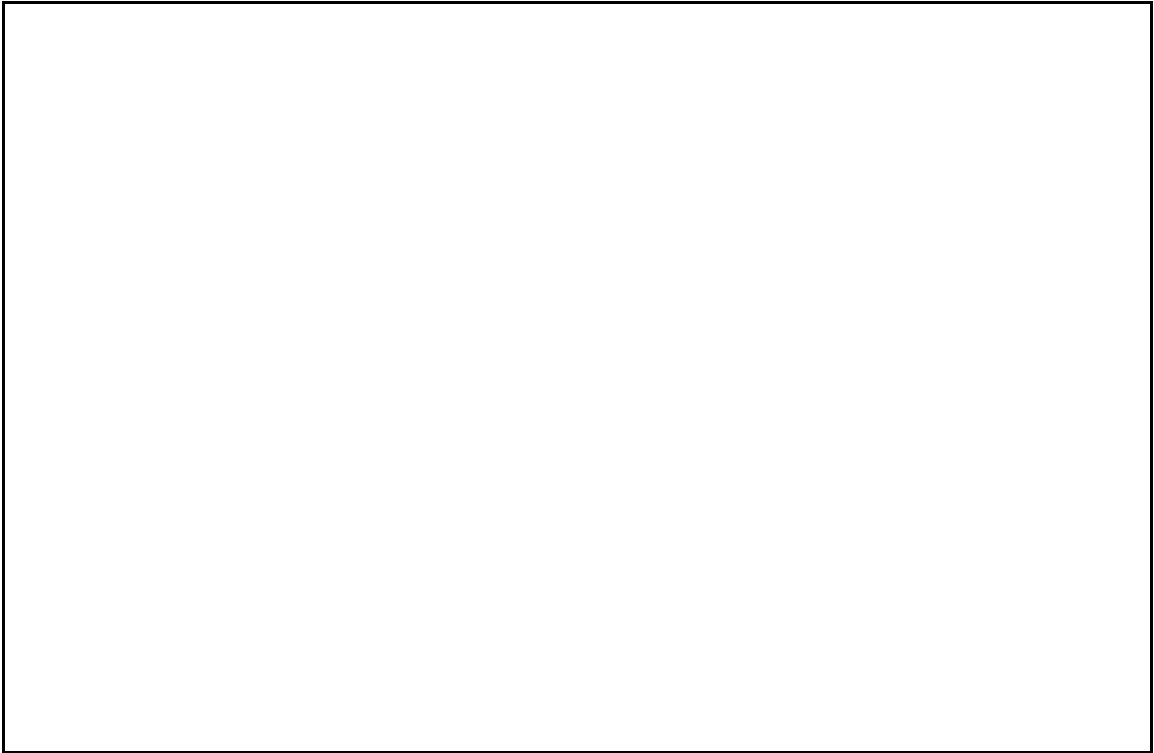
Part of the former Larundel Psychiatric Hospital site, Bundoora.

6.259 In October 1998, the Minister for Finance agreed that the Hospital site could be sold. Subsequently, in November 1998 the Department of Human Services advised the Department of Treasury and Finance that the Hospital would be vacated by late June 1999. However, later in 1998 the Psychiatric Intensive Care Unit of the Hospital expressed a concern in achieving this timeframe.

6.260 During this time, a real estate agent was appointed by the Department of Treasury and Finance to facilitate the sale of the property and a valuation of the property was sought from Valuation and Survey Services. As the development plans obtained from the Department contained insufficient detail, Valuation and Survey Services appointed a land development consultant to assist it in providing an informed valuation by identifying options for alternative uses of the land. Valuation and Survey Services also engaged an independent valuer on behalf of the Department to provide a second valuation of the site.

6.261 The land development consultant proposed a plan comprising a sub-division of the site into 209 allotments, with a substantial portion of the site to be retained for public open space. The consultant further proposed the maintenance of the existing road structure, the continued use of various buildings constructed in the 1930s and the protection of certain well-established trees, which would comply with local government planning requirements. The cost of the development was estimated to be \$6.3 million, with the cost for the demolition of building structures which were not to be retained estimated at around \$460 000.

6.262 Based on the advice of the land development consultant, in December 1998 the valuers estimated the market value of the property at between \$11.3 million to \$14.5 million, on the assumption that there was no contamination on the site. Subsequently, the Department commissioned a preliminary contamination study on the site to determine the extent of any contamination and the impact that this may have on the site's valuation. The study's findings disclosed limited environmental concerns on the site, with the exception of contamination in the vicinity of several underground fuel tanks, which could be removed at a estimated cost of \$25 000.



Current demolition works at the former Heatherton Hospital site.

Sale process

6.263 In March 1999, following the offer of the site for sale by public tender, the Department received 5 bids ranging in price up to \$16.25 million, with the 2 highest bids assessed as non-conforming due to a number of attached conditions to the tenders. The highest bid imposed certain conditions such as that the site be used for residential aged care purposes, that there was no change in the planning status affecting the property and that the final payment of the purchase price be deferred from June 1999 to August 1999. The second highest tender of \$16.2 million, being the Urban Land Corporation, sought to cap contamination clean-up costs at \$430 000, with the Government required to pay for any excess required to comply with environmental audit standards. The Urban Land Corporation also requested the deletion of a clause from the draft contract, which sought to indemnify the Government from contamination and/or pollution claims in the future.

6.264 Following discussions with these 2 tenderers to facilitate their re-consideration of the conditions imposed on the bids, and to ensure that the Government obtained the best value from the sale of the property, the Department received 2 revised bids with the same prices as previously offered. Under these revised bids, the tenderer with the highest offer only withdrew the condition that there be no change in the planning status, with the revised tender submitted by the Urban Land Corporation removing the condition in the proposed contract of sale that the Corporation indemnify the Government against any contamination and/or pollution claims that may arise in future as a result of the property's former use.

6.265 In order to make an informed decision on the selection of the successful bid, the Department obtained advice from Valuation and Survey Services on the financial benefits that would be forgone by the Department from the proposed delay in settlement offered by the highest bidder. Valuation and Survey Services advised that the forgone financial benefits, after taking into account the risks of a delayed settlement, would be approximately \$225 000. Based on this advice, the Department accepted the offer of \$16.2 million from the second highest bidder, namely the Urban Land Corporation.

6.266 In late March 1999, the Minister for Finance approved the sale of the Hospital site for a price of \$16.2 million to the Urban Land Corporation, a Victorian Government body whose core activity is to develop residential land.

6.267 In June 1999, the proposed date of settlement of the sale as per the contract of sale was not achieved due to delays experienced by the Department of Human Services in vacating the Hospital. In order to avoid the cancellation of the contract, in July 1999 the parties entered into a Deed of Variation which extended the settlement date for the sale until vacant possession occurred, which was not to be later than February 2000.

6.268 As at the date of preparation of this Report, a small part of the Hospital site remained in use, however the Department of Human Services expected all occupants to be relocated by January 2000.

Key terms of sale

6.269 Consistent with the terms of the sale agreement, a 10 per cent deposit was paid into the Consolidated Fund as follows:

- a deposit of \$162 000 at the time of submitting of the tender; and
- a further deposit of \$1.5 million upon acceptance of the Urban Land Corporation's bid.

6.270 The balance of the purchase price of \$14.6 million was to be paid by the purchaser in June 1999. However, the previously mentioned Deed of Variation has extended the settlement date until the Department of Human Services provides vacant possession of the property to the purchaser.

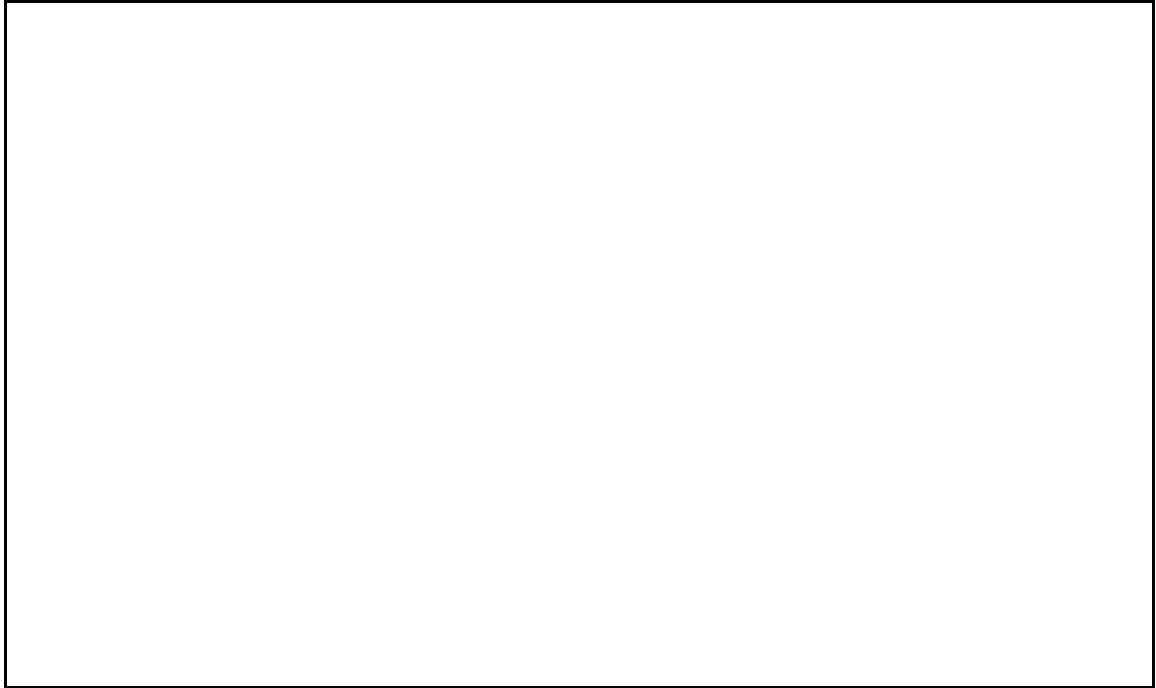
Assessment of the sale result

6.271 An analysis of the result achieved from the sale of the former Larundel Psychiatric Hospital indicated that:

- the purchase price of \$16.2 million was \$1.7 million greater than the valuation provided by Valuation and Survey Services and \$4.9 million greater than the valuation provided by an independent valuer in December 1998;
- the proceeds of sale were \$400 000 higher than the recorded book value of the site at the date of sale; and
- the net proceeds to the State, after taking into account the cost of sale of approximately \$150 000 associated with consultancies, legal representation and marketing, will be around \$16.1 million when settlement occurs.

Sale of the former Preston and Northcote Community Hospital site

6.272 The Preston and Northcote Community Hospital was first established in 1961 and was located on a 2.5 hectare site bounded by Bell Street, Hotham Street, Young Street and Harold Street in Preston. The site included various buildings erected over many years, including the main hospital building, a nurses' home, an educational unit, the more recently constructed south hospital block (a surgery centre), student accommodation and associated utility buildings.



Former Preston and Northcote Community Hospital.

6.273 In March 1998, the Hospital was de-commissioned with all inpatients transferred to the newly constructed Northern Hospital in Epping, some 18 kilometres from the central business district of Melbourne, with the other services transferred to the nearby Austin and Repatriation Medical Centre. At this time, the site was declared surplus to the requirements of the Department of Human Services and responsibility for the sale of the site was assigned the Department of Treasury and Finance.

6.274 The de-commissioning and subsequent sale of this Hospital site has aroused continued interest from the local community. In accordance with the Government's *Plan for Metropolitan Health Care*, it was initially proposed that the inpatient services provided by the former Hospital would be transferred to the new Northern Hospital and that a new stand-alone integrated care centre, providing community-based health care needs such as day surgery, out-patients clinics, diagnostics and aged care programs would be established on the site. However, the North Western Care Network which incorporated the former Hospital subsequently conducted a review of all proposed capital developments within the Network and concluded that, due to the proximity of alternative health care services, the proposed integrated care centre was not justified. On this basis, the project did not proceed and the site was made available for sale.

Sale process

6.275 In September 1998, the Department of Treasury and Finance appointed a selling agent to undertake the marketing and sale of the Hospital site. Subsequently, in October 1998, the Minister for Finance in conjunction with the Minister for Health announced that expressions of interest for the redevelopment of the former Hospital site would be sought from interested parties, with a closing date of early December 1998, followed by a selected tender process which would close in late January 1999. It was further indicated that the Government would also be seeking tenders from suitably qualified operators to purchase and operate the South Block of the Hospital as a satellite surgical centre. The South Block surgery facility on the site incorporates 4 operating theatres, administration offices, conference rooms, patient recovery area and undercover parking.

6.276 At that time, preliminary negotiations with the nearby Northern Melbourne Institute of TAFE were in progress to facilitate the purchase by the Institute of the former nurses' home on the site for use as student accommodation. In addition, the City of Darebin approached the Department to explore the potential transfer of one of the buildings on the site to the Council, at no cost, for use as a community facility. However, as this building was strategically located on the site, this proposal was rejected by the Department.

6.277 In October 1998, the Department engaged 2 valuers to assess the value of the site, taking into account the various available options for its use. One of the valuers, a contractor engaged by Valuation and Survey Services (a unit within the Department of Natural Resources and Environment) subsequently concluded that the highest return that could be achieved from the site would be around \$3.25 million. This valuation assumed that the various allotments comprising the site were sold separately, with the existing nurses' home to be redeveloped as student accommodation and that the South Block be upgraded and maintained as a surgical/medical centre, consistent with the Minister's earlier announcement. The second independent valuer assessed the site to have an estimated market value of \$3.94 million, based on the same assumptions.

6.278 However, both valuers identified the presence of asbestos on the site and areas of potential soil contamination. Consequently, the valuers qualified the valuations provided on the basis that they were not able to determine the effect of such conditions on the value of the property.

6.279 In December 1998, the Department received 8 expressions of interest for the purchase of the entire former Hospital site, with prices ranging from \$2.2 million to \$4.1 million. The selling agents identified that while there was substantial interest for the site from commercial and residential developers, there was no interest for the separate purchase of the South Block surgical centre.

6.280 Based on an assessment of the preliminary bids received against a number of criteria, including the offer price for the property, a tender evaluation panel short-listed 5 of the above parties and requested that they submit formal tenders for the purchase of the entire site by February 1999.

6.281 In January 1999, the Department requested its valuers to re-assess the previously provided valuations for the site based on the scenario that the property would be offered to the market as a single site. Subsequently, both valuers discounted the previously assessed market values for the property to around \$2.6 million, but these valuations continued to be based on the assumption that the nurses' accommodation would be converted to student accommodation and that the South Block would be used as a medical centre.

6.282 During this period, the Department received 3 formal tenders for the site, ranging in price from \$3.5 million to \$5.28 million. Following consideration of the tenders by the evaluation panel, in March 1999, **the Minister for Finance approved the sale of the site to the highest bidder, namely Asian Pacific Building Corporation Pty Ltd, for a total price of \$5.28 million.** The sale price comprised an amount of \$4.97 million for the entire former hospital site and \$305 000 for the 2 adjoining residential properties under the control of the North Western Health Care Network which were also offered for sale. **The book value of the Hospital site and the 2 adjoining residential properties prior to their sale was \$24.5 million and \$220 000, respectively.**

6.283 The purchaser has proposed to redevelop the site over a 3 year period, at a cost of approximately \$200 million, for the purposes of providing a community medical centre, student accommodation, commercial offices, and a hotel and restaurant complex. The first stage of the development is expected to commence in January 2000, with completion of the second stage expected by late 2002.

Key terms of sale

6.284 In March 1999, the purchaser and the Minister for Finance entered into a contract of sale for the former Hospital site. The key terms of the sale agreement included:

- The purchaser to accept the land in its present condition and acknowledge that the site was known to be contaminated. Furthermore, the State and its agents were released from any claims or liabilities arising from the existence of contamination or pollution on the land or emanating from the land;
- The State made no warranty or representation that any improvements on the property comply with the *Building Act 1993*, *Building Code of Australia 1990*, municipal laws or relevant statutes and regulations. Any failure to comply will not constitute a defect in the State's title and the purchaser is not entitled to make a claim for compensation;
- The purchaser to acknowledge and agree that the zoning of the property will be determined by the State and the purchaser in consultation with the City of Darebin. This condition was satisfied in March 1999 with the rezoning of the property from public purpose hospital to mixed-use; and
- The execution of the contract was conditional upon the concurrent completion of a contract of sale between the purchaser and the North Western Health Care Network for the 2 adjoining residential properties, which also occurred in March 1999.

6.285 The purchaser and the State also entered into a Guarantee and Indemnity Agreement whereby the purchaser agreed to indemnify the State against any loss or damage suffered in relation to the sale resulting from liquidation of the company or any other arrangements entered into with the purchaser's creditors.

6.286 Consistent with the terms of the sale arrangements, a deposit of \$497 000 was paid into the Consolidated Fund in March 1999 upon acceptance of the tenderer's offer for the sale of the former Hospital site, with the balance of \$4.47 million paid into the Consolidated Fund at settlement date in June 1999. The net sale proceeds of \$301 000 for the 2 adjoining residential properties were paid to the North Western Health Care Network at the date of settlement. In addition, around \$14 000 was paid into the Consolidated Fund on account of an interest penalty resulting from a delay in the settlement of the sale by the purchaser.

Assessment of the sale result

6.287 An analysis of the sale result of the former Preston and Northcote Community Hospital site and the 2 adjoining properties indicates the following:

- the sale price of \$4.97 million for the former Hospital site was around \$2.4 million greater than the comparable independent valuations for the site provided in January 1999;
- the gross sale price of \$305 000 for the 2 adjoining properties was consistent with a valuation obtained in December; and
- the net proceeds to the State from the sale of the former Hospital site and the 2 residential properties, after taking into account the costs of sale of approximately \$193 000, were around \$5.1 million.

Property at Salmon Street, Port Melbourne

6.288 A property located at Salmon Street in Port Melbourne was declared surplus to the Government's requirements in the late 1980s. The property covered a total area of around 10.7 hectares and was developed in the 1960s as a warehouse and storage site for various government departments, incorporating a manufacturing and fabrication facility associated with the provision of prison services. The western section of the site had been used as a sand quarry, however upon its later closure, the land was re-filled with domestic and industrial waste.

6.289 In late 1991, the Valuer-General advised the former Department of Finance that the estimated value of the property was \$3.7 million. The valuer also advised that, as the site had been extensively re-filled with domestic and industrial waste, it was probable that the site could be contaminated to a level which was likely to affect the future use of the property.

Sale process

6.290 Following a number of developments near the property, in July 1993, the Department commissioned a feasibility study to determine whether the property should be sold or retained for government use. However, in 1994 the newly established Docklands Authority requested that the Department offer the property for sale, in the first instance, to a number of tenants which were required to re-locate from the Docklands project area. In this regard, the Minister for Roads and Ports sought the assistance of the Minister for Finance in allowing private treaty negotiations to be explored with these tenants in relation to the property prior to its placement on the market, in order to minimise any possible compensation claims which may arise from the relocation of these tenants. Subsequently, in June 1996, the Minister for Finance approved the commencement of negotiations between the tenants and the Department of Treasury and Finance.

6.291 In mid-July 1996, the Department appointed a property consultant to manage the disposal of the property and, in September 1996, the consultant offered designated areas of the site to 4 parties affected by the Docklands development. Despite extensive negotiations with these parties over a protracted period, an agreement could not be reached on the commercial terms and conditions of the sale.

6.292 In the meantime, in May 1997, the Department of Education submitted an offer of \$1.7 million for the acquisition of the rear portion of the property, comprising an area of approximately 1.95 hectares, which had been previously utilised by the Department to store portable classrooms, at no cost. Given that the offer price was consistent with the Valuer-General's estimate of the site's value provided in May 1997, the offer was accepted by the Department of Treasury and Finance in June 1997.

6.293 Subsequently, in April 1997, a decision was taken by the Department to offer the remainder of the site to the market, either as 2 parcels of land or as a whole, with a selling agent appointed by the Department to assist in the sale of the property.

6.294 To facilitate the sale of the property, the Department sought valuations from the Valuer-General in May 1997, which resulted in the provision of the following valuations:

- \$7 million for the larger parcel of the property;
- \$2.5 million for the smaller parcel of the property, including a number of existing buildings; and
- \$8 million for both parcels if sold as a single lot.

6.295 The site was subsequently advertised for sale by public tender, which resulted in the receipt of one tender for the larger parcel, with 2 further expressions of interest received for the purchase of the entire property. Although the tendered price of \$8 million received for the larger site was above the previously provided valuation for the parcel, the tender was assessed as non-conforming as it proposed amendments to the contamination clause within the proposed contract of sale which would require the State to provide a partial indemnity with respect to contamination. Furthermore, as the prospective tenderer was not willing to accept the original clauses of the proposed contract, the Department terminated negotiations with this party.

6.296 Consequently, in June 1997 the Department directed its property consultant to commence discussions with the 2 parties that had expressed an interest in the entire property. Following a protracted process of offers and counter offers made by the interested parties, the party which had previously submitted the non-conforming bid, submitted a revised offer of \$7.5 million for the entire site in late June 1997. The Department declined this offer as it was below the property valuation.

6.297 Due to the lack of interest in the site, in early August 1997 the Department instructed its selling agents to also offer the site for leasing, as an interim arrangement, to enable the Government to contemplate the sale of the land at a later date, when market conditions were more favourable. However, minimal interest was again expressed at that time for either the sale or the leasing of the site.

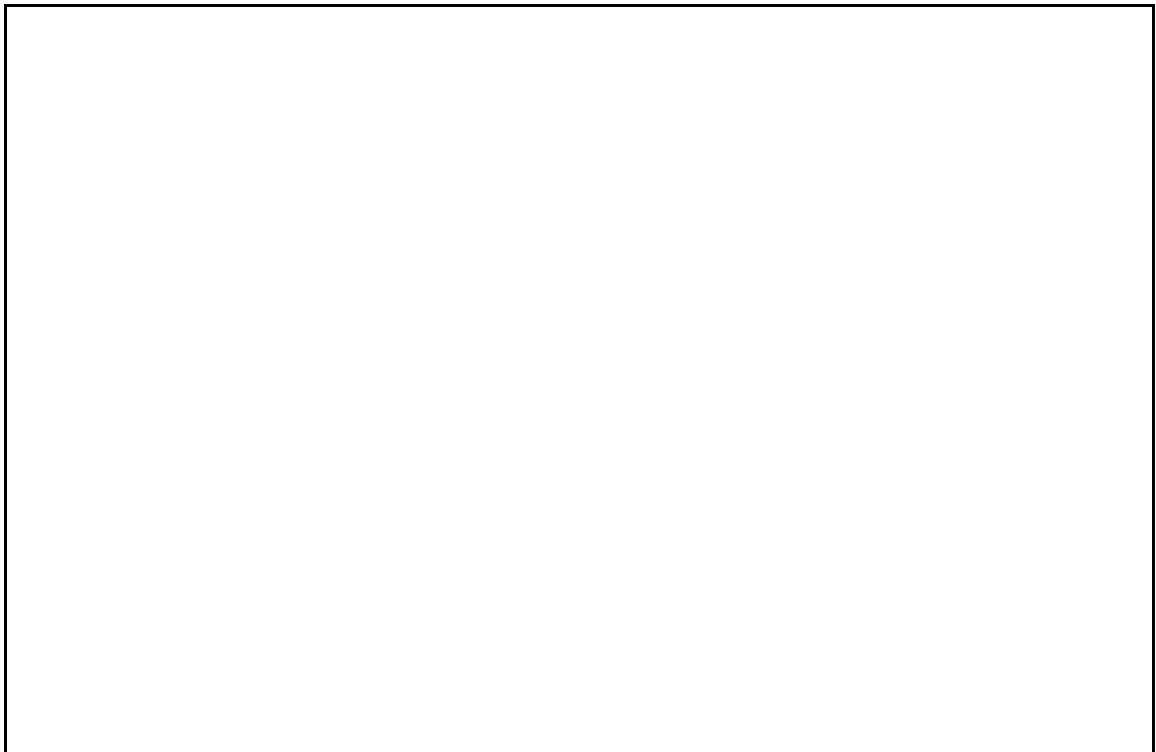
6.298 In August 1997, the same tenderer submitted a revised offer of \$7.65 million for the entire site. The valuers engaged by the Department advised that this offer represented the market value of the land at that time, as the initial expectations of increased land values due to developments around the Docklands area were not being achieved. However, following consideration of the above and various options in dealing with the property at that time, the Minister for Finance advised the Department not to proceed with the sale until further notice.

6.299 In May 1998, the selling agents informed the Department that a firm offer had been made by an interested party, namely Sheralex Nominees Pty Ltd, to purchase the entire site for \$8 million, including a \$10 000 non-refundable deposit upon acceptance of the offer and a further deposit of \$790 000 conditional upon a satisfactory outcome from a due diligence audit. Subsequently, in June 1998, the Minister for Finance provided an in-principle approval to offer the property for sale by private treaty.

6.300 The due diligence audit undertaken by consultants for the prospective purchaser in August 1998 revealed that the groundwater below the western section of the site, which had previously been used as a landfill, was contaminated. Consequently, the prospective purchaser subsequently revised the offer for the property to \$7.7 million, conditional upon completion of further environmental investigations to be funded by the Department, with the State retaining some of the risk associated with contamination.

6.301 In October 1998, the Valuer-General re-assessed the value of the property at \$7.7 million, conditional upon further environmental investigations. Subsequently, the Department appointed an environmental auditor to review all environmental data and advise on any further investigations required to assess the risk associated with contamination. As a result of these further investigations, the auditor concluded that the site was suitable for industrial use with minimal remediation, provided that an appropriate management plan was developed. In January 1999, the legal advisers to the Department further identified that a statement from an environmental auditor certifying the suitability of the site for commercial/industrial use could be obtained without incurring significant additional costs. The advisers recommended that the Department continue to negotiate a contract that would release the Government from any contamination risk associated with the site.

6.302 Based on the above advice, the Department declined the revised offer of \$7.7 million and re-commenced negotiations with the prospective purchaser at the original purchase price of \$8 million. **These negotiations proved successful, with the company subsequently accepting the terms and conditions offered by the Department and the Minister for Finance in February 1999 approving the sale of the property to Sheralex Pty Ltd for \$8 million.**



Vacant Salmon Street site.

Key terms of sale

6.303 The Minister for Finance and the purchaser entered into a contract of sale in February 1999, with a deposit of \$800 000 paid into the Consolidated Fund at the time of signing the contract and the balance of \$7.2 million paid at settlement date in late June 1999. The key terms of the sale agreement included:

- as from the date of sale, the risks of ownership passed to the purchaser;
- that the purchaser acknowledge that the land and the groundwater within or emanating from the land were known to be contaminated and that the purchaser would not make any claim for compensation with respect to any such matters;
- the State be indemnified by the purchaser for any costs, losses, damages or liabilities arising from the release of any contamination or pollution into the environment on or from the land after the date of sale;
- the purchaser be required to comply with any notice requiring the remediation of any contaminant or pollution on the land or emanating from the land, whether or not the contamination existed at the date of sale;
- that a right of access be provided to PowerNet Victoria for the purposes of protecting certain services on the property for the transmission of electricity, with a requirement by the purchaser to keep the designated area free of any obstructions; and
- prior to settlement date, the purchaser be able to access the land for the purposes of demolishing and removing improvements.

Assessment of sale result

6.304 The analysis of the sale of the property at Salmon Street, Port Melbourne indicated that the net result achieved from the sale was \$7.8 million, after taking into account the costs associated with the sale of around \$162 000.

Latrobe Valley land exchange

6.305 Since 1995, the Government has deliberated over a proposal by Amcor Plantations Pty Ltd (Amcor), a subsidiary of Amcor Limited, to exchange certain of its surplus land holdings with certain surplus land parcels owned by the State Electricity Commission of Victoria (SECV) in the Latrobe Valley. This exchange would enable Amcor, which supplies pulpwood to the Maryvale Pulp and Paper Mill in the rural city of Morwell, to expand its eucalypt plantations which in turn would facilitate an expansion of its plant, while the State would acquire land which would enable an expansion of its public land holdings.

6.306 In December 1996, the Treasurer provided in-principle support to this proposal on the basis that there would be an equal exchange of value, with Amcor making a payment to the State where the value of SECV land was assessed to be greater than the value of the land to be surrendered by Amcor.

6.307 The government policy associated with the disposal of public land requires that, when dealing with surplus land which is not subject to a lease which confers any purchase rights to the lessee, such land is to be offered for public sale and not sold at a price less than its market value. However, **in relation to this transaction, this policy was not adopted as the proposal was considered to provide a better result for the State in terms of enhanced benefits to the regional economy by supporting industry development, and at the same time the conservation of native forests by extending the State's public land holdings.** In this regard, the Minister for Finance approved the continuation of discussions between the parties on the proposed land exchange, with the transaction to proceed under the authority of section 99A of the *Land Act* 1958 which provides for the sale of land by way of private treaty at a price not less than a valuation provided by Valuation and Survey Services (formerly the Office of the Valuer-General), subject to the approval of the Governor-in-Council.

6.308 To progress the negotiations in relation to the proposal, in mid-December 1996 the Department of Treasury and Finance requested Valuation and Survey Services to provide a valuation for the subject land. In February 1997, Valuation and Survey Services provided the Department with land valuations based on 2 options, namely, all land areas being exchanged, and all land areas being exchanged except for river flats which would be retained by the State. Table 6Q outlines the valuations provided in relation to these options.

TABLE 6Q
LAND VALUATIONS
(\$million)

<i>Details</i>	<i>Amount</i>
<u>Option 1: Full exchange of all lands</u>	
<i>Amcor land</i>	4.3
<i>SECV land -</i>	
Not leased	0.3
Leased to Amcor	0.6
Leased to other parties	4.9
	<u>5.8</u>
Difference in value	1.5
<u>Option 2: Exchange of land, except for river flats retained by State</u>	
<i>Amcor land</i>	4.3
<i>SECV land -</i>	
Not leased	0.3
Leased to Amcor	0.6
Leased to other parties	4.2
	<u>5.1</u>
Difference in value	0.8

6.309 At that time, the Treasurer, Minister for Finance, and the Minister for Conservation and Land Management jointly agreed that the proposed exchange of lands would proceed on the following basis:

- An equitable result was to be achieved for both the State and Amcor;
- Land owned by the SECV which was currently leased to Amcor and high value agricultural land such as river flats would be excluded from the exchange. However, the SECV land which was leased to Amcor was to have the current lease term extended to the year 2016 to facilitate the harvesting of existing plantations on that land; and
- Amcor would be required to surrender to the State certain land which was required to accommodate the long-term requirements of Loy Yang Power Limited, an electricity generator within the Latrobe Valley, with this land to be ultimately sold to Loy Yang Power Limited at its market value.

6.310 Overall, the SECV land that was proposed to be transferred to Amcor amounted to approximately 3 000 hectares and had an estimated value of \$4.5 million, while Amcor land proposed to be surrendered in exchange encompassed around 4 400 hectares and had an estimated value of \$4.3 million.

6.311 In April 1997, a Heads of Agreement was entered into between the State and Amcor Limited, which included the following key terms:

- Amcor to ensure that its subsidiary, Australian Paper Plantation Pty Ltd, entered into a contract with the State for the sale of the subject land to the State;

- Amcor to receive title from the State in respect of the subject SECV land, with a restriction that “... *the land is to be used solely for the production of timber associated with the operations of the pulp and paper business in Gippsland associated with Amcor or its successors*”; and
- A lease to be granted to Amcor in relation to a specific part of the land, with a term extending to the year 2016, to enable the existing plantation to be harvested and a peppercorn rental to be payable by Amcor.

6.312 The finalisation of the contractual arrangements was subject to a number of conditions, including an agreement being reached between the parties on the valuation of the exchanged lands, Amcor being satisfied with the results of its due diligence investigation of the land proposed to be acquired, and a requirement that the use and development of the land acquired by Amcor is not subject to any conditions restricting timber production under the relevant municipal planning scheme.

6.313 In March 1998, the Minister for Finance was advised that extensive negotiations had ensued following the above agreement to effect the land transfer and substantial work had been undertaken to precisely identify the land involved in the exchange and to complete an extensive land survey.

6.314 Following the finalisation of the above work, in December 1998 Amcor and the Department of Treasury and Finance formally executed an agreement to exchange the subject land. Consistent with the established legislative requirements, the transaction was approved by the Governor in Council. **While the estimated value of SECV land transferred to Amcor exceeded the value of land acquired by the State by around \$250 000 (SECV land valued at \$4.57 million while Amcor land was valued at \$4.32 million), the Minister for Finance, the Treasurer and the Minister for Conservation and Land Management jointly agreed to waive the need for any payment by Amcor on the basis of:**

- the substantial conservation value of the land gained by the State;
- the economic benefits to the regional economy that would flow from the land exchange; and
- the removal of the need for the State to compulsorily acquire a part of the land from Amcor to accommodate the requirements of Loy Yang Power Limited, which avoided the payment of associated compensation estimated to exceed \$250 000.

6.315 In addition, while government policy required that the surplus land be offered for public sale, this policy was not adopted in relation to this transaction as the Government considered that the land exchange offered greater benefits for the regional economy and also supported the State’s conservation management objectives.

6.316 As at the date of preparation of this Report, discussions were continuing between the parties to address a number of residual issues associated with this transaction, including certain discrepancies in relation to the areas of land being exchanged, the registration of easements and the introduction of planning scheme amendments to address certain issues relating to fire risk.

PART 7

Liabilities and Commitments



**VICTORIAN
AUDITOR-
GENERAL'S
OFFICE**

*Auditing in the
Public Interest*

AGGREGATE LIABILITIES OF THE STATE

7.1 A key focus of the former Government's financial management strategies in recent years has been the effective management and reduction of the State's liabilities and the associated costs, in order to strengthen the State's financial position and its capacity to deliver programs and services to the public. Thus, one of the longer-term strategic targets of the former Government was the reduction of State debt to a level consistent with the restoration of the State's AAA credit rating.

7.2 Previous Auditor-General Reports to the Parliament have tracked the former Government's progress towards achieving its debt reduction target. In particular, our Reports have provided detailed comment on the significant improvements in liability management, flowing from the substantial privatisation program and various other initiatives that have been implemented in recent years which have led to the substantial reduction in the level of State liabilities and an improvement in the budgetary position of the State.

7.3 In this Part of the Report, I analyse the State's financial obligations and commitments as at 30 June 1999, and provide an assessment of the impact of the year's activities on the State's financial position.

7.4 **The Government's Annual Financial Statement reports liabilities of the State totalling \$41.3 billion at 30 June 1999**, mainly comprising borrowings, payables, unfunded superannuation and other employee-related entitlements. This position represents **a reduction of \$7.8 billion in the level of liabilities when compared with the previous year. This is mainly due to a reduction in State debt and unfunded superannuation liabilities which has been partially off-set by an increase in the level of outstanding claims liabilities, mainly relating to the State's workers' compensation scheme.**

7.5 Table 7A illustrates the composition of the State's liabilities at 30 June 1999.

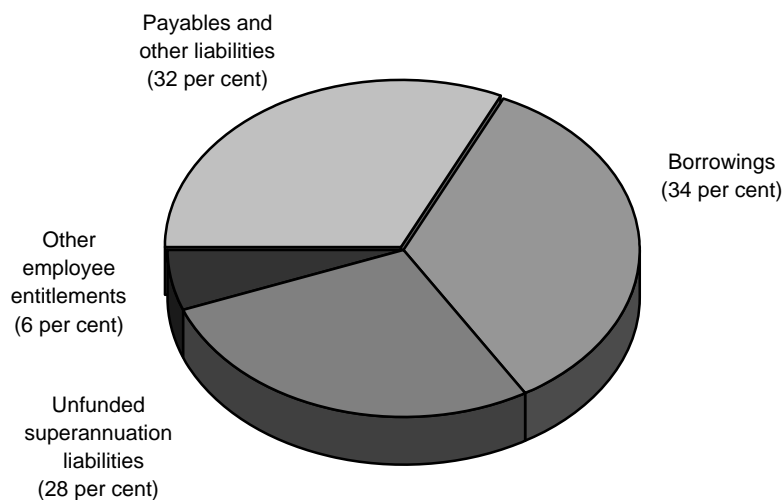
TABLE 7A
COMPOSITION OF STATE LIABILITIES
(\$billion)

<i>Type of liability</i>	<i>General government</i>	<i>Public trading enterprises</i>	<i>Public financial institutions</i>	Total June 1999	<i>Total June 1998</i>
Borrowings	6.8	3.2	15.3	14.3	19.0
Unfunded superannuation liabilities	11.4	0.1	-	11.5	14.9
Other employee entitlements	2.1	0.3	-	2.4	2.5
Payables and other liabilities	1.9	2.9	9.4	13.1	12.7
Total State liabilities	22.2	6.5	24.7	(a) 41.3	(a) 49.1

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

7.6 As shown in the above table, **as at 30 June 1999, borrowings and unfunded superannuation liabilities were the largest components of the State's liabilities, accounting for 62 per cent of total liabilities.** Chart 7B further illustrates this position.

CHART 7B
COMPOSITION OF STATE LIABILITIES,
AT 30 JUNE 1999
 (per cent)



7.7 In addition to the liabilities disclosed above, **the State also has quantifiable contingent liabilities of around \$951 million** (1997-98, \$1.4 billion). These liabilities, which are contingent in nature, represent potential commitments the occurrence of which is dependent on future events or outcomes. The reduction in the level of quantifiable contingent liabilities in the year was mainly due to the termination or restructuring of various previously established financial arrangements during the current financial year. These included a number of performance bonds issued by the former State Insurance Office in relation to certain construction contracts, and certain financial arrangements entered into by the State associated with the Monash Medical Centre, transport leases, an annuity loan transaction and the Melbourne 2000 Commonwealth Games bid, each of which are commented on in detail in this Report.

7.8 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 1999 was \$2.7 billion** (30 June 1998, \$2.9 billion). These do not include all the State's commitments under outsourcing contracts entered into for the provision of services to the public sector, such as health services.

BORROWINGS

7.9 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 various public sector bodies. As indicated previously, the reduction of this component of State liabilities has been a key element of the Government's overall financial strategies in recent years.

7.10 The State's accumulated borrowings at 30 June 1999 stood at \$14.3 billion, compared with \$19 billion in the previous year. Table 7C illustrates the major sectors contributing to this position.

TABLE 7C
STATE DEBT, 1998-99
((\$billion))

<i>Sector</i>	1998-99	1997-98
General government	6.8	11.2
Public trading enterprises	3.2	4.9
Public financial institutions	15.3	21.0
Inter-sector eliminations	(11.0)	(18.1)
Total State debt	14.3	19.0

7.11 The reduction of \$4.7 billion in the level of State borrowings in the year mainly reflects the impact of the former Government's privatisation program under which several public trading enterprises, mainly within the gas sector, were sold and the associated proceeds were partly applied towards debt retirement.

Borrowing composition and maturity profile

7.12 The mix and maturity structure of the borrowings portfolio significantly influence the State's financing requirements in any one year and the State's exposure to adverse movements in interest rates, which ultimately impact on the level of financing costs incurred. Accordingly, the effective management of the portfolio mix and maturity structure is critical to the achievement of the debt management objectives established at an individual public sector agency level and at a Statewide strategic level by the Government.

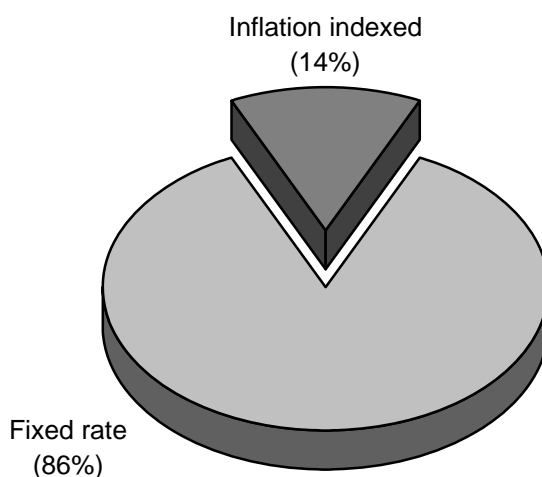
7.13 While individual public authorities establish specific debt management objectives within predetermined risk parameters relating to the borrowing portfolios they manage, the overall Government objectives in recent years, relating to the management of the core budget sector portfolio which represents a substantial part of total State debt, have been as follows:

- achievement of relative certainty of interest cost over the budgeting period, while minimising the net borrowing costs;
- minimisation of refinancing risk; and
- identification and management of the financial and operational risks of budget sector treasury operations in a conservative manner.

7.14 To minimise interest costs and exposures to specific financial markets, the State borrows domestically and overseas, and in various forms, commonly referred to as fixed rate, floating rate and inflation indexed borrowings. These borrowings are complemented, as deemed appropriate, by the use of various debt management instruments known as derivatives. 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.

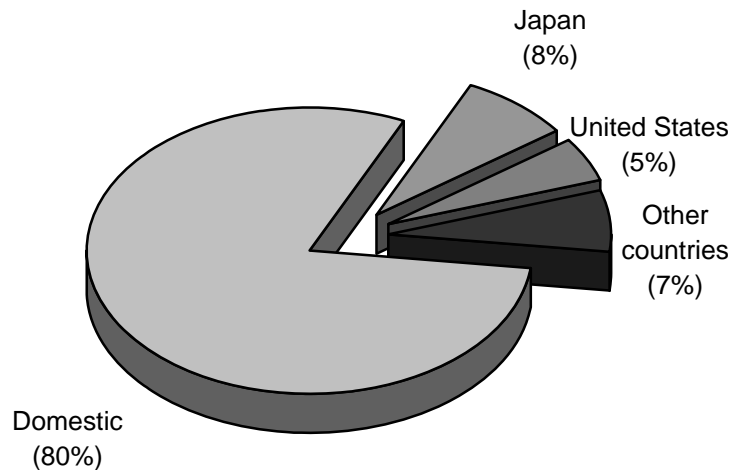
7.15 Charts 7D and 7E show the composition of State debt at 30 June 1999 in terms of the types of physical borrowing, and the markets in which they are raised.

CHART 7D
COMPOSITION OF STATE DEBT,
BY INSTRUMENT TYPE, AT 30 JUNE 1999 (a)
(per cent)



(a) Based on market value.

CHART 7E
COMPOSITION OF STATE DEBT,
BY MARKET IN WHICH RAISED,
AT 30 JUNE 1999 (a)
 (per cent)



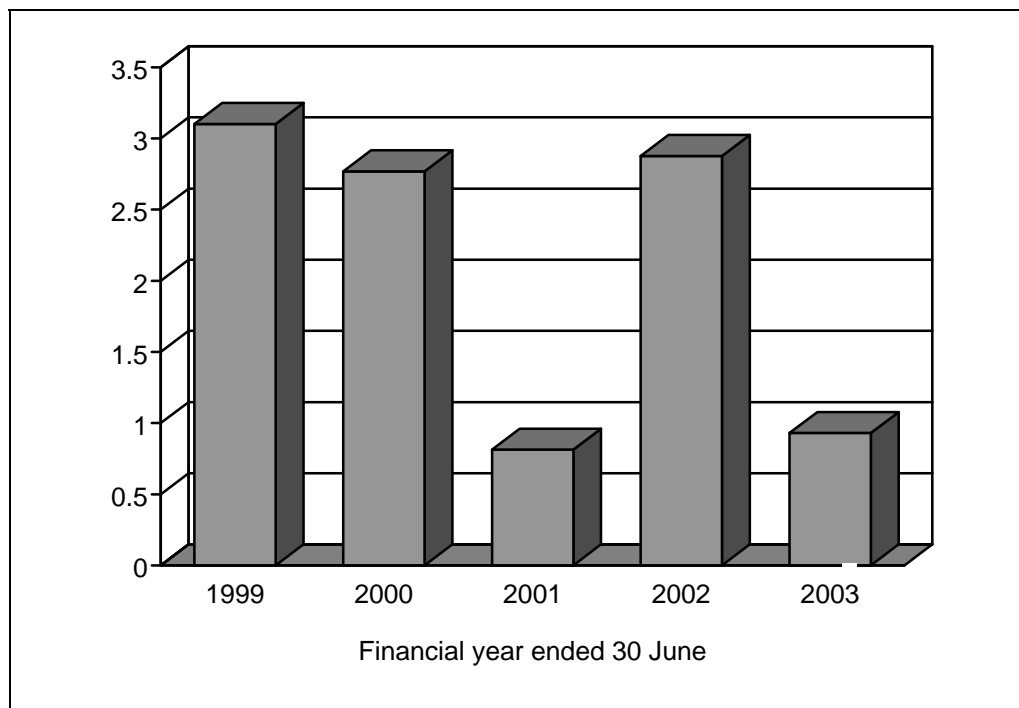
(a) Based on book value.

7.16 As illustrated in the above charts, the State's debt portfolio predominantly comprises fixed rate instruments, which account for 86 per cent of the debt portfolio at 30 June 1999. As a result of holding this type of instrument, the State's exposure to increases in interest rates in relation to the total portfolio has been minimised. While borrowings have been raised in both domestic and foreign markets, the State's exposure to foreign currency fluctuations has also been minimised through the establishment of appropriate hedging arrangements for all foreign currency borrowings.

State debt maturity profile

7.17 An analysis of the State debt portfolio at 30 June 1999 indicates that around 57 per cent or \$7.8 billion (market value) of the portfolio will mature and require repayment or refinancing in the next 5 years. **During the 1999-2000 financial year, \$1.7 billion will require repayment or refinancing.** Treasury Corporation of Victoria's current investment holdings are sufficient to enable this amount to be repaid. Chart 7F illustrates the maturity profile for the next 5 years.

CHART 7F
STATE DEBT MATURITY PROFILE FOR THE NEXT 5 YEARS,
AT 30 JUNE 1999 (a)
 (\$billion)



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

7.18 In achieving the debt management objectives previously outlined, the *1999-2000 Budget Papers* have stated that the budget sector debt management activities will continue to be focused on increasing the flexibility and lengthening the maturity of the financing facilities provided by the Treasury Corporation of Victoria, the State's central borrowing agency.

State's credit rating

7.19 The State's credit rating is a major determinant of the level of finance charges that are payable on borrowings, and on financial market and investor assessments of the strength and stability of the State's finances. In this regard, previous Auditor-General's Reports to the Parliament have tracked the former Government's progress towards achieving one of its key long-term financial targets, namely, to reduce the State's debt to levels consistent with the restoration of Victoria's former triple-A credit rating.

7.20 Following the implementation of major structural reforms within the Victorian public sector and the strengthening of the State's financial position, the former Government achieved the abovementioned long-term target in the previous financial year, when the international credit rating agency, Standard and Poor's, upgraded the State's long-term local currency debt rating from AA+ to AAA, reflecting "... *the moderate and still falling levels of the Victorian Government's debt burden, the very strong position of its ongoing finances, and the State's broad economic base, which should be durable and diverse enough to cope with the impact of the east Asian economic crisis without undue stress*".

7.21 In March 1999, another major international rating agency, Moody's Investors Service, revised the State's domestic currency debt rating outlook from "stable" to "positive", stating that "... *the change in the outlook reflects the recent positive trends in the State's fiscal and debt profile*".

7.22 The upgraded credit ratings reflect the positive impact of the extensive reforms and financial management strategies implemented by the former Government over recent years, and represent a substantial achievement in enhancing financial market confidence in the State's finances.

Termination of transport rolling stock leasing arrangements

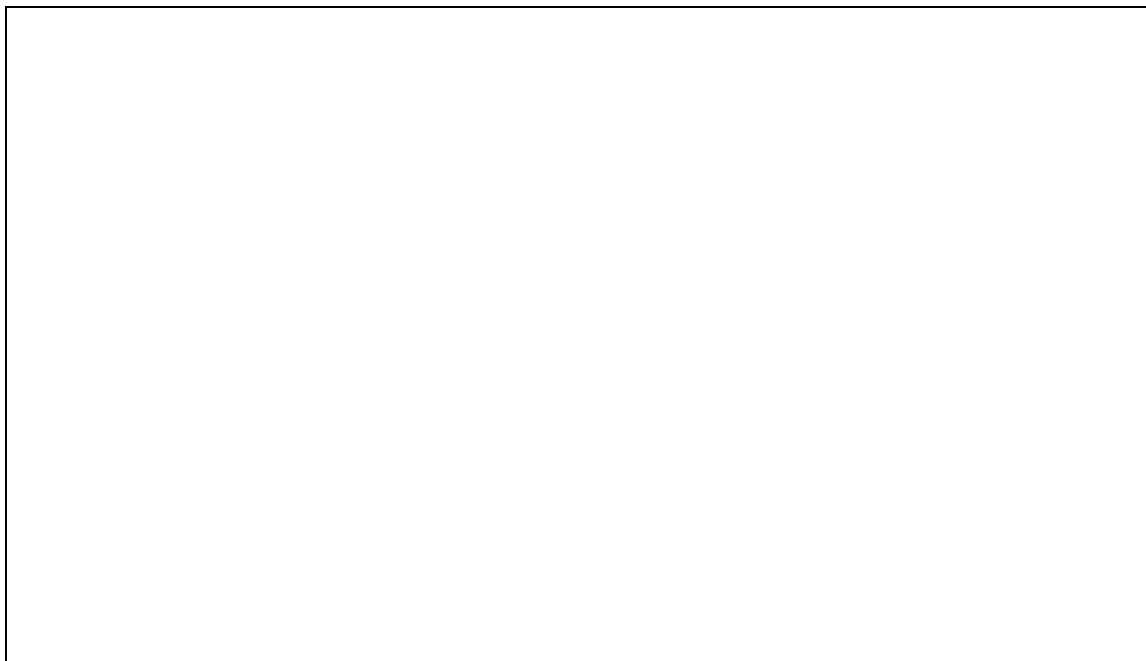
7.23 In the late 1980s, the Public Transport Corporation (PTC) at the direction of the Treasurer entered into a series of sale and lease-back arrangements involving various transport rolling stock assets, including suburban trains, locomotives, light rail vehicles and buses. The *Report of the Auditor-General on the Government's Annual Financial Statement, 1996-97*, commented on the early termination of 2 of these leasing arrangements at a total cost to the State of \$303.8 million.

7.24 Following a Government decision to privatise the public transport businesses, the Department of Treasury and Finance engaged financial consultants to investigate the feasibility of a number of options relating to the rolling stock which was subject to the remaining sale and lease-back arrangements, including the option of the State obtaining ownership of the rolling stock through the early termination of the leasing arrangements and the option of the State entering into sub-leasing arrangements with the prospective purchasers of the transport businesses. The consultants advised that while the proposal to sub-lease the rolling stock to the purchasers of the transport businesses would allow the leases to run their full term and would not be as costly as the early termination of the arrangements, this option would have a negative impact on the sale process. Due to the impact on the sale process, it was concluded by the consultants that the leases should be terminated.

Cross-border tram leases

7.25 The Public Transport Corporation's fleet of around 470 light rail vehicles included 50 light rail vehicles that were subject to a cross-border leasing arrangement involving 3 separate leases with a German-based company, having maturity dates of December 1999 (27 vehicles), April 2000 (19 vehicles) and June 2000 (4 vehicles), respectively.

7.26 In August 1998, the Department of Treasury and Finance's legal and financial advisers assessed the indicative cost of the early termination of these leases at around \$75 million. Subsequently, the Department accepted a recommendation from its consultants to commence negotiations with the lessor for the early termination of these leases. However, cost estimates of early termination varied significantly from the initial assessment of \$75 million, the Department determined that further consideration would need to be given to the adoption of the previously mentioned sub-lease option. In January 1999, following preliminary negotiations with the lessor, the consultants revised the indicative early termination cost from \$75 million to \$64 million.



Light rail vehicle previously subject to leasing arrangements.

7.27 In January 1999, the Treasurer approved the exercise of the option under the lease agreement for the early termination of the leases. However, the sub-lease option was to be retained in the event that the final cost of early termination varied significantly from the estimated termination amount.

7.28 Following negotiations between the parties, in March 1999 the lessor agreed to the early termination of the leasing arrangements at a cost to the State of \$64 million. Subsequently, in June 1999 the Public Transport Corporation, the former Treasurer and the lessor entered into a termination agreement under which the parties agreed to terminate the 3 separate leases, with the ownership of the leased assets to be transferred to the State. Consequently, **an amount of \$63.3 million was paid by the State to the lessor for the early termination of the leases**, comprising:

- \$34.6 million relating to the outstanding principal and interest payments, including \$2.9 million which represented the scheduled rental payments due in June 1999;
- \$22.4 million relating to the residual value of the leased equipment; and
- \$6.3 million representing the early termination premium payable by the State.

7.29 As part of the lease termination arrangements, the State agreed to reimburse the lessor for any costs incurred in relation to the termination, including legal costs and any applicable taxes. As at the date of preparation of this Report, audit was advised by the Department that no such claims had been made by the lessor. Furthermore, certain taxation indemnities that had been provided by the Government to the lessor under the original lease agreements were required to be retained by the State subsequent to the termination of the transaction.

7.30 Following the termination of the leases, the then Treasurer entered into an agreement with Swanston Trams and Yarra Trams to facilitate the transfer of ownership of the rolling stock to the respective transport operators for a nominal purchase price of \$10.

7.31 In summary, during the 1998-99 financial year the State incurred a total cost of around \$63 million associated with the termination of the 3 German cross-border leases, including a \$6.3 million early termination penalty.

Novated passenger rail carriage leases

7.32 In the early 1980s, the former Metropolitan Transit Authority (a predecessor body of the Public Transport Corporation) entered into 2 leasing arrangements with a major Australian Bank, involving 188 Comeng suburban rail passenger carriages. The first of these leases involved 144 rail carriages with a value of \$66.2 million, maturing in March 1999. The second lease, established in January 1984, involved 74 carriages valued at \$50 million, maturing in September 1999. The lease liability associated with these arrangements was novated from the Public Transport Corporation to the Treasury Corporation of Victoria in 1989 and 1991 respectively, with sub-leases established between these entities in relation to the use of the equipment.

7.33 As part of the former Government's transport reform program, in June 1998 the then Treasurer approved the termination of the 2 novated leases and the acquisition of the related equipment for a total cost not exceeding \$27 million, including rental payments due and payable from that date. Subsequently, in March 1999 the first of these leases matured and a termination payment of \$12.1 million was made by the Treasury Corporation of Victoria to the lessor, mainly comprising an amount of \$6.6 million representing the residual value of the rolling stock and \$5.5 million representing the final rental payment.

7.34 In December 1998, the Treasurer approved the early termination of the remaining transport lease in order to facilitate the reforms within the public transport sector, with a notice of termination provided to the lessor at this time. Subsequently, in March 1999 a termination payment of \$6.1 million was made by the Treasury Corporation of Victoria to the lessor comprising a termination amount of \$3 million (including a premium of \$947 000) and an outstanding rental payment of \$3.1 million.

7.35 Upon termination of these leases, ownership of the rolling stock passed to the Treasury Corporation of Victoria and a sale and purchase agreement was subsequently entered into with the respective transport operators to take legal possession of the assets for a nominal amount of \$10.

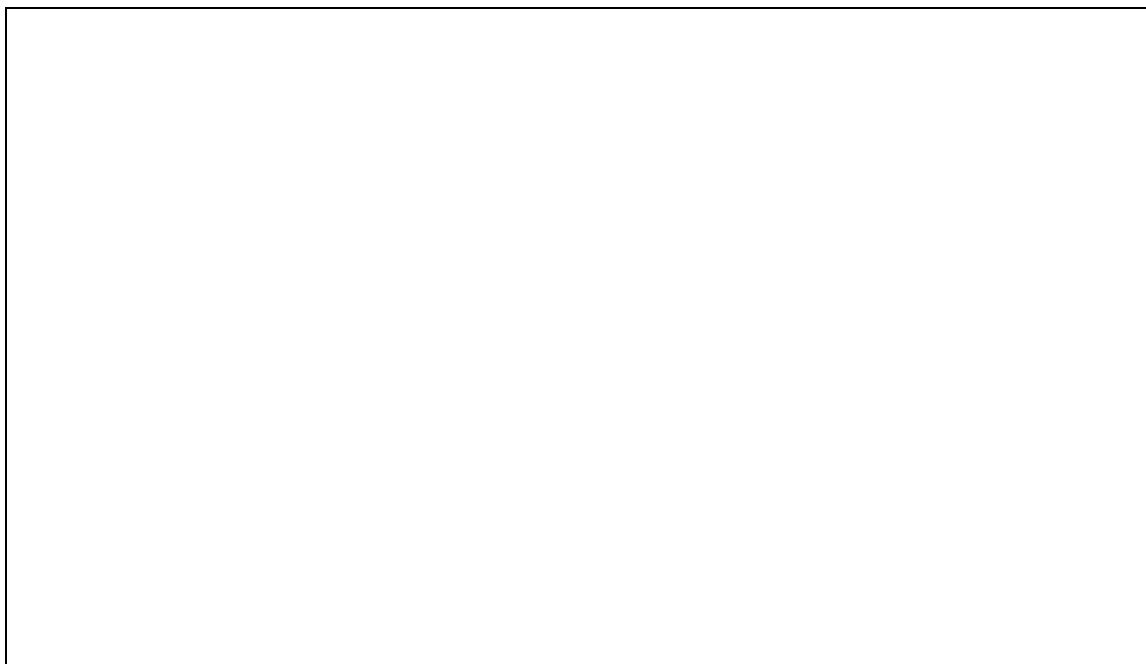
7.36 The total cost of termination to the State of these novated leases was \$18.2 million, including a \$1 million early termination penalty.

Overall cost to the State from the termination of transport leases

7.37 Over the past 3 financial years, the State has incurred a total cost of around \$385 million associated with the termination of the transport rolling stock leasing arrangements that were established during the 1980s and the acquisition of the related assets. These costs included \$212 million associated with final and deferred rental payments, \$164 million relating to the residual value of the leased equipment under the leasing arrangements and \$9 million associated with premiums and other costs payable upon the early termination of the arrangements. **While the leasing arrangements were terminated, the State was required to retain certain taxation indemnities that were provided to the lessors when the arrangements were initially established.**

Termination of Monash Medical Centre financing arrangements

7.38 The Auditor-General's November 1998 *Report on the Victorian Government's Finances* outlined the complex arrangements entered into by the State in 1983 with a special purpose company, namely South Eastern Medical Complex Limited (SEMCL), which, at the time, was controlled by the former State Bank of Victoria, to finance the construction of a new hospital complex in the outer south-eastern region of Melbourne. The construction of the complex was funded from conventional borrowings of around \$120 million and \$30 million obtained through a unit structure. The Treasurer guaranteed the borrowings of the company under the *Queen Victorian Medical Centre (Guarantees) Act 1982*.



Monash Medical Centre.

7.39 Under the established arrangements, SEMCL leased a parcel of land from the former Queen Victoria Medical Centre, a wholly-owned State entity, for a period of 15 years with a renewal option. In exchange, the company agreed to construct the hospital complex which was subsequently leased to the Centre. In substance, the leasing arrangement effectively transferred all the risks of ownership and operation of the public hospital to the Centre, and consequently the State as the primary stakeholder.

7.40 In late 1986, the Queen Victoria Medical Centre was amalgamated with certain other hospitals to form the Monash Medical Centre. More recently, amendments to the *Health Services (Metropolitan Hospitals) Act 1995* consolidated the Monash Medical Centre, which continues to be a major provider of health care services in the outer south-eastern region of Melbourne, to form part of the Southern Health Care Network.

7.41 Following the sale of the State Bank of Victoria to the Commonwealth Bank of Australia in 1991, the ownership structure of SEMCL was as follows:

- *The Treasurer on behalf of the State* - 25 per cent shareholding held through State Trustees Limited;
- *ANZ Bank* - 25 per cent shareholding, with an option by the State Trustees Limited on behalf of the Treasurer to purchase these shares at their par value; and
- *Commonwealth Bank of Australia* - 50 per cent shareholding.

7.42 In August 1997, an assessment was undertaken by the Department of Treasury and Finance of the risks to the State associated with the financing and leasing arrangements in place between the Centre and SEMCL. As part of this assessment, various options were investigated by the Department to minimise the potential risks and costs to the State, including the risk associated with the Treasurer's guarantee over the outstanding borrowings of the company. The assessment identified that the termination of the established financing and leasing arrangements would result in a substantial outlay to the State as it would require the purchase of the remaining shares in SEMCL by the Treasurer, the repayment of its outstanding debt and the termination of the unit trust arrangement.

7.43 The initial lease relating to the public hospital, between the Monash Medical Centre and SEMCL, was due to expire in June 1998, with the Centre obligated to lease the public hospital component of the Centre for a further 15 year period as long as the company exercised its option to lease the land. Consequently, in February 1998, based on legal advice, the Southern Health Care Network, as the successor in law to the Monash Medical Centre, issued a notice to SEMCL exercising its option to renew the public hospital lease for a further term of 15 years. In May 1998, the Treasurer also renewed the guarantee in place over the company's outstanding borrowings for a further period of 12 months ending in July 1999.

7.44 Following a further assessment by the Department of the options available for the termination of the financing and leasing arrangements, in August 1998 the Treasurer approved a strategy to facilitate this outcome. The strategy included the purchase by the Department of the remaining shares in SEMCL, the repayment of the company's outstanding loans and the termination of the associated unit trust arrangements.

Commencement of termination process

7.45 In October 1998, the Treasurer directed State Trustees Limited to exercise the option to purchase the ANZ Bank shareholding in SEMCL. This transaction was concluded in November 1998 with a nominal payment of \$250, representing the par value of the shares held by the bank.

7.46 Following the acquisition of these shares, the Department continued with its termination strategy by offering to purchase the remaining shares in SEMCL held by the Commonwealth Bank at a nominal cost of \$500. This purchase was concluded by the Department in December 1998.

7.47 Prior to the acquisition of the Commonwealth Bank shares, the Southern Health Care Network secured a reduction in lease payments to SEMCL, from \$21.6 million to \$2.4 million per annum, **thereby reducing the Network's finance lease liability to SEMCL by \$107 million. This reduction in the liability is disclosed as an abnormal expense within the Consolidated Operating Statement in the Government's Annual Financial Statement.**

7.48 Following the acquisition of all SEMCL shares by the State, the Department commenced action to retire the company's borrowings of \$65.5 million, which comprised:

- \$35.5 million "conventional" debt with banks; and
- \$30 million loan under a complex unit trust-based financing structure.

Retirement of conventional debt

7.49 The Department considered various options for the repayment of the company's "conventional" debt however, on advice from its advisers, determined that the best available option would be to retire the debt through a loan from the Treasurer to the company. Consequently, **in February 1999 the Acting Treasurer approved the provision of an interest bearing loan of \$35.5 million to the company to enable the company to repay its "conventional" borrowings.** Upon receipt of the loan funds from the Department, the company repaid its outstanding "conventional" borrowings.

Status of unit trust financing arrangements

7.50 As mentioned earlier in this Report, the remaining financing of \$30 million, used to fund the construction of the hospital complex, was raised through a complex unit trust structure. **As at the date of preparation of this Report, negotiations were continuing between the Department and the parties associated with the unit trust arrangements to facilitate the termination of the financing arrangements.**

Interim funding arrangements for the company

7.51 Under the previously explained arrangements established in late 1998 to facilitate the acquisition by the State of all shares in the company, which included a reduction in the value of lease rentals payable by the State to the company, the Treasurer agreed to consider providing finance to the company to enable it to meet any costs that could not be funded by the company to ensure that it remained solvent.

7.52 Consequently, in February 1999 the Department provided a cash injection of \$320 000 to the company. A further \$2.75 million loan was provided to the company in June 1999 to allow the company to meet the estimated cash shortfall for the quarter ended September 1999. As at the date of preparation of this Report, an additional loan of \$2.1 million had been requested by the company to enable it to meet its cashflow obligations for the period ended December 1999 which was being considered by the Department.

Concluding comments

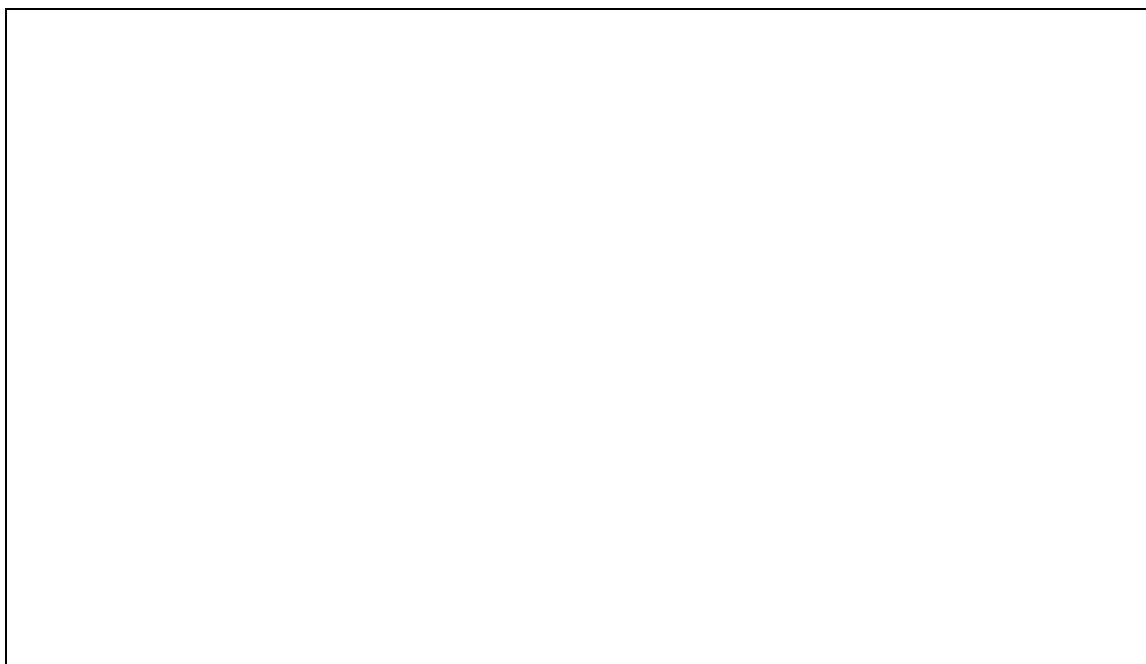
7.53 During the 1998-99 financial year, the Department successfully obtained full ownership of SEMCL, the special-purpose private sector company which funded the construction of the Monash Medical Centre, at a nominal cost of approximately \$750. As an initial step in facilitating the termination of the associated financing arrangements, the State provided a loan of \$35.5 million to the company which was applied towards the repayment of its “conventional” borrowings, and is in the process of negotiating the termination of the remaining complex trust-based financing arrangements with the relevant parties.

7.54 A key element of the termination arrangements involved a reduction in the value of the lease payments made by the State to the company. The Treasurer later provided SEMCL an undertaking to consider the provision of any necessary funding for the company to remain solvent. Under this undertaking, an amount of \$3.07 million was provided by the Department of Treasury and Finance to the company during the 1998-99 financial year to meet its cash flows, with further amounts potentially payable by the State until such time as the financing arrangements are terminated.

7.55 The State has now assumed sole ownership of the company and the State continues to carry sole responsibility for any financial obligations resulting from the prior operations of the company and the winding-down of the company.

Accelerated Infrastructure Program

7.56 The Accelerated Infrastructure Program was established in the early 1990's by the Government, in conjunction with a private sector company, to provide accommodation for certain government agencies, mainly police stations and law courts. Under the arrangements, the company was established to build and subsequently lease properties to the Government, with the construction costs funded through the issue of various bonds which matured over a period of 20 years. The provision of a government indemnity to bondholders effectively transferred the financing risk associated with this arrangement to the State.



Dandenong law courts complex, constructed under the Program.

7.57 Previous Auditor-General Reports to the Parliament have outlined the initial steps taken by the Department of Treasury and Finance to un-wind the arrangement in order to minimise the financial exposures to the State. This process commenced during the 1995-96 financial year with the purchase of all the bonds that were issued by the company, at a total cost to the Consolidated Fund of \$258 million.

7.58 In May 1998, the Department of Justice, which has responsibility for the management of the program, was advised by its legal and corporate consultants that there were substantial financial advantages to the Government in terminating the program. Consistent with this advice and further advice provided by the Department of Treasury and Finance, the Treasurer approved a strategy to facilitate the termination of the program. At that time, the Treasurer noted that the direct net costs associated with this approach were estimated at \$86 million, after taking account of the costs of purchasing the bonds less the value of the cash reserves held by the company and the estimated value of the properties. However, these costs could increase if certain potential risk exposures were realised and if certain other fees associated with the early termination of the arrangements became payable.

Progress towards termination of arrangements

7.59 The program termination process commenced in August 1998 when an informal offer was made by the Department of Treasury and Finance to the shareholder of the company for the purchase of all shares at a nominal amount. Subsequent negotiations resulted in Heads of Agreement being entered into by the various parties, under which it was agreed that the State could acquire the shares of the company for a nominal amount, subject to the completion of a satisfactory due diligence process and the payment of a compensation payment to the financial manager for loss of income and redundancies.

7.60 In November 1998, the Department's advisers recommended the establishment, prior to the acquisition of the company shares by the State, of a Trust with the State as the sole beneficiary, as the preferred vehicle to terminate the financing arrangements. Consequently, in April 1999 a Trust was established on the above basis by the Department to facilitate the acquisition of all the private sector company shares, with the Trust managed for this purpose by a private sector trustee company.

7.61 As at the date of preparation of this Report, the Department had engaged legal and financial consultants to undertake a due diligence review of the company's affairs and this review was in progress. Consistent with the terms of the above agreement, it is the Department's intention to proceed with the acquisition of the company shares and the termination and re-packaging of the associated financing arrangements during the 1999-2000 financial year, following the receipt of a satisfactory due diligence report from its consultants.

7.62 Given the impending termination of the arrangements, **the realisable value of the bonds, which had been initially issued by the company to finance the construction of the properties under the program, and which had been previously purchased by the State at a cost of \$258 million, was written-down by \$122 million in June 1999. This write-down reflected the net expected value from the liquidation of the program's assets following the restructuring and termination of the arrangements. This has resulted in the value of the bonds being disclosed in the Government's Annual Financial Statement as at 30 June 1999 at \$136 million and an abnormal expense being reported of \$122 million.**

Overall audit comment

7.63 During 1998-99 financial year, protracted negotiations between the State and the shareholders of the private sector company have slowed the termination of the Accelerated Infrastructure Program financing arrangements. As at the date of preparation of this Report, an in-principle agreement had been entered into between the company and the State under which all company shares will be acquired at a nominal amount by a newly created trustee company established by the State for this purpose. Following the acquisition of these shares, it is proposed that the financing arrangements will be terminated and the future of the properties will be addressed.

7.64 The reduction of \$122 million in the value of the bonds held by the State associated with the financing arrangements during the 1998-99 financial year, represents the reduced return the State expects to obtain upon the termination of the arrangements. However, the ultimate cost to be borne by the State will be dependant upon a number of external factors, including the values achieved by the State from the sale of the company's properties and the satisfactory and timely resolution of certain related issues to facilitate the ultimate termination of the financing arrangements. Nevertheless, the Department of Treasury and Finance expects that the above financing costs will be significantly offset by reduced future payments on public sector accommodation and reduced exposures to property risk.

Financial obligations of the SECV

7.65 Previous Auditor-General Reports to the Parliament have commented on the disaggregation of the electricity and gas industries and the operation of the State Electricity Commission of Victoria (SECV) which has been retained as a *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 date of preparation of this Report, the key obligations of the SECV included:

- management of the rights and obligations under electricity supply contracts with the wholesale electricity market relating to the Snowy Mountains power entitlement and the electricity arrangements relating to the Portland and Point Henry aluminium smelters;
- demolition of the former Yallourn Power Station complex, including the removal of hazardous materials including asbestos, and site rehabilitation; and
- resolution of residual issues associated with the Government's electricity, gas and ports reform program, under which the residual assets and obligations of the previously State-owned businesses within these industries were vested in the SECV.

7.66 Based on the SECV's financial statements, the entity's equity position as at 30 June 1999 amounted to \$192 million (30 June 1998, \$82 million).

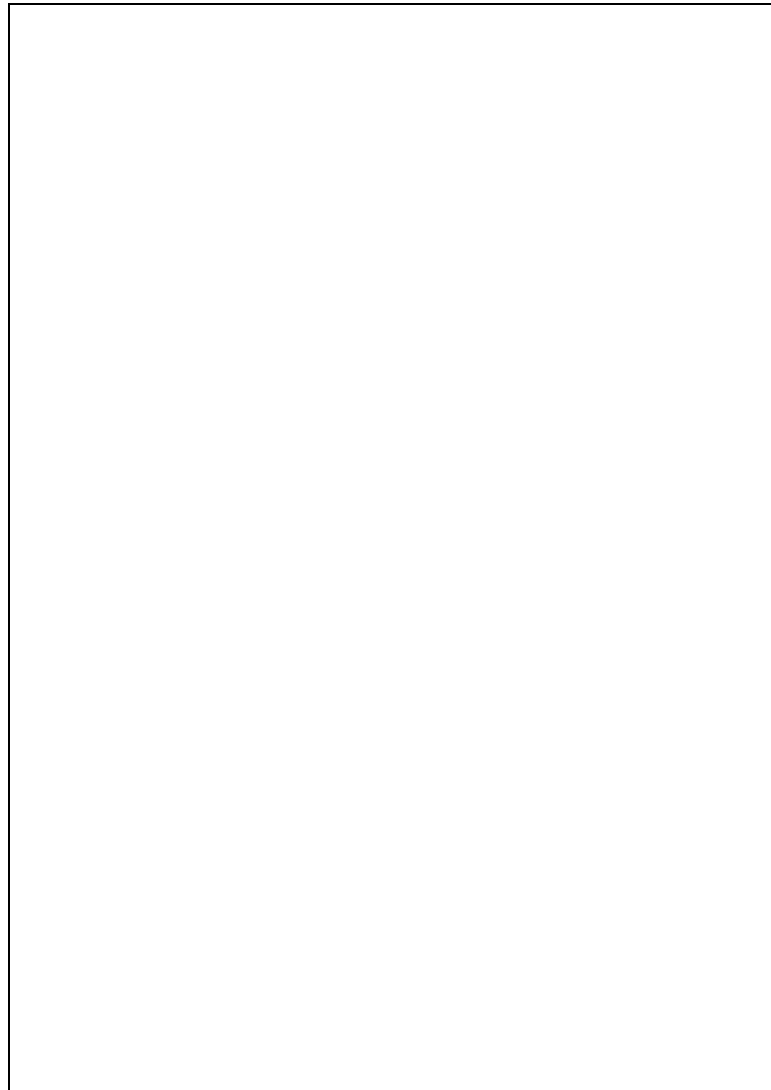
Major developments during the year

7.67 The key developments occurring in the operations of the SECV since June 1998 are outlined below:

Asset sales

- In August 1998, the SECV sold a building located at 452 Flinders Street, Melbourne, for a gross price of \$119.5 million. The details associated with this sale were outlined in the Auditor-General's November 1998 Report to the Parliament;
- In September 1998, the SECV received \$8 million relating to the cancellation of an agreement with Pacific Power Ltd, which was established in 1957 and was due to expire in 2007, under which the SECV had an entitlement to 50 per cent of the power generated from the Hume Power Station in return for contributing towards 50 per cent of its operating costs;

- The SECV's interest in certain properties which were the subject of a land exchange between the Department of Treasury and Finance and Amcor Ltd were transferred to the Department. Subsequent to the transfer, in December 1998, the land exchange transaction was completed. Comment on this transaction is also included in Part 6 of this Report;
- On 30 July 1999, the SECV disposed of its 33 per cent interest in the Golden Beach joint venture, which was previously established for the purposes of gas exploration, for a price of \$2.25 million which was received in September 1999; and
- The Department of Treasury and Finance commenced action to facilitate the sale of a site in the Latrobe Valley, which is known as the Loy Yang 3-4 Bench.



Former SECV building, located at Flinders Street, Melbourne.

Aluminium smelter electricity supply arrangements

- Net payments made by the SECV to the Point Henry and Portland Aluminium Smelters under certain onerous electricity supply arrangements during the year totalled \$188 million. Further comment on these arrangements are provided later in this Report.

HRL Limited

- As was commented in the Auditor-General's November 1998 Report to the Parliament, in August 1998 the Commissioner for Patents determined that the SECV and a third party had a joint entitlement to a patent for certain technology and associated unpatented technical information relating to the generation of electricity from brown coal. Consequently, the SECV initiated action in the Federal Court to defend its interest in the technology. This matter was subsequently settled in December 1998, with a payment of \$1.5 million made by the SECV to the third party for the assignment to the SECV of all interest in the technology and the withdrawal of opposition to the SECV's ownership of the patent. The SECV has advised that there has not been significant commercialisation of the technology and accordingly, any benefit which may accrue to the SECV over future years from its interest in the above technology is difficult to determine at this time; and
- Action commenced to terminate certain complex financing arrangements associated with the construction and financing of a property occupied by HRL Limited, located in Mulgrave, south-east of Melbourne. The termination process was completed during October 1999, with the SECV released from certain taxation indemnities and obtaining unencumbered ownership of the property at that time. Further comment on this matter will be incorporated in future Reports to the Parliament.

Other residual matters

- Since January 1995, the SECV has managed certain residual personal injury liabilities relating to former employees, contractors and the general public, associated with activities undertaken by the electricity, gas and port entities prior to the commencement of the former Government's reform program. On 30 June 1999, these liabilities were transferred to the Department of Treasury and Finance and, in turn, the Department arranged for the Victorian Managed Insurance Authority (VMIA) to manage these liabilities on its behalf. Under the arrangements, the SECV paid an amount of \$105 million to the VMIA to meet the actuarially determined claim costs and the related expenses associated with the "quantifiable" liabilities, while the Department of Treasury and Finance is required to make future payments to the VMIA, on an emerging cost basis, for any claims which were not "quantifiable" as at the date of transfer;

- In February 1998, the SECV, the Treasurer and Power Partnership Pty Limited (a Victorian electricity retailer) entered into an agreement under which the company paid to the SECV an amount of \$186.5 million between April 1998 and June 1999, representing a prepayment of franchise fees due to the State up until the January 2001, which would have been progressively payable by the company to the Consolidated Fund over this period. Under the terms of the agreement, the SECV is required to make quarterly franchise fee payments to the Consolidated Fund on behalf of the company up to January 2001, consistent with the initial arrangements established when the electricity industry was privatised. As at 30 June 1999, the SECV still held \$86.9 million relating to this prepayment which will be paid into the Consolidated Fund over the remaining term;
- On 30 June 1999, the SECV's residual interest in certain properties and related liabilities that were previously the responsibility of the former ports and gas businesses, including lease and contamination obligations, were transferred to the Department of Treasury and Finance for nil consideration;
- In May 1997, the SECV had terminated an external contract associated with the demolition and clearance of the former Yallourn power station complex. Various disputes relating to the performance of the contractor were settled in August 1998, with no material financial impact on the SECV. A further contractor was appointed in February 1998 for completion of the works within a 2 year period, at a cost to the SECV of \$24.4 million. The SECV has advised that the demolition of the site is currently ahead of schedule, with the site anticipated to be vacated by early December 1999;
- As reported in the Auditor-General's November 1998 *Report on the Victorian Government's Finances*, the SECV's obligations to the Victorian electricity distribution businesses relating to sales taxes payable by the businesses following their privatisation were mainly settled in June 1998 and July 1998, with final claims required to be lodged by 30 September 1998. However, a dispute subsequently arose with one of the distribution businesses in relation to the final amount payable by the SECV. At the date of preparation of this Report, negotiations were continuing in relation to this matter; and
- The SECV together with GASCOR and certain other public sector entities have been named as cross-respondents in a representative proceeding (class action) before the Federal Court. The proceeding against Esso was initiated on behalf of the gas users and stood down workers who suffered losses during the Longford gas incident in September 1998. The SECV, along with certain other cross respondents, have issued a cross claim in relation to this issue.

UNFUNDED SUPERANNUATION LIABILITIES

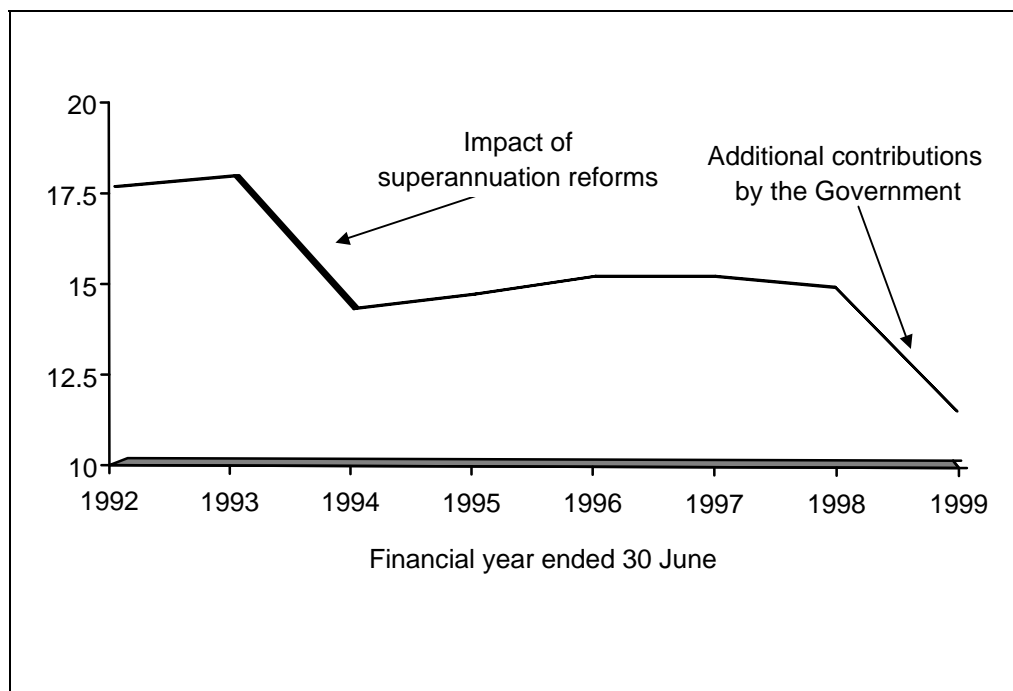
7.68 Unfunded superannuation liabilities represent the second largest component of the State's liabilities. They comprise employer superannuation contributions yet to be paid by the Government and certain public sector bodies to superannuation schemes in respect of services previously provided by employees. The liabilities have resulted from decisions of previous governments to progressively meet the employer share of superannuation benefits after employees retire, rather than as benefit entitlements accrue over the working lives of employees.

7.69 The Government's Annual Financial Statement shows unfunded liabilities of public sector superannuation funds shows as at 30 June 1999 totalling \$11.5 billion, compared with \$14.9 billion in the previous year. The unfunded superannuation liabilities relate to the following sectors:

- General Government - \$11.4 billion (30 June 1998, \$14.8 billion); and
- Other - \$84 million (30 June 1998, \$97 million).

7.70 Approximately 97 per cent of the State's unfunded superannuation liabilities are attributable to the State Superannuation Fund. Chart 7G shows the movement in the level of the State's superannuation liabilities since 1992.

CHART 7G
MOVEMENT IN THE STATE'S UNFUNDED
SUPERANNUATION LIABILITIES (a)
(\$billion)



(a) All figures are presented in nominal values.

7.71 Previous Reports of the Auditor-General to the Parliament have explained that a substantial reduction in the overall level of public sector unfunded superannuation liabilities occurred between the 1991-92 and 1993-94 financial years. This was principally due to:

- a reduction in the budget sector workforce and a low rate of growth in wages and salaries over that period;
- substantial one-off Consolidated Fund contributions to various superannuation schemes to meet the Government's liability for deferred employer contributions; and
- the effect of various superannuation reforms introduced by the Government with effect from the 1993-94 financial year.

7.72 The overall upward trend which occurred in the period up to 1997-98 in the level of unfunded superannuation liabilities was mainly due to Government superannuation contributions failing to keep pace with the increase in the accruing liabilities of the superannuation funds.

7.73 During the 1998-99 financial year, there was a \$3.4 billion reduction in the State's unfunded superannuation liabilities, mainly due to equivalent additional contributions being made in the year from the Consolidated Fund to the State Superannuation Fund. These additional contributions are further discussed below.

Additional superannuation payments

7.74 As outlined in the previous Reports of the Auditor-General to the Parliament, following advice by an actuary appointed by the Victorian Superannuation Board, over recent years the Government has been funding additional contributions to the State Superannuation Fund to assist in reducing the growth in the State's unfunded superannuation liabilities. In this regard, a "top-up" contribution of \$516 million was made by the Government to the Fund during the 1998-99 financial year.

7.75 In addition to the above contribution, the Government approved 4 additional payments to the State Superannuation Fund during the 1998-99 financial year, which resulted in the substantial reduction in the State's unfunded superannuation liabilities as at 30 June 1999. Table 7H provides details of these payments.

TABLE 7H
ADDITIONAL CONTRIBUTIONS TO REDUCE
UNFUNDED SUPERANNUATION LIABILITIES, 1998-99
(\$millions)

<i>Details of payment</i>	<i>Amount</i>
Application of privatisation proceeds.	2 574
Payment of 1999-2000 "top-up" contribution.	481
Funding of retrenchment benefits and other transfer amounts payable to former employees of public transport businesses.	271
Further payment to reduce unfunded liabilities and to fund certain other redundancy and retrenchment benefits.	68
Total	3 394

7.76 As outlined in the table, \$2.574 billion of the proceeds received by the State during the 1998-99 financial year from the privatisation of a number of major enterprises, including the gas businesses, the Victorian Plantations Corporation and Aluminium Smelters Victoria Pty Ltd, were applied towards the reduction of the State's unfunded superannuation liabilities.

7.77 In addition, the Government financed "top-up" contributions of \$481 million during the 1998-99 financial year which would normally be paid to the State Superannuation Fund during the 1999-2000 financial year. The Government also provided further funding of \$271 million for retrenchment benefits and transfer amounts to be paid by the Fund mainly during the 1999-2000 financial year in relation to public transport business employees effected by the privatisation or franchise of these businesses, and paid a further amount of \$68 million to further reduce the State's unfunded superannuation liabilities and meet certain other redundancy and retrenchment benefit payments.

7.78 In the 1999-2000 *Budget Papers* the former Government identified that, on the assumption that emerging superannuation costs will continue to be funded by departments and other agencies, the unfunded liabilities associated with the defined benefit schemes are expected to grow on a nominal basis to around \$13 billion by 30 June 2003 and to peak in the year 2008. However, the level of the liabilities in real terms, on an unchanged policy basis, is expected to fall as the impact of previous reforms takes effect.

State obligations relating to the funding of universities' superannuation

7.79 The unfunded superannuation liabilities of the State as at 30 June 1999, as disclosed in the Government's Annual Financial Statement, include an amount of \$203 million, which represents the State's obligation to the Commonwealth Government relating to its funding of the superannuation liabilities of Victorian universities. The aggregate value of Victorian universities' unfunded liabilities as at 30 June 1999 was \$847 million.

7.80 As outlined in the previous Auditor-General Reports to the Parliament, under the *State Grants (General Purpose) Act 1994*, the State is required to make annual payments to the Commonwealth Government, as determined by the Commonwealth Minister for Education, to assist in the funding by the Commonwealth Government of costs incurred by Victorian universities associated with their unfunded superannuation liabilities for members of Victorian superannuation funds. Under the Act, should the State not make the required payments, the Commonwealth Government is empowered to reduce, by an equivalent amount, grants made to the State.

7.81 Under the established cost-sharing arrangements between the State and Commonwealth Governments, prior to the 1997-98 financial year the State's liability to the Commonwealth associated with the universities' unfunded superannuation liabilities had been determined on the basis of 50 per cent of the aggregate unfunded liabilities of Victorian universities. In the 1997-98 financial year, a review of these arrangements resulted in the reduction of the State's contribution from 50 per cent to 28 per cent. **A further review of the cost-sharing arrangements during the 1998-99 financial year resulted in the further reduction of the State's contribution to the Commonwealth to 24 per cent of the unfunded liabilities of universities, representing a saving to the State of around \$34 million.**

7.82 In May 1999, the Commonwealth Department of Education, Training and Youth Affairs advised the Department of Treasury and Finance that it had commissioned the Office of the Australian Government Actuary to verify the universities' unfunded liabilities in State superannuation schemes. The objective of this review was to quantify the total unfunded liabilities and to design a mechanism for determining the appropriate cost-sharing arrangements between the various States and the Commonwealth. The Department of Treasury and Finance has recommended to the Commonwealth Department of Education, Training and Youth Affairs a simplification of the cost-sharing arrangements, whereby the relevant outstanding amounts could be valued and fully funded over a mutually agreed timeframe. As at the date of preparation of this Report, the above Commonwealth Department had not responded to this proposal.

Emergency services agencies' funding of superannuation obligations

7.83 The Emergency Services Superannuation Scheme provides superannuation benefits to emergency services employees in Victoria, including Victoria Police, the Country Fire Authority, the Metropolitan Fire and Emergency Services Board, and Ambulance Service Victoria. Under the arrangements established over a number of years, the employing agencies are required to progressively meet the employer share of superannuation contributions.

7.84 Audit identified that while the Scheme as a whole had unfunded liabilities of \$182 million, the assets in respect of a number of employing agencies exceeded the accrued superannuation liabilities relating to their scheme members by \$213 million. Table 7I discloses the key entities whose share of the Scheme assets exceeded their superannuation liability.

TABLE 7I
AGENCIES WITH SUPERANNUATION ASSETS IN EXCESS
OF THEIR SUPERANNUATION LIABILITIES,
30 JUNE 1998 AND 30 JUNE 1999
(\$million)

Agency	<i>Excess of assets</i>	
	30 June 1999	30 June 1998
State Electricity Commission of Victoria (administrator)	66	52
Ambulance Service Victoria	49	43
Country Fire Authority	42	35
Metropolitan Fire and Emergency Services	56	32

7.85 It is important that future employer contributions are consistent with the related accrued liabilities. In this regard, the Scheme has accepted an actuarial recommendation to reduce the employer contributions for the above employing agencies for the 1999-2000 financial year and consequently expects that the “over-funded” amounts will decline during the financial year. Furthermore, audit was advised that the Scheme’s actuary will continue to review the level of employer contributions on an annual basis to ensure that the related employing agencies remain fully funded.

Recent reforms to the administration of public sector superannuation funds

7.86 During the 1998-99 financial year, the Government announced a number of reforms to the administration of public sector superannuation schemes, with effect from July 1999. A key element of these reforms involved the transfer of responsibility for the supervision of the Hospitals Superannuation Fund and the Victorian Superannuation Fund, from the State Government to the Commonwealth Government under the framework established by the Commonwealth *Superannuation Industry (Supervision) Act* 1993 which covers the regulation of the majority of superannuation funds within Australia.

7.87 Consequently, as at 1 July 1999, three major Victorian public sector superannuation funds remained under the supervision of the State, namely the State Superannuation Fund, the Emergency Services Superannuation Scheme and the Parliamentary Contributory Superannuation Fund, together with a number of constitutionally protected schemes which, due to their nature, remained under State supervision.

Creation of the Government Superannuation Office

7.88 A further element of the reform process involved the transfer, as from July 1999, of the functions of the Victorian Superannuation Board, which was previously responsible for the administration of the State Superannuation Fund defined benefits scheme and the Victorian Superannuation Fund accumulation scheme, to 2 newly-established entities, namely the Government Superannuation Office and VicSuper Pty Ltd.

7.89 The Government Superannuation Office was established as a separate service agency within the Department of Treasury and Finance to administer the State Superannuation Fund and to manage the associated unfunded liabilities of the defined benefits schemes. The board of directors of the Office comprises 3 employer representatives, 3 member-elected employee representatives and an independent President nominated by the Minister for Finance and appointed by Governor-in-Council. Under the provisions of the enabling legislation:

- the administrative operations and activities of the Government Superannuation Office will be subject to contestability, with these activities to be tendered and allocated to the most efficient provider within 2 years of establishment; and
- the Victorian Funds Management Corporation has been designated as the Scheme's fund manager, with the Corporation responsible for the management of the Scheme's investments in accordance with strategies determined by the board of directors of the Government Superannuation Office.

7.90 VicSuper Pty Ltd, which is a company established under the Corporations Law and limited by shares, will act as the trustee company responsible for administering the Victorian Superannuation Fund which now comes under Commonwealth supervision. This Scheme which is an "accumulation fund", by its nature, is fully funded.

7.91 Under the new arrangements, there have been no changes to the existing rights and entitlements of members of either the State Superannuation Fund or the Victorian Superannuation Fund.

7.92 The State Superannuation Fund incurred expenses totalling \$12.5 million, which were initially funded from members' funds, relating to the establishment of the Government Superannuation Office and VicSuper Pty Ltd. These expenses mainly related to the purchase of assets, the prepayment of contracts for systems management facilities and certain transitional costs mainly associated with the creation of VicSuper Pty Ltd. As a result of legal advice received regarding the application of members' funds for the above purposes, in November 1999 a payment of \$12.5 million was made by the Department of Treasury and Finance to the State Superannuation Fund to finance these costs.

OTHER EMPLOYEE ENTITLEMENTS

7.93 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.

7.94 The State's financial obligations in respect of accrued employee entitlements, excluding unfunded superannuation liabilities, at 30 June 1999 amounted to \$2.4 billion (1997-98, \$2.5 billion). Table 7J outlines the key components of these obligations.

TABLE 7J
OTHER EMPLOYEE ENTITLEMENTS,
AS AT 30 JUNE
((\$billion))

<i>Type of entitlement</i>	1999	1998
Long service leave	1.8	1.7
Recreation leave	0.4	0.5
Other employee entitlements	0.2	0.3
Total	2.4	2.5

7.95 The reduction in the overall level of State liabilities relating to employee entitlements between the 1997-98 and 1998-99 financial years reflects the impact of the Government's privatisation program under which several substantial State Trading Enterprises were sold in the 1998-99 financial year. Notwithstanding the impact of privatisation, the State's liabilities associated with long service leave entitlements increased in the year, mainly within the General Government sector. This increase was principally attributable to an increased number of employees eligible for long service leave and increased pay rates associated with industrial awards made in the year, at the Department of Education.

PAYABLES AND OTHER LIABILITIES

7.96 The State's financial obligations disclosed in the Government's Annual Financial Statement as part of *payables and other liabilities* mainly relate to outstanding claims for transport accident and workers' compensation, amounts payable under the flexible electricity tariff arrangements established in relation to the operation of the Portland and Point Henry aluminium smelters, accrued interest on State debt and amounts owing to trade creditors.

7.97 The financial obligations of the State in respect to payables and other liabilities at 30 June 1999 totalled \$13.1 billion, compared with \$12.7 billion in the previous year. Table 7K outlines the key components of these obligations.

TABLE 7K
PAYABLES AND OTHER LIABILITIES,
AS AT 30 JUNE
(\$billion)

<i>Type of obligation</i>	<i>Total 1998-99</i>	<i>Total 1997-98</i>
Outstanding claims	8.0	7.3
Flexible electricity tariff obligations	1.3	1.3
Payables and other accrued expenses	3.8	4.1
Total payables and other liabilities	13.1	12.7

7.98 The increase of around \$480 million in the year in the level of payables and other liabilities was mainly due to an upward movement in the level of outstanding claims liabilities relating to the State's various insurance schemes. This increase reflected the results of actuarial re-assessments of outstanding liabilities after taking into account, *inter alia*, the claims experience of the schemes, movements in the average weekly earnings of claimants, and the effect on the value of the liabilities resulting from the introduction of the Commonwealth Government's new goods and services tax (GST) due to come into operation from 1 July 2000.

Aluminium smelter electricity supply arrangements

7.99 The previous reports of the Auditor-General to the Parliament have commented on certain onerous contracts associated with the supply of electricity to the Portland and Point Henry aluminium smelters, which were established by the Government in 1984 and have imposed significant financial obligations on the State. Under these arrangements, which extend to the year 2016, the Consolidated Fund was responsible for meeting the Government's obligation to make flexible electricity tariff payments to the State Electricity Commission of Victoria (SECV) to subsidise it for lower prices charged for electricity supplied to the smelters when aluminium prices fell below a stipulated level, a situation that has occurred consistently in recent years.

7.100 During the 1997-98 financial year, the Treasurer entered into certain deeds to suspend the flexible electricity tariff payments to the SECV by the Consolidated Fund, under which the onerous obligations associated with the flexible electricity tariff arrangements were effectively transferred from the Department of the Treasury and Finance to the SECV as from 30 June 1998. Furthermore, the following arrangements were established to reduce the SECV's, and ultimately the State's exposure associated with the aluminium smelter electricity supply arrangements:

- A hedge arrangement between the SECV and Edison Mission Energy Australia Limited, the owner of the Loy Yang B power station, which effectively fixed the price of energy, at a load equivalent to that supplied by the SECV to the aluminium producers from the year 2001 to 2016, at \$23.95 per megawatt hour, indexed to movements in the consumer price index; and
- A *smelter reduction amount levy* payable by wholesale electricity market participants (mainly distribution companies) as from 1 July 1997, which is applied by the SECV in funding part of the future expected losses to be incurred under the flexible tariff arrangements. This levy superseded a previous "energy levy" mainly payable by electricity distributors to the SECV, which was aimed at recovering losses incurred by the SECV in trading of energy produced by the Loy Yang B power station.

7.101 In August 1998, the State sold its 25 per cent interest in the Portland Smelter, without divesting that share of the exposure relating to the flexible electricity tariff arrangements.

7.102 Net payments made by the SECV to the aluminium smelters under the onerous electricity supply contracts during the 1998-99 financial year totalled \$188 million (1997-98, \$180 million).

7.103 Based on Government expectations of future aluminium prices and inflation levels, and after taking account of the impact of the above hedge and levy arrangements, the Government's Annual Financial Statement as at 30 June 1998 included the estimated net present value of the State's future liabilities under the smelter electricity supply arrangements of \$1.3 billion (30 June 1998, \$1.3 billion) and the estimated amount receivable of \$1.1 billion (30 June 1998, \$894 million) from the levy on distribution businesses.

7.104 The value of the above liabilities and receivables as at 30 June 1999 was determined using a sophisticated valuation model developed by the SECV together with its consultants, which took into account the latest available data and associated assumptions. The major factor contributing to the net increase of \$179 million in the estimated value of future smelter levies receivable by the SECV was the use of revised discount rates in the valuation model. While in the previous year a consistent rate was used to discount all estimated future cash flows, as at 30 June 1999 individual forward estimate rates relating to each of the forward years were developed by the Department of Treasury and Finance, based on Commonwealth bond rates, and used to further refine the calculation of the receivable and the associated liabilities.

CONTINGENT LIABILITIES OF THE STATE

7.105 Contingent liabilities of the State represent potential commitments, the occurrence of which is dependent upon future events or outcomes. Such commitments, which are not required to be included as part of the liabilities of the State as disclosed in the Statement of Financial Position, 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.

7.106 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. Indemnities, on the other hand, generally impose a primary obligation on the Government to protect entities in receipt of indemnities against certain financial losses.

7.107 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.

7.108 The Government's Annual Financial Statement discloses that the estimated quantifiable contingent liabilities of the State at 30 June 1999 were around \$951 billion. In addition, various other contingent liabilities existed as at 30 June 1999, which could not be reliably quantified. These contingent liabilities are summarised in the Government's Annual Financial Statement.

7.109 Comment follows on two of the matters which give rise to contingent liabilities of the State.

Transmission of business issues

7.110 A major focus of the former Government's reform program in recent years has been the privatisation of State-owned business enterprises and the outsourcing of functions that were previously performed by Government agencies.

7.111 As a result of the outsourcing of functions, appointed contractors have often engaged staff on lesser pay rates and employment conditions than those which previously applied under awards applicable to public sector employees. Recent Federal Court decisions have indicated that, under the provisions of the Commonwealth *Workplace Relations Act* 1996, previous award rates and conditions may apply to the contractor's employees performing what were previously government functions. The application of this principle requires the transfer of part of the business (in this case from the State to the contractor) and the test that is generally applied is whether there is "substantial identity" between the activities undertaken before and after the outsourcing. If applicable, this principle would generally cause increases in employment costs for the contractor.

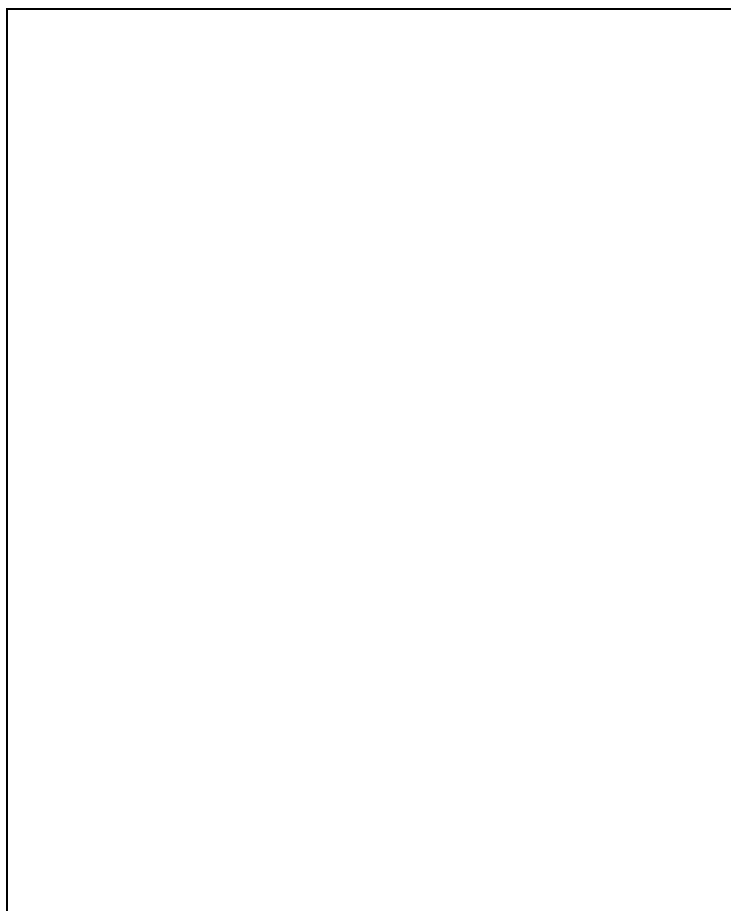
7.112 As reported in the Government's Annual Financial Statement, the Federal Court decision is subject to an application for leave to appeal to the High Court by the State. The financial implications on the State of the transmission of business provisions under the *Workplace Relations Act 1996* are therefore unclear, pending the appeal.

Melbourne City Link

7.113 Previous Auditor-General's Reports to the Parliament have 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.

7.114 The Melbourne City Link project represents one of the largest infrastructure projects ever undertaken in Australia and has an estimated total cost of around \$2 billion. 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 Monash (previously known as the South-Eastern), West Gate and Tullamarine Freeways, together with the upgrading of parts of the Monash and the Tullamarine Freeways. The key elements of the development include:

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



Western Link, including the new Bolte bridge.

7.115 The primary contractual document establishing the basis upon which the Melbourne City Link 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 incorporated the Concession Deed and was passed by the Parliament in December 1995, 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.

7.116 Under the established arrangements, once the City Link is 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, financing, 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.

7.117 A detailed audit analysis of the allocation of key project risks and responsibilities between the relevant parties revealed that, **while certain project responsibilities and risks were assumed by the State, substantial risks and exposures were also transferred to Transurban and users of the City Link.** In particular, the State has accepted certain obligations, mainly relating to the maintenance of the current overall operating environment for the project and 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.

7.118 Under the arrangements, **while the users of the City Link via toll payments will, in substance, be the financiers of the project, Transurban has accepted substantial obligations associated with the delivery and operation of the City Link, including traffic and revenue risks.**

Exhibition Street Extension project

7.119 Following the Government's announcement in May 1995 that Transurban was selected as the preferred bidder to undertake the City Link project, there was substantial interest in the development of a connection between the south-east sector of the Melbourne central business district and Batman Avenue. Subsequently, in late 1996 the Government made an in-principle decision to proceed with the Exhibition Street Extension Project and, in June 1997, the *Melbourne City Link (Further Amendment) Act 1997* was enacted to facilitate the construction and operation of the project.

7.120 At that time, the Melbourne City Link Authority issued a formal notice to Transurban, under the terms of the Melbourne City Link Concession Deed, advising the company of the changes required to facilitate the efficient integration of the Exhibition Street Extension with City Link. Furthermore, the Minister for Planning and Local Government formally announced that the Government would proceed with the extension of Exhibition Street south-east of Melbourne's central business district in two distinct parts, including:

- *Section 1* (known as the *Punt Road end*), comprising works from Burnley to Batman Avenue, east of Swan Street, with this section being developed by Transurban for inclusion in the existing City Link project; and
- *Section 2* (known as the *City end*), comprising works along Batman Avenue including the Swan Street and Batman Avenue intersection, and along a new alignment and structure over the rail-yards to Flinders Street, with this section operated by Transurban or another private sector operator on the same basis as the existing City Link project. However, the State retained responsibility for the design and construction of this section, with the operator required to make a financial contribution to the State covering its design, construction and delivery.



Exhibition Street Extension.

7.121 A detailed analysis of the arrangements established between the State and other contractual parties for the delivery and operation of the Exhibition Street Extension Project was included in the Auditor-General's *May 1999 Report on Ministerial Portfolios*.

7.122 Based on the audit analysis of the terms and conditions incorporated within the extension project documentation, audit concluded that the risks associated with the construction of the *Punt Road end* of the project are borne by Transurban.

7.123 However, under the arrangements associated with the development and operation of the *City end* of the extension, the State has accepted the construction risk, that is the risk of completion and delivery of this section of the extension within agreed completion dates and in accordance with agreed design and performance specifications. But, by virtue of the payment of an expected contract sum of \$37.5 million by Transurban to the State upon completion and delivery of the *City end* of the extension, the State aims to recoup the total cost of its design, construction and delivery. At the date of preparation of this Report, the State had received \$37 million of this sum, with the balance of \$500 000 receivable upon the completion of works at the Swan Street and Batman Avenue intersection.

7.124 As at September 1999, VicRoads acting as project manager for the Authority agreed with the builder engaged for the construction of the *City end* of the extension to 6 contract variations, resulting in a net increase of \$1.5 million in the previously agreed contract sum of \$19.6 million. These variations primarily related to changes in the scope of works in the vicinity of the Melbourne Park and Federation Square access roads, additional costs incurred by the contractor associated with reduced access to the construction site due to the acceleration of the Jolimont Rail Rationalisation program by the Public Transport Corporation and improved road pavement construction works.

7.125 These additional requirements were partially offset by reduced costs associated with the transfer of responsibility for tolling works to Transurban and reduced electrical work requirements. These variations did not impact on the project completion date and did not result in the project exceeding its overall construction budget of \$26.9 million.

Recent legislative amendments

7.126 In the period May 1999 to August 1999, the Minister for Planning and Local Government, on behalf of the State, entered into a number of amending deeds with Transurban in relation to the operation of the entire City Link, covering:

- the establishment of the necessary regulations associated with the operation of the project, mainly covering toll evasion issues;
- certain project integration issues;
- various issues relating to the charging of tolls and associated fees by Transurban;
- amendments to the Concession Deed to facilitate the opening of the Western Link without the charging of tolls; and
- termination of the construction licences for the Western Link.

Project opening dates

7.127 The estimated completion dates for the Western and Southern Links were initially assessed by Transurban to be April 1999 and December 1999, respectively. However, following a number of revisions to the completion date for the Western Link, this roadway was subsequently opened to the public without charging tolls in August 1999. Transurban has advised the Melbourne City Link Authority that the reason for delays in the tolling of the Link has been to allow final commissioning of the tolling system. **At the date of preparation of this Report, Transurban was yet to announce when system commissioning would be finalised and, as a consequence, the timing for commencement of the tolls on this part of the City Link.**

7.128 In addition, at the date of preparation of this Report, the *City end* and the *Punt Road end* (except for the Swan Street and Batman Avenue intersection) of the Exhibition Street Extension had opened on a toll-free basis, with the revised opening date for the Southern Link expected to be by mid-2000.

Costs incurred in relation to the entire project

7.129 Expenditure incurred by the Authority in relation to the total City Link project during the period ended 30 June 1995 to 30 June 1999 amounted to \$362 million, of which \$71 million related to the Exhibition Street Extension Project. The expenditure incurred to 30 June 1999 in relation to the City Link Project, excluding the Exhibition Street Extension Project, comprised \$91 million expended towards the acquisition of land, \$153 million expended towards specified State works and \$47 million for other costs, including salaries and administrative expenditure, consultancies and contractor services, and other project costs.

7.130 In relation to the cost of \$71 million incurred by the Authority for the Exhibition Street Extension Project, \$47.6 million related to the *Punt Road end* of the extension while \$23.4 million related to the *City end* of the extension. While at 30 June 1999 only an amount of \$42.5 million of the total project cost had been funded by Transurban, upon delivery of the *City end* of the extension it is anticipated that the total project cost will be met by Transurban. The Authority estimates the total expected cost for the extension at \$92.3 million, including \$63.8 million associated with the *Punt Road end* and \$28.5 million associated with the *City end*.

7.131 At 30 June 1999, the State's capital commitments in relation to the entire City Link amounted to \$28 million (30 June 1998, \$120 million), and 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 City Link project, including the Exhibition Street Extension.

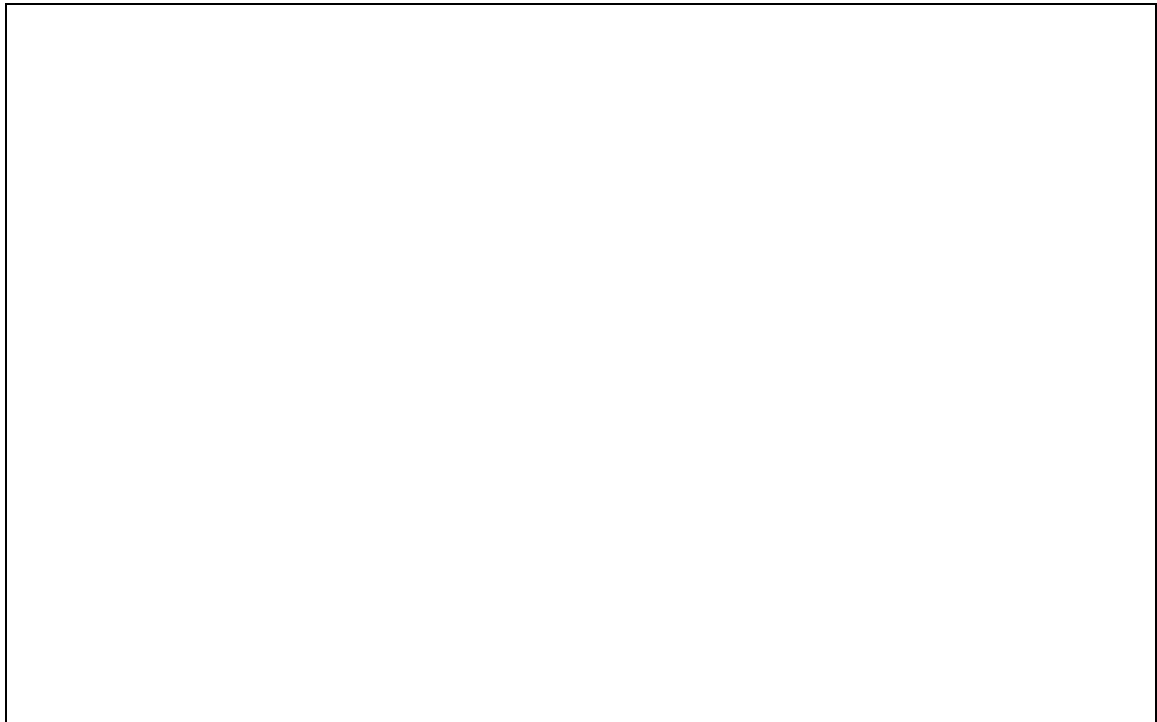
Disputes between the various parties

7.132 Since the commencement of construction works on the City Link in May 1996, Transurban has submitted various claims to the Authority for relief against the State, associated with various events which were considered to have either adversely impacted on the progress of the Melbourne City Link project or have a material adverse effect on the ability of Transurban to repay the project debt, and the level or timing of outgoings incurred or paid in respect of the project. In all cases, these claims have been rejected by the Authority as they have been assessed to involve matters associated with the design and construction contracts between the company and its contractors, to which the State is not a party.

7.133 In August 1997, Transurban served a Supreme Court writ on the State in relation to disputes that had arisen, namely:

- 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.

7.134 These matters were subsequently settled between the parties in September 1997, however either party had the right to re-instate the Supreme Court proceedings at a later time. In particular, it was resolved between the parties that, as an interim measure, the State and Transurban would pay an equal portion of the maintenance costs for the Tullamarine and South-Eastern Freeways during the construction period, and that the State would acquire the "non-project" land and share the cost of acquisition equally with Transurban.



*Western Link city entrance, Flemington Road –
poorly maintained surrounds.*

7.135 As the entire City Link project neared completion, there was a concerted effort by all parties to resolve any outstanding construction-related issues. Consequently, **in August 1999 a settlement was reached between the parties in relation to the Western Link. Under the settlement terms, the State agreed to pay Transurban and the contractors for the Western Link a total of \$10 million as full settlement of claims against the State in relation to works conducted on that section of the City Link.** These claims mainly related to cost increases associated with:

- the effect on the project of certain changes to Commonwealth and State legislation relating to industrial and workplace matters;
- delays in construction arising from the acceleration of certain design works on the Tullamarine Freeway which were required jointly by the Authority and Transurban;
- issues associated with access to licensed land, which caused operational difficulties for Transurban's contractors; and
- certain access and design issues relating to the Western Link/ Westgate Freeway interchange.

7.136 In return for the agreed settlement, the contracted parties have agreed to discharge and indemnify the State against all future claims in relation to works associated with the Western Link. The respective parties have also agreed to make the relevant adjustments to works schedules so that there will be no adjustment to the contract price for State Works associated with the Western Link.

7.137 As at the date of preparation of this Report, audit was advised by the Authority that negotiations were continuing between the parties in relation to claims associated with the Southern Link. In addition, the Authority advised that there were no disputes specifically relating to the Exhibition Street Extension project.

OTHER FINANCIAL COMMITMENTS OF THE STATE

7.138 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 1999, the public sector had financial commitments relating to operating leases and works not performed under existing contracts, valued at \$2.7 billion (1997-98, \$2.9 billion) including:

- operating lease commitments of \$1.4 billion; and
- capital expenditure commitments of \$1.3 billion.

7.139 However, as highlighted earlier in this Report and in previous Reports to the Parliament, the above amounts do not include the State's commitments under all outsourcing contracts entered into to provide services to Victorian taxpayers, such as contracts relating to the provision of information technology and health services.