

VICTORIA

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Auditor General

Victoria

# Results of special audits and other investigations

*August 2006*

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AUDITOR GENERAL  
VICTORIA

The Hon. Monica Gould MP  
President  
Legislative Council  
Parliament House  
MELBOURNE

The Hon. Judy Maddigan MP  
Speaker  
Legislative Assembly  
Parliament House  
MELBOURNE

Dear Presiding Officers

I am pleased to forward this report to you for presentation to each House of Parliament, pursuant to section 16AB of the *Audit Act 1994*.

This report sets out the results of a number of special audits and other investigations undertaken up to the date of preparation of the report.

Yours faithfully

JW CAMERON  
*Auditor-General*

23 August 2006

# Foreword

This report contains the results of 5 recently completed special audits and other investigations.

The first 2 audits examine the delivery of intended improvements to Victoria's regional rail system, including:

- introduction of fast rail services to regional centres
- conversion of Victorian regional freight lines to a common, standard gauge compatible with the national rail network.

Following the completion of feasibility studies in 2000, the government approved funding to convert 13 freight lines to standard gauge, and to upgrade rail lines to provide fast rail passenger services between Melbourne and Ballarat, Bendigo, Geelong and Traralgon. This report examines the adequacy of the planning and management of these initiatives.

We report that none of the targeted rail lines were converted to standard gauge by the government's deadline of late 2005. While fast rail infrastructure upgrades were delivered to the fast rail corridors by the middle of 2006, they were between 9 and 19 months behind schedule, and are only expected to deliver modest journey time savings for most travellers. The expected costs of both these initiatives had significantly exceeded initial budget estimates.

The remaining 3 audit investigations outlined in this report examine matters drawn to my attention by external parties, about:

- the financial support provided by the state to the developer of the Docklands film and television studios, including the extent to which the expected outcomes of this project are being achieved
- aspects of administration and management at the Westernport Region Water Authority
- the extent to which the state's interests associated with the provision of public funding are protected by the funding and service agreements established between the Department of Human Services and non-government organisations.

The report identifies opportunities for improvement in each of the areas examined, and makes recommendations to strengthen the audited agencies' practices and performance. While the findings and recommendations are primarily directed towards the specific agencies examined, they also provide useful insights and lessons to be learned for other agencies with similar activities.



JW CAMERON  
*Auditor-General*

23 August 2006

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# 1. Executive summary



## 1.1 Introduction

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This report sets out the results of 5 special audits which examine:

- the management of 2 major rail transport initiatives by the Department of Infrastructure (DoI), namely, the delivery of regional fast rail services and the rail gauge standardisation project
- the status of the state's interest in the Docklands film and television studios, including the extent to which the expected outcomes of this project are being achieved
- various aspects of administration and management at the Westernport Region Water Authority
- the extent to which the state's interests associated with the provision of public funding are protected by the funding and service agreements established between the Department of Human Services and non-government organisations.

The major conclusions from these audits are presented below.

## 1.2 Overall conclusions

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### 1.2.1 Delivering regional fast rail services

Following a pre-1999 election commitment by the government to consider the feasibility of introducing fast rail services to regional centres, and the completion of related feasibility studies, in 2000 the government approved funding to upgrade rail lines to provide fast rail passenger services between Melbourne and Ballarat, Bendigo, Geelong and Traralgon.

Delivering regional fast rail services required the coordination of several related activities. These activities included upgrading the rail infrastructure; providing new, faster trains; installing a fibre optic cable network as the backbone of an upgraded signalling system; designing a new timetable; and improving connecting regional bus services. We examined how well this initiative was managed by DoI.

We found that the delivery of more frequent fast rail services in the Geelong, Ballarat, Bendigo corridors by the agreed dates was not achieved. The Latrobe Valley corridor fast rail services are planned to commence in September 2006.

## **Fast rail initiative costs**

In December 2004, DoI estimated the cost of delivering the rail infrastructure upgrade to be \$750.5 million, some \$194.5 million greater than the original estimate of \$556 million (actual expenditure to April 2006 was \$696.3 million).

The costs for other components necessary to deliver fast rail services (not forming part of the above estimates) included:

- \$46.6 million to upgrade 29 slower, 2-car trains ordered under the 1999 V/Line Passenger franchise agreement
- \$33 million to extend the new train safety system on the fast rail corridors
- an additional \$16.1 million cost for the fibre optic cable used for fast rail signal communications (this is an estimate of the share of the total cost of \$21.5 million)
- an additional \$72.5 million over 7 years that V/Line Passenger would need to operate fast rail services.

The Rail Project Group (RPG), jointly sponsored by DoI and the Department of Treasury and Finance, did not adequately develop the rail infrastructure upgrade budget and most of the budget increase is directly attributable to the inadequate design specifications. Both the RPG, during the development phase and DoI, during the delivery phase, incorrectly left out additional costs that were directly linked to the delivery of fast rail services.

## **Timelines**

Up until June 2006, V/Line Passenger was aiming to introduce a fast rail timetable in July 2006 on 3 corridors, and at a later date on the Latrobe Valley corridor. DoI has not finalised the timetable for the 4 corridors, and the introduction of fast rail services will be delayed beyond the end of July 2006.

DoI was unable to manage the infrastructure upgrade to agreed timelines. The rail infrastructure upgrade completion dates are between 9 and 19 months behind schedule. The timelines set for the completion of the infrastructure upgrade, at the time that the contracts were signed, were clearly unrealistic and this should have been understood at the time.

## **Feasibility studies report and the recommendation to proceed**

DoI's advice to government in September 2000 recommending approval and funding of the rail infrastructure upgrade was incomplete and contributed to some of the delays in timing and cost overruns that emerged during construction. The cost-benefit analysis included in the project feasibility studies report overestimated the benefits and underestimated the costs of the upgrade.

## **Infrastructure upgrade contracts**

The primary cause of the time delays and additional costs was the lack of proper planning, and failure to reach agreement on key design issues with stakeholders, including Freight Australia Limited and the Director of Public Transport Safety before the construction contracts were awarded.

The state awarded fixed-fee contracts requiring the development of final, accredited infrastructure designs, and construction of the infrastructure in accordance with the final accredited design. A fixed-fee contract, incorporating a design component, was inherently high risk in the circumstances where the design at the time was only conceptual and other stakeholders were able to enforce changes to the scope and amend previously agreed design decisions.

Most of the delays and cost increases can be directly linked to scope changes that mostly arose from legitimate stakeholder concerns about the ability of the design to meet passenger needs and safety requirements.

## **Absence of an integrated approach to planning and delivering regional fast rail services**

To achieve the faster and more frequent train services to the communities along the 4 corridors, a number of dependent activities were required:

- new, faster trains and improved infrastructure, together providing the potential for train services to achieve faster, more frequent journey times
- timetables through which this potential is translated into services that best meet passengers' needs and expectations.

In November 2001, the government announced the planned purchase of 29, 2-car high-speed trains for the delivery of the first trains from the end of 2004 with final delivery in late 2006. Had the completion dates for the rail infrastructure works of between March 2004 and June 2005 been achieved, the new trains would not have been available. The acquisition of new rolling stock was a requirement of the franchise agreement entered into by the previous government for V/Line Passenger Services in 1999.

Up until the infrastructure contracts were awarded in June 2002, DoI, during the feasibility phase, and the RPG, during the development phase, had done little to develop a proposed timetable. The timetable development was not well-integrated with other aspects of the fast rail initiative, and for a considerable time focus was on the infrastructure upgrade before DoI gained a full understanding of the market's needs. The timetable development should, in our view, have occurred in parallel and informed the infrastructure upgrade decisions.

### **Outcomes for passengers**

The objective of the infrastructure upgrades was to achieve journey times across the country sections of the fast rail corridors which meant that an express train service could be scheduled to meet the government's journey time targets. Timed, non-stop journeys on the Ballarat, Bendigo and Geelong corridors confirmed that the combination of the upgraded infrastructure and new trains could deliver these target journey times. The proving of this capability for the Latrobe Valley corridor is set to take place in August 2006.

The infrastructure upgrades deliver the capability to achieve the government's targets if the trains run express with very few stops. The actual outcomes for passengers depend on how these capabilities are translated into timetabled services.

We compared the draft fast rail timetables of July 2006 with the last timetables where services were unaffected (July 2004). The final timetables may be different from these draft timetables as DoI continues to refine the fast rail services before they commence operation. The July 2006 draft timetables were not available for the Latrobe Valley corridor, and we used the previous drafts publicly released by the government in December 2004.

The draft timetables deliver a significant increase in the number of weekday and weekend train services between the regional centres of Ballarat, Bendigo, Geelong and Traralgon and Melbourne. The timetables also extend the hours during which services run on these corridors.

The timetables also deliver the government's express journey times on all the fast rail corridors. However, the average journey time improvements between the regional centres and Melbourne are more modest because in all cases less than 7 per cent of trains achieve these target, express times.

We looked at the impacts of the draft timetables on the travel outcomes for intermediate stations along the 4 corridors for travel to Melbourne in the morning peak period. For those using these intermediate stations, most of the benefits come in the form of an extra one or 2 peak train services, although not all stations will receive extra services. The journey time savings for these travellers will be at best modest and, in most cases, negligible.

In total, the journey time outcomes will be more modest than we would have expected with only a minority of travellers likely to benefit from significant journey time improvements. These outcomes occur because giving some passengers full express services means bypassing often large numbers of passengers at intermediate stations along the corridors.

On all corridors, the majority of passengers using fast rail services do not travel to the ends of the fast rail corridors. So, in terms of meeting the needs of all passengers, it is likely that only a handful of trains will run as full express services and achieve the government's journey time targets.

While the draft and final timetables are likely to increase the number of train services at most stations, average journey time savings for all passengers using these services are likely to be more modest than foreshadowed by the government's target journey times.

### **DoI initiatives to improve its management capability**

This audit examined DoI's development, planning and management of this initiative between 2000 and 2006. An external review of transport planning, project development and delivery within DoI in late 2001 concluded that it did not have sufficient resources to undertake adequate project development work.

In response, DoI continues to take action and has introduced a range of initiatives to address this weakness and improve its project management capability. These actions and initiatives should, over time, enhance DoI's capability to plan, develop and deliver major capital works projects.

## **1.2.2 Rail Gauge Standardisation Project**

We examined how well DoI has planned and managed the rail gauge standardisation project, which aims to convert 13 prioritised broad gauge Victorian freight lines across 4 rail corridors to standard gauge.

We report that the government's May 2001 commitment to convert the 13 prioritised freight lines to standard gauge by late 2005 has not been achieved. Expenditure to 28 February 2006 (\$14.2 million) has largely involved project development and management costs and purchase of materials. At the time of preparing this report, no physical work had commenced on any of the originally announced line conversions.

In January 2003, DoI estimated the full risk-adjusted cost of the Rail Gauge Standardisation (RGS) Project to be more than double the original 2000 estimate of \$140 million, and the expected benefits to the state to be less than half the original 2000 estimate. Based on work undertaken for DoI by external specialists in 2004-05, the estimated cost to standardise lines in the 4 rail corridors is now around \$359 million.

DoI's advice to government in 2000-01 recommending approval and funding of the project was incomplete and directly led to many of the issues concerning cost and timing that emerged later. The feasibility study prepared for the project in October 2000 did not provide an adequate basis for DoI's recommendation to government to approve the project and allocate funding. The government approved the project in March 2001 before detailed scoping and costing had been done, and before critical operational and financial issues had been resolved. Furthermore, a rigorous cost-benefit analysis had not been undertaken at the time of government approval. These issues presented significant risks to project delivery.

A number of the rail corridors approved for conversion do not meet the test of "where cost-effective and practical" as provided for in the government's 2000 *Linking Victoria* initiative.

The most crucial factor in successful implementation and delivery of the RGS project is the cooperation of the private sector party which controls the state's broad gauge intrastate regional rail network. The project involves the state changing rail infrastructure assets controlled by the private sector. Under lease arrangements entered into in 1999, control over these assets passed to Freight Australia (now Pacific National). The initial intrastate lessee (Freight Australia) has adopted a commercial position which largely negated the state's ability to advance the project under the existing lease agreement.

Over the period in which DoI has been seeking to progress the RGS project, it has also been undertaking a number of other major rail projects. These projects, together with the RGS project, have all involved ongoing complex commercial negotiations with the intrastate rail infrastructure lessee.

Despite a protracted period of negotiation following approval of the RGS project in March 2001, DoI has not reached agreement with the intrastate regional rail infrastructure lessee on the project scope, or arrangements for access to rail track to enable work to commence on the project. For this reason, since early 2003, DoI has attempted instead to progress components of the project as separate stand-alone projects.

Some (\$2.5 million) of the \$5.7 million of materials purchased to date for the RGS project are proposed to be used on the Port of Geelong Rail Access Improvement Project.

The government has periodically considered the status and progress of the RGS project and, in May 2003, announced that it had been delayed. Most recently, in mid-2005, the status of the project was considered but no decision to change the original scope or timetable for the project has been announced. DoI's website continues to indicate that all 13 prioritised broad gauge lines (announced in 2001 to be converted to standard gauge) will be converted.

There is a need for a decision on the future of the project in the context of other rail projects and commitments announced by government which impact on the regional rail network.

### 1.2.3 Docklands film and television studios - Status of state's interest

#### Increased state support for the studios

In November 2004, the government entered into new contractual arrangements with the developer of the Docklands film and television studios (Melbourne Central City Studios Pty Ltd) to supplement the original contracts agreed in September 2002. Under the original contracts, the developer was to build and operate film and television studios and a surrounding commercial development at Melbourne's Docklands precinct. The government loaned the developer \$31.5 million to build the studios.

The new arrangements significantly increased the support provided by the state to the developer. The department responsible for managing the state's interest in the studios – the Department of Industry, Innovation and Regional Development (DIIRD), advised that the new arrangements aimed to assist the developer to be more competitive in the global market, primarily through increased investment in enhanced studio facilities. They comprised:

- a new state guarantee of the developer's \$14.5 million borrowings, the repayment of which takes precedence over the state's loan

- deferral of the repayment of the state's loan by a further 2 years (to February 2008<sup>1</sup>), with interest accrued over the 2-year period added to the loan principal amount
- suspension of lease payments to the state for the studio site for the first 3 years of the new arrangements, which will become payable by the developer over the following 6 years
- deferral of the start of construction of the supporting commercial development (by 1½ years, to December 2005<sup>2</sup>)
- funding for an improved perimeter fence for the studios
- charging a peppercorn rent for the use of certain crown land, and transfer of ownership of a warehouse on that land to the developer.

In return, the state strengthened its position in relation to the studios by receiving a right to appoint an administrator or receiver for the studios under certain circumstances. Further, the developer has committed to increasing its equity in the studios by \$2.5 million.

We found that DIIRD did not assess the likelihood that the state would have to pay out or take over the developer's \$14.5 million borrowing. Neither did it assess how the new contracts would affect the likely extent of repayment of the state's original \$31.5 million loan by the developer, prior to entering into the new arrangements. Consequently, DIIRD did not brief the minister about these matters before executing the new contracts.

We considered that this represented a significant shortcoming in the advice provided to the minister in support of the decision to enter into the new arrangements with the developer. Nevertheless, DIIRD did seek independent legal, industry and commercial advice about other aspects of the changed arrangements prior to briefing the minister and included that advice (together with its assessment of project risks) in its briefing to the minister. DIIRD advised us that its overriding consideration was to ensure that the project was best placed to achieve the state's industry development goals.

### **DIIRD's monitoring and management of studios' performance**

DIIRD's management regime for the studios has several positive elements. These include the development of a detailed contract administration manual to help guide its internal management arrangements, and a good working relationship with studio management.

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<sup>1</sup> The original 2002 contractual arrangements had already provided that repayment of the state's loan would not commence until 2 years after completion of the construction of the studios, that is February 2006 (subject to the studios being sufficiently profitable at that time).

<sup>2</sup> DIIRD subsequently extended this deadline in December 2005 by another 6 months, to June 2006.

However, we found that evidence detailing the results of DIIRD's review of periodic operational and performance information provided by the developer, including the conclusions reached and action taken, was not always available.

DIIRD did not require the developer to comply with the contractual requirements to prepare business plans on a financial year basis, which made comparisons of budget forecasts with actuals difficult. It also did not require the developer to prepare certain other financial and operational information. This meant that DIIRD did not have all the information it was contractually entitled to during 2004 when it advised the minister to enter into the new arrangements with the developer. DIIRD advised us that it undertook ongoing monitoring of the studios' performance during 2004 as part of its intense negotiations with the developer about the proposed new arrangements.

At the time of our audit, DIIRD had not exercised its contractual right to audit the studios to confirm compliance with the contracts and the key performance indicators (such as the utilisation rates and levels of production spend). In our opinion, it should have done so in order to verify the developer's reports to the department.

### **Performance against the key performance indicators**

We consider that the developer has not achieved 3 of the 7 performance indicators included in the contractual arrangements (relating to the developer not having recourse to any further funding from the state and the level of minimum additional film and television production spending in Victoria). This is because the state is now exposed to the risk of having to provide up to \$14.5 million in extra funding to the project (on top of the other financial concessions it has made) and the sound stages have not serviced film and television productions having an additional production spend in Victoria of at least \$100 million, or serviced Australian productions of at least \$25 million.

We could not assess performance against 2 of the other indicators (relating to whether the studio complex is regarded as an integrated world class facility that provides for an expanded and more efficient and effective film and television production sector in Victoria), mainly because DIIRD had not gathered sufficient and appropriate evidence to assess them. The remaining 2 indicators (relating to studio utilisation rates and the operation of an open access policy) appear to have been met, but we base this conclusion on evidence provided by the developer which had not been verified by DIIRD.

While we acknowledge that the studios are still in their start-up phase, our review of the studios' 2004-05 financial statements identified several indicators of poor financial performance or position.

The developer is now projecting, for the period 2006 to 2011, substantially lower operating profits than it had in the 2002 contracts. The developer has made these major reductions in forecast net profit due to a downturn in television and film production during 2003-04. Consequently, we estimate that only around \$12 million of the state's \$33.4 million loan (including the original loan amount of \$31.5 million and estimated capitalised interest totalling \$1.9 million) to the developer may be repaid over the 20-year term of the loan. In these circumstances, the contracts provide that ownership of the studios would transfer to the state at the end of the 20-year loan term (unless the developer elected at that time to fully repay the state's loan and either opted to purchase the site from the state or sought to extend the site lease for a further 10 years at market rates).

#### **1.2.4 Westernport Region Water Authority - Investigation of aspects of the authority's management**

We investigated a number of allegations referred to our Office by the Ombudsman of Victoria<sup>3</sup>, concerning aspects of management and administration at the Westernport Region Water Authority. The allegations related to:

- the taxation treatment of certain employment arrangements for some senior staff
- certain unauthorised changes to the authority's financial statements
- the management of personnel
- the use of credit cards
- certain accounting practices adopted by the authority
- the appropriateness of the authority's involvement in what was alleged to be "non-core" business, such as its involvement in natural gas reticulation in the area.

We found that some of the allegations made by the whistleblower were unproven. In other cases, we were unable to conclusively form an opinion on the validity of allegations due to the lack of documentary evidence to support either the whistleblower's claims or the views expressed by management.

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<sup>3</sup> These allegations were made to the Ombudsman under the *Whistleblowers Protection Act 2001*.

We concluded that there were areas where the authority needed to improve its policies and management procedures in place during the period subject to review. Required improvements included:

- strengthening of monitoring and approval processes over the authority's annual financial statements
- continuing action to address staff-related issues (as evidenced by the results of staff surveys conducted by the authority and from issues raised by certain staff during discussions with us during our audit)
- strengthening control over the use of credit cards issued to senior staff, and the reimbursement of expenditure, to ensure all expenditure is appropriately approved and is adequately supported by documentation.

The authority highlighted that our findings related to a period of extensive change for the authority and its staff, and should be considered in that context. Nevertheless, the authority advised that it has actioned and continues to refine a range of measures to implement the above improvements.

From a broader perspective, our review identified that the overall performance of the authority has been sound and improving over the last 6 years, particularly relating to financial management and the strengthening of its overall financial position. During this period, improved financial management has resulted in consistently strong financial performance, improved risk management, documented policies and procedures, and the discontinuation of unacceptable work practices. Other areas where the authority's performance has improved includes:

- strategic planning, as evidenced by the authority's comprehensive corporate, business and water plans
- improved customer service, as demonstrated in its strong customer survey results
- new processes to better manage staff, including the authority's employee performance management system and its "Better Teams" program.

### **1.2.5 Accountability for public funds provided to a non-government organisation**

In response to an external inquiry, we reviewed the actions taken by the Department of Human Services (DHS) to recover publicly-funded assets from South Gippsland Community Support Service Inc., a non-government not-for-profit entity, following termination by DHS in April 2003 of the funding and service agreement with the community support service.

We identified that some of the public funds received by the community support service had not been accounted for fully and that certain assets sourced from public funds, including 4 motor vehicles, were not returned to DHS by the community support service in accordance with the requirements of the funding and service agreement.

Based upon DHS's difficulty in obtaining information, and protecting and recovering assets from the community support service, it is our view that the funding and service agreements between DHS and non-government organisations need to be enhanced to facilitate ongoing access by DHS following termination of such agreements with agencies. In particular, DHS needs to be able to obtain access to undertake its own review of the operations of a non-government organisation following the termination of a funding and service agreement.

## 1.3 General

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The audits and investigations included in this report were performed in accordance with Australian auditing standards. The total cost of the audits and investigations, including the preparation and printing of this report, was \$700 000.

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## 2. Delivering regional fast rail services



## 2.1 Audit conclusion

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The delivery of more frequent fast rail services in the Geelong, Ballarat, Bendigo corridors by the agreed dates was not achieved. The Latrobe Valley corridor fast rail services are planned to commence in September 2006.

Delivering regional fast rail services required the coordination of several related activities. These activities included upgrading the rail infrastructure; providing new, faster trains; installing a fibre optic cable network as the backbone of an upgraded signalling system; designing a new timetable; and improving connecting regional bus services.

The delivery of fast rail services was progressed in 3 phases:

- Feasibility phase: the Department of Infrastructure (DoI) assessed the economic viability to inform the government's decision to proceed.
- Development phase: the Rail Projects Group (RPG) was formed under the joint governance of the Department of Treasury and Finance (DTF) and DoI. It developed a commercial and legal framework, culminating in the acceptance of contracts to design and construct the rail infrastructure upgrade.
- Delivery phase: DoI implemented the infrastructure upgrade and the other activities needed to deliver fast rail services.

### 2.1.1 Fast rail initiative costs

In December 2004, DoI estimated the cost of delivering the rail infrastructure upgrade to be \$750.5 million, some \$194.5 million greater than the original estimate of \$556 million (actual expenditure to April 2006 was \$696.3 million).

The costs for other components necessary to deliver fast rail services (not forming part of the above estimates) included:

- \$46.6 million to upgrade the 29 slower, 2-car trains ordered under the 1999 V/Line Passenger franchise agreement
- \$33 million to extend the new train safety system on the fast rail corridors
- the additional \$16.1 million cost of the fibre optic cable used for fast rail signal communications (this is an estimate of the share of the total cost of \$21.5 million)
- the additional \$72.5 million over 7 years that V/Line Passenger would need to operate fast rail services.

The RPG did not adequately develop the rail infrastructure upgrade budget and most of the budget increase is directly attributable to the inadequate design specifications. Both the RPG, during the development phase and DoI, during the delivery phase, incorrectly left out additional costs that were directly linked to the delivery of fast rail services.

### **2.1.2 Timelines**

Up until June 2006, V/Line Passenger was aiming to introduce the fast rail timetable in July 2006 on 3 corridors, and at a later date on the Latrobe Valley corridor. DoI has not finalised the timetable for the 4 corridors, and the introduction of fast rail services will be delayed beyond the end of July 2006.

In terms of the timelines, the rail infrastructure upgrade completion dates are between 9 and 19 months behind schedule. The timelines set for the completion of the infrastructure upgrade, at the time that the contracts were signed, were clearly unrealistic and this should have been understood at the time. Accordingly, DoI was unable to manage the infrastructure upgrade to the agreed timelines.

### **2.1.3 Feasibility studies report and the recommendation to proceed**

DoI's advice to government in September 2000 recommending approval and funding of the rail infrastructure upgrade was incomplete and contributed to some of the delays in timing and cost overruns that emerged during construction. The cost-benefit analysis included in the project feasibility studies report overestimated the benefits and underestimated the costs of the upgrade.

While the cost-benefit analysis was substantially consistent with DoI guidelines in place at the time, in our view the analysis made a number of incorrect assumptions and calculations. A number of the components of the guidelines used at the time have now been changed.

### **2.1.4 Infrastructure upgrade contracts**

The primary cause of the time delays and additional costs was the lack of proper planning, and failure to reach agreement on key design issues with stakeholders, including Freight Australia Limited (FAL) and the Director of Public Transport Safety (DPTS) before the construction contracts were awarded.

The state awarded fixed-fee contracts requiring the development of final, accredited infrastructure designs, and construction of the infrastructure in accordance with the final accredited design. A fixed-fee contract, incorporating a design component, was inherently high risk in the circumstances where the design at the time was only conceptual and other stakeholders were able to enforce changes to the scope and amend previously agreed design decisions.

Most of the delays and cost increases can be directly linked to scope changes that mostly arose from legitimate stakeholder concerns about the ability of the design to meet passenger needs and safety requirements.

The accreditation process included in the alliance agreement was not an adequate mechanism to manage the volume of scope and design changes generated by the stakeholders, including the independent DPTS.

### 2.1.5 Absence of an integrated approach to planning and delivering regional fast rail services

To achieve the faster and more frequent train services to the communities along the 4 corridors, a number of dependent activities were required:

- new, faster trains and improved infrastructure, together providing the potential for train services to achieve faster, more frequent journey times
- timetables through which this potential is translated into services that best meet passengers' needs and expectations.

In November 2001, the government announced the planned purchase of 29, 2-car high-speed trains for the delivery of the first trains from the end of 2004 with final delivery in late 2006. Had the completion dates for the rail infrastructure works of between March 2004 and June 2005 been achieved, the new trains would not have been available. The acquisition of new rolling stock was a requirement of the franchise agreement entered into by the previous government for V/Line Passenger services in 1999.

Up until the infrastructure contracts were awarded in June 2002, DoI, during the feasibility phase, and the RPG, during the development phase, had done little to develop a proposed timetable. The timetable development was not well-integrated with other aspects of the fast rail initiative, and for a considerable time focus was on the infrastructure upgrade before DoI gained a full understanding of the market's needs. The timetable development should, in our view, have occurred in parallel and informed the infrastructure upgrade decisions.

### 2.1.6 Outcomes for passengers

The objective of the infrastructure upgrades was to achieve journey times across the country sections of the fast rail corridors which meant that an express train service could be scheduled to meet the government's journey time targets. Timed, non-stop journeys on the Ballarat, Bendigo and Geelong corridors confirmed that the combination of the upgraded infrastructure and new trains could deliver these target journey times. The proving of this capability for the Latrobe Valley corridor is set to take place in August 2006.

The infrastructure upgrades deliver the capability to achieve the government's targets if the trains run express with very few stops. The actual outcomes for passengers depend on how these capabilities are translated into timetabled services.

We compared the draft fast rail timetables of July 2006 with the last timetables where services were unaffected by the project (July 2004). The final timetables may be different from these draft timetables as DoI continues to refine the fast rail services before they commence operation. The July 2006 draft timetables were not available for the Latrobe Valley corridor, and we used the previous drafts publicly released by the government in December 2004.

The draft timetables deliver a significant increase in the number of weekday and weekend train services between the regional centres of Ballarat, Bendigo, Geelong and Traralgon and Melbourne. The timetables also extend the hours during which services run on these corridors.

The timetables also deliver the government's express journey times on all the fast rail corridors. However, the average journey time improvements between the regional centres and Melbourne are more modest because in all cases less than 7 per cent of trains achieve these target, express times.

We looked at the impacts of the draft timetables on the travel outcomes for intermediate stations along the 4 corridors for travel to Melbourne in the morning peak period. For those using these intermediate stations, most of the benefits come in the form of an extra one or 2 peak train services, although not all stations will receive extra services. The journey time savings for these travellers will be at best modest and in most cases negligible.

In total, the journey time outcomes will be more modest than we would have expected with only a minority of travellers likely to benefit from significant journey time improvements. These outcomes occur because giving some passengers full express services means bypassing often large numbers of passengers at intermediate stations along the corridors.

On all the corridors, the majority of passengers using fast rail services do not travel to the ends of the fast rail corridors. So, in terms of meeting the needs of all passengers, it is likely that only a handful of trains will run as full express services and achieve the government's journey time targets.

While the draft and final timetables are likely to increase the number of train services at most stations, average journey time savings for all passengers using these services are likely to be more modest than implied by the government's target journey times.

### 2.1.7 DoI initiatives to improve its management capability

This audit examined DoI's development, planning and management of this project between 2000 and 2006. An external review of transport planning, project development and delivery within DoI in late 2001 concluded that it did not have sufficient resources to undertake adequate project development work.

In response, DoI continues to take action to address this weakness and improve its project management capability. These include establishing:

- *Project managing at DoI*, a project to set up protocols, guidelines and supporting systems for project management by DoI
- the Project Review Committee which aims to ensure greater rigour in the planning, development and costing of all major infrastructure projects
- the Capital Subcommittee, which monitors all capital projects following approval by the Project Review Committee and, in particular, those projects involving major capital expenditure or major risk
- the Project Governance and Review Group, which monitors and reviews all DoI projects from initial selection to the implementation and achievement of project outcomes
- guidelines for estimating costs, evaluating risks and the assembly of a business case.

These initiatives should, over time, enhance DoI's capability to plan, develop and deliver major capital works projects.

***RESPONSE provided by the Acting Secretary, DoI***

*DoI appreciates the opportunity to provide comment on the Auditor-General's review of the Regional Fast Rail (RFR) project.*

***Context***

*When the current government was elected in late 1999, there was a major policy shift with regards to the rail sector. The new government made a number of policy commitments during the election period, including the delivery of fast rail services to Geelong, Ballarat, Bendigo and the Latrobe Valley (this project), and the examination of other rail initiatives.*

*This was in contrast to the previous decade or more, during which there had been progressive institutional and structural change in the rail sector – with no comparable major rail infrastructure projects being undertaken and against a background of limited financial resources. This period culminated during 1999 in the selection of private franchisees to operate the metropolitan and regional train services, and the metropolitan tram services.*

*It is thus not surprising that there were limited resources and expertise – in both the public and the private sectors – to utilise in the early development of this project. The report acknowledges in part 2.1.7 the actions taken by DoI to increase its project management capability since 2002.*

***Feasibility studies***

*The audit report provides considerable details regarding the feasibility work undertaken by DoI, recognising in part 2.3.4 that “In August 2000, DoI advised government that the feasibility studies report estimates were preliminary and required a substantial amount of additional technical investigation to firm up the costs and related travel times.”*

*The 2000 feasibility work was completed using accepted cost-benefit methodology in accordance with the prevailing project evaluation standards of that time. The Auditor-General's report recognises that the work was substantially consistent with guidelines in place at that time, and also that a number of the guideline components have now been changed.*

*Therefore, it is erroneous for the Auditor-General to conclude that the studies provided an inadequate basis for a recommendation to government to approve the project and allocate the funding, particularly when the government had already committed to the project and it was only one of several inputs into the decision.*

***RESPONSE provided by the Acting Secretary, DoI - continued******Safety***

*Bidders for the RFR project were required to propose a safety system to ensure that the rail system was “no less safe” with the increased speed proposed under RFR. Both successful bidders proposed implementing the Train Protection Warning System (TPWS) on the sections of track approved for speeds in excess of 130 kph and on the new rolling stock.*

*A review of the TPWS by the Public Transport Safety Regulator in late 2003, after the 2001 Waterfall accident in NSW and other incidents in Australia and overseas, resulted in the Regulator issuing a draft TPWS policy. Under this draft policy, implementation of TPWS was extended to apply to all passenger trains and to significantly extended areas of track. The changes required as a result of the draft TPWS policy could not have been foreseen (as they were the consequence of incidents that occurred after the initial scoping of the RFR project) and came at a critical stage of the project. The required retro-fitting created significant cost and time impacts through redesign, additional signalling work by the contractors and in delay costs as recognised in part 2.5.2 of the report. Accordingly, a higher level of train protection will operate when fast services commence, than was envisaged in 2000.*

***Additional work required***

*Once the contractors commenced detailed site surveys, it was clear that the infrastructure was in a substantially more degraded state than originally understood. Extensive works were required to rectify and improve the condition of the regional rail infrastructure.*

*An Alliance Agreement with Freight Australia, the track lessee, was entered into in recognition of the project complexities and the contractual obligations as specified in the Primary Infrastructure Lease (PIL).*

*Notwithstanding the agreement, Freight Australia was able to expand the scope of the project to secure other enhancements which created cost and time impacts for the infrastructure works.*

***Timetable development***

*The audit report is critical that the development of a timetable for the new services did not occur earlier. DoI has a different view. Over the life of particular rail infrastructure, there will be many different timetables, in response to changing community requirements and patronage numbers. It would be a major mistake to tailor the infrastructure to a particular timetable; the infrastructure needs to be designed and constructed to be able to cater for a range of timetables over time.*

***RESPONSE provided by the Acting Secretary, DoI - continued***

*In addition, the audit report overlooks the extensive customer research and community consultation with some 10 000 regional customers that underpins the new timetable. The timetable responds to customer and community needs for more services at more convenient times and over more hours of the day, both during the week and on weekends. Although not a part of the project scope, many of the new stopping services will also achieve reduced travel times from intermediate stations. The new timetable has delivered 401 additional rail services, an increase of 41 per cent in services to major regional centres.*

***Outcome for passengers***

*The original concept of the Regional Fast Rail project in 1999 was to provide a limited number of express higher-speed rail services between Victoria's 4 main regional centres (Geelong, Ballarat, Bendigo and the Latrobe Valley) and Melbourne to promote regional and social development.*

*The audit report notes in part 2.1.6 that DoI has delivered the capability to achieve the target travel times set by the government for point-to-point travel between Melbourne and each of the 4 regional centres, thus achieving the original aim of the project.*

*The audit report mentions in passing another major benefit of the project – the major increase in the number of rail services – but in considering the outcome for passengers, concentrates almost exclusively on travel times. The new regional timetables announced by the government early this month (August 2006) include an additional 401 services per week to regional centres (305 of these services are to the Regional Fast Rail centres), which will become operational from September 2006. These additional services include weekday and weekend services. For weekdays, the additional services include additional peak hour services, additional early morning, day time and evening services, including later evening services, and for the Ballarat and Bendigo corridors, new earlier counter peak services.*

*This enhanced rail capacity now allows regional passengers to continue their end-to-end journey anywhere within zone 1 in Melbourne at no extra cost.*

***RESPONSE provided by the Acting Secretary, DoI - continued***

*Given the maintenance backlog that became evident as the RFR work proceeded, without this project, the future of ongoing regional passenger rail services over the next decade or so would have been in doubt. Again, the audit report does not reflect this in considering the benefits to passengers. The delivery of RFR services has provided additional benefits to the Victorian community greater than was previously envisaged at the time the project was initiated. It represents an inter-generational upgrade for an essential part of Victoria's rail network. It has delivered a world class rail service, incorporating the latest safety and communications technologies, modern, comfortable and fast trains and a historic increase in the frequency of services across the regional network.*

## 2.2 Background

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### 2.2.1 Introduction

Reliable and efficient transport services are vital to linking Melbourne and regional Victoria.

Nearly 6 million passengers are carried each year on the Bendigo, Ballarat, Geelong and Latrobe Valley rail corridors. Communities in these regions have a combined population of more than half a million people and represent 40 per cent of Victoria's rural and regional population. Their travel opportunities are limited by ageing rolling stock and by rail infrastructure that could not support fast rail operation. The objective of the fast rail initiative was to improve rail services to help overcome many of the obstacles to growth in regional Victoria, and provide a major boost to its economy, population, employment and quality of life<sup>1</sup>.

Delivering regional fast rail services required the coordination of several related activities. These activities included upgrading the rail infrastructure: providing new, faster trains; installing a fibre optic cable network as the backbone of an upgraded signalling system; designing a new timetable; and improving connecting regional bus services.

Throughout this report, we use the term "fast rail initiative" to describe the whole set of related activities required to deliver fast rail services to the travelling public. Otherwise, we specify the part of the overall initiative we are dealing with at any point within the report.

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<sup>1</sup> Regional Fast Rail, Invitation for Expression of Interest, Rail Projects Group, Department of Infrastructure, May 2001, p. 1.

## 2.2.2 Government policy and decisions on regional fast rail initiative

### Government policy and project objectives

In the run-up to the 1999 election, the current government undertook to “kick start the development of more frequent, competitively priced, fast rail to regional centres”, [through the] “consideration of the feasibility of more frequent, competitively priced, fast rail”<sup>2</sup>.

The government’s *Linking Victoria* initiative, launched in February 2000, stated that:

- “Labor will complete the \$550 million fast rail program to provide substantial improvements to rail services in the Geelong, Ballarat, Bendigo and Latrobe Valley corridors
- higher frequency services will be introduced in the peak and off-peak periods on all the corridors. This will include counter-peak, early morning services to Bendigo and Ballarat
- Labor has commenced an extensive program of community consultations to develop new timetables and related additional services
- the new timetable will ensure all population centres benefit from the fast rail project by delivering a mix of express, semi-express and stopping all stations service patterns”<sup>3</sup>.

The government’s 2001 *Growing Victoria Together* statement reiterated its commitment to regional fast rail as part of its work towards ensuring a fast, reliable and efficient transport infrastructure<sup>4</sup>.

On 16 December 1999, the government announced an \$80 million commitment to the initiative and the start of feasibility studies as the first step in delivering on this commitment.

Following completion of the feasibility studies, the government announced, in August 2000, its intention to contribute \$550 million of the projected \$810 million that would be required to achieve the preferred target express journey times. To deliver this option, the state would need to seek private sector involvement to fund the additional \$260 million.

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<sup>2</sup> The Australian Labor Party, 1999, *Rebuilding the transport network, A better transport network for all Victorians, Fast rail links to regional Victoria*.

<sup>3</sup> The Australian Labor Party, 2000, *Linking Victoria, Labor’s plan for safe, efficient and reliable transport*, p. 13.

<sup>4</sup> Government of Victoria, 2001, *Growing Victoria Together*, p. 16.

Figure 2A outlines the estimated costs of the infrastructure upgrade component of the fast rail initiative in each of the corridors: either achieving the target express travel times (costing \$810 million); or achieving reduced express travel times (costing \$550 million).

**FIGURE 2A: FAST RAIL INFRASTRUCTURE UPGRADE OPTIONS**

Corridor	Target express journey times (a)	Reduced express journey times (a)	Current fastest express times	Expected time saving from maximum times	Original completion date (b)
	(minutes)	(minutes)	(minutes)	(minutes)	
Ballarat	60	64	82	18	June 2005
Bendigo	80	84	101	17	October 2004
Latrobe	90	95	117	22	March 2004
Geelong	45	45	51	6	February 2005
<b>Total estimated cost (\$ million)</b>	<b>810</b>	<b>550</b>			

(a) Ballarat and Bendigo journey times based on full express service. Latrobe journey times based on one stop at Dandenong, and Geelong journey times based on stops at North Melbourne and North Geelong. (Source: Fast Rail Links to regional centres, Feasibility Studies: Final Report, Linking Victoria, Victorian Government, March 2000).

(b) Estimated completion dates for infrastructure upgrade works were provided by the Department of Infrastructure in September 2002.

It became clear by 2001 that the private sector would not fund the additional \$260 million to achieve the target express journey times. In June 2002, the government committed \$556 million to the delivery of the reduced express journey times after awarding contracts to upgrade the rail infrastructure.

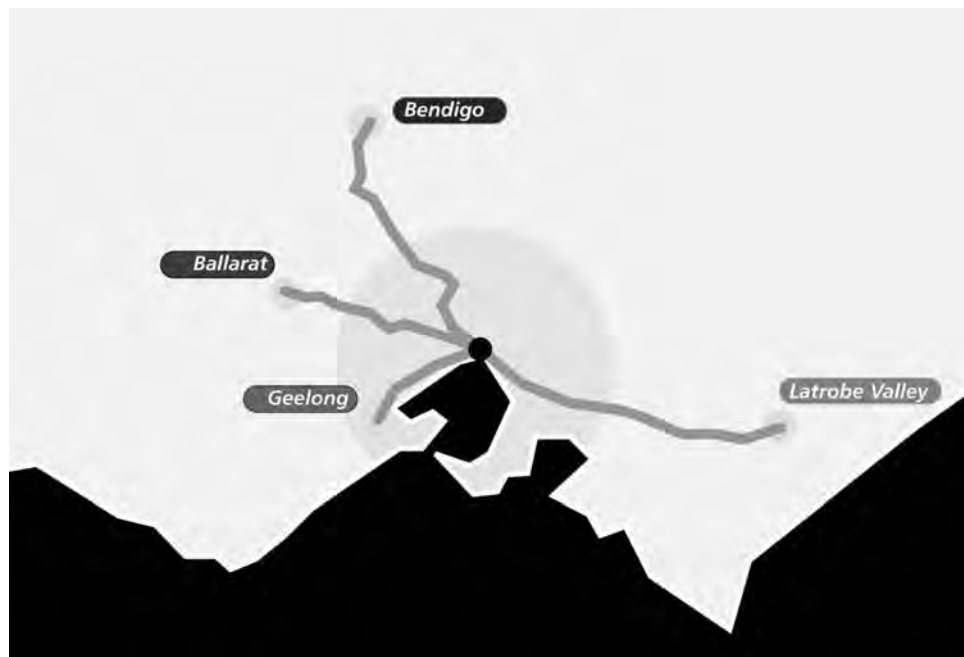
The government's objectives for the fast rail infrastructure upgrade were:

- Journey times: to secure the delivery of a fast rail service between Melbourne and Geelong, Ballarat, Bendigo and the Latrobe Valley that would achieve shorter express rail journey times and the best value-for-money, within the context of the state's financial commitment to the project
- Quality: to ensure that the faster rail service provides safe, convenient, comfortable and affordable rail services for the travelling public
- Patronage: to achieve a substantial and sustained increase in rail patronage on the 4 rail lines
- Cost: to minimise the long-term costs to the taxpayer of the upgrading, maintenance and operation of the upgraded rail network
- Risk transfer: to transfer risk to the private sector where it is appropriate to do so

- **Timeliness:** to secure the delivery of the infrastructure upgrade in a timely fashion, in accordance with target dates and deadlines set by the state
- **Accountability:** to manage the infrastructure upgrade in a transparent and accountable way, in consultation with stakeholders and in accordance with the highest standards of probity<sup>5</sup>.

Figure 2B shows the transport corridors for the fast rail services between Melbourne and Ballarat (119 kms), Bendigo (162 kms), Geelong (73 kms) and the Latrobe Valley (158 kms).

**FIGURE 2B: TRANSPORT CORRIDORS FOR THE REGIONAL FAST RAIL SERVICES**



Source: Department of Infrastructure.

The fast rail initiative included 5 key components:

- **Upgrading rail infrastructure:** construction works would be undertaken to upgrade rail infrastructure to allow trains to travel safely at speeds of up to 160 km/h on the country sections of the corridors
- **New fast trains:** a total of 29 new velocity trains were to be purchased
- **Installation of fibre optic cable:** a new fibre optic cable network was to be installed as part of the upgraded rail signalling and communications systems
- **New timetable:** a revised 2006 V/Line timetable would be developed, incorporating some faster and several additional train services
- **Interconnecting bus services:** a package of improvements to connecting bus services to the fast rail regional centres.

<sup>5</sup> Regional Fast Rail, Invitation for Expression of Interest, Rail Projects Group, Department of Infrastructure, May 2001, p. 2.



*A new Velocity train for use on the fast rail corridors.*

### 2.2.3 Governance arrangements

A review of DoI's records indicated that the delivery of fast rail services had 3 phases:

- Feasibility phase: assessment of the fast rail initiative's economic viability to inform the government's decision to proceed
- Development phase: developing a commercial and legal framework for implementation, culminating in the acceptance of contracts to design and construct the rail infrastructure upgrade
- Delivery phase: implementing the infrastructure upgrade and the delivery of the other activities needed to deliver fast rail services.

Each of these phases was subject to separate governance arrangements.

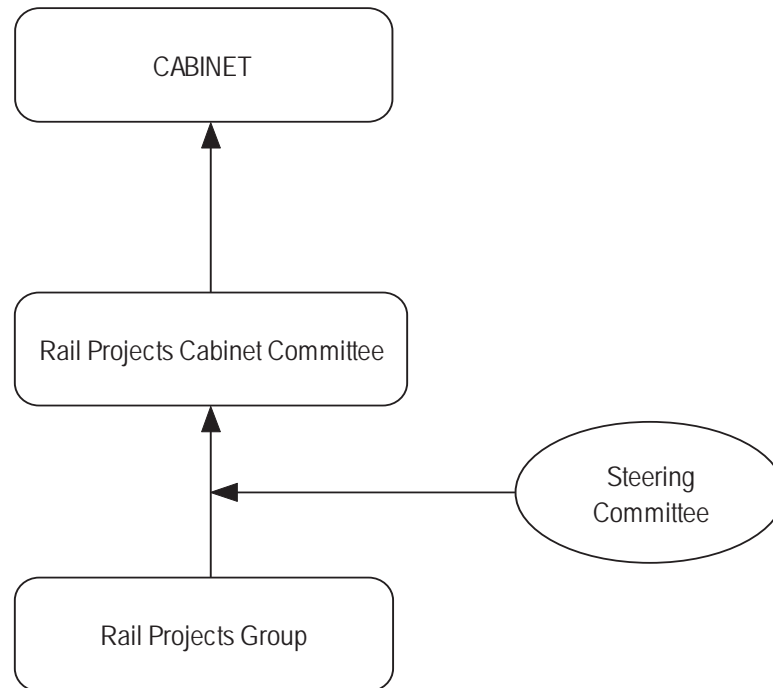
#### **Feasibility phase managed by the Department of Infrastructure**

DoI was responsible for development of the fast rail initiative feasibility studies and the final feasibility studies report supporting the decision by the government, in August 2000, to proceed.

#### **Development phase managed by the Rail Projects Group**

Figure 2C shows the governance structure for the development phase and we explain the roles of the various groups and committees below.

**FIGURE 2C: DEVELOPMENT PHASE GOVERNANCE STRUCTURE**



Source: Victorian Auditor-General's Office.

In September 2000, Cabinet established:

- the Rail Projects Cabinet Committee comprising the Premier, the Treasurer and the Ministers for Finance and Transport to oversee regional fast rail, the Spencer Street Station redevelopment and the Airport Transit Link
- the Rail Projects Steering Committee comprising the secretaries of the Departments of Premier and Cabinet, Treasury and Finance and DoI and the executive director and deputy executive director of the yet to be established RPG.

The steering committee had the following distinct responsibilities during the development and delivery phases:

- Development phase: during this period, the steering committee was chaired by the secretary of the Department of Treasury and Finance (DTF) because of the importance of commercial and legal disciplines in establishing contracts to deliver the infrastructure upgrade. This phase focused on refinement of the feasibility study content to a level of detail and reliability which could form a solid basis for entering into design and construct contracts. This included developing a viable delivery strategy, gaining a better understanding of the infrastructure upgrade costs and risks, and the development and delivery of contracts for the infrastructure upgrade and variations to the order for new trains so these met the needs of the fast rail initiative.

- Delivery phase: during this period the steering committee was chaired by the secretary of DoI. In this phase, DoI focused on: making sure that the infrastructure upgrade was delivered according to the contractual agreements; and coordinating the delivery of the other components of the fast rail initiative, such as the new rolling stock and the revised timetable.

Approval of \$40 million of additional funding was provided to DoI to set up the RPG to directly manage these responsibilities during the development phase.

In December 2000, the RPG was formed as a “joint venture” between DTF and DoI. This group reported to the Rail Projects Cabinet Committee which, in turn, reported to Cabinet with input from 2 other permanent Cabinet subcommittees.

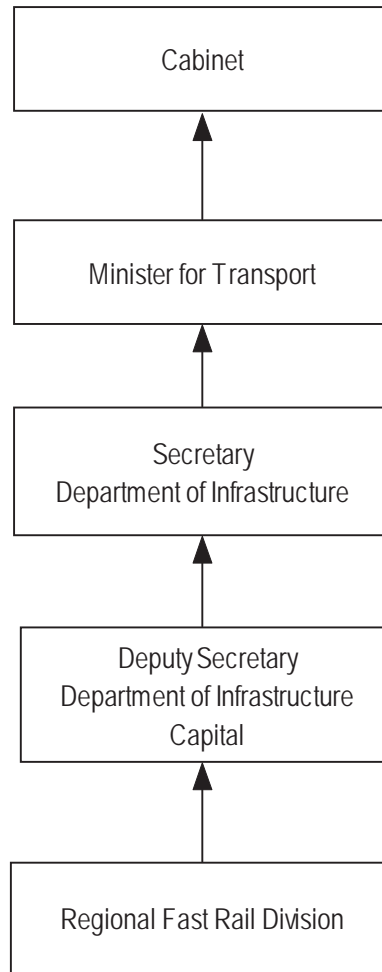
While the RPG was part of DoI, it reported to the senior management of both DoI and DTF. During the development phase, DTF took the lead with the focus on commercial and legal issues, with DoI assuming this role once contracts had been established and the focus moved to the delivery of agreed engineering solutions.

## **Delivery phase managed by the Department of Infrastructure**

### ***Delivering the rail infrastructure upgrade***

The governance arrangements for the delivery of the rail infrastructure upgrade are shown in Figure 2D.

**FIGURE 2D: RAIL INFRASTRUCTURE UPGRADE: GOVERNANCE 2006**



Source: Victorian Auditor-General's Office.

In 2002, the Regional Fast Rail Division (RFRD) was established to manage the infrastructure upgrade contracts and to ensure the delivery of the contract outcomes on time and within budget.

The RFRD monitors progress and reports to DoI's:

- infrastructure upgrade Project Control Group through monthly briefings. This group includes an independent chair, representatives external to government and officers from the Department of the Premier and Cabinet, DTF, and DoI. Reports are detailed and cover major issues related to capital works across the 4 fast rail corridors, project costs, and potential project exposures
- Capital Subcommittee which reviews projects above \$10 million
- Capital Planning and Review Division (CPRD). The CPRD submitted quarterly briefings on the infrastructure project to the Expenditure Review Committee of Cabinet on costs, risks and timescales.

### *Delivering other components*

Since 2001, responsibility for managing the delivery of the other components of the project has been allocated to the following public agencies:

- V/Line Passenger and the Public Transport Division (PTD) of DoI for timetable development
- DoI for the purchase of the fast rail rolling stock
- VicTrack for the fibre optic cable network used to carry signal communications on the fast rail corridors
- PTD for the development of interconnecting bus services to the fast rail regional centres.

PTD has the overall responsibility for making sure that all these components come together to deliver the fast rail initiative outcomes.

## **2.2.4 Fast rail initiative context**

Planning for the fast rail initiative took place from 2000, when DoI was also working on 2 other major rail projects: the restoration of country passenger rail services, and the rail gauge standardisation project. This required careful planning and coordination of project schedules to minimise the possibility of disruptions to delivery schedules. This was particularly so for the proposed gauge standardisation of the north-western rail corridor, as part of the rail gauge standardisation project, which could have impacted on the fast rail initiative if it proceeded at the planned time.

A further challenge arose from the rail privatisation arrangements introduced by the previous government. In 1999, the Victorian country intrastate (largely broad gauge) rail infrastructure was leased for 15 years (with options for 2 further 15-year lease extensions) to a private operator, Freight Australia Limited (FAL), now Pacific National (PN). The Primary Infrastructure Lease was transferred to PN in September 2004. FAL and then PN:

- controlled access to the regional broad gauge infrastructure for the purpose of upgrading or changing the infrastructure for the operation of fast trains
- was responsible for rail system safety and was required to submit material change documentation to the Director of Public Transport Safety whenever there was a change in the infrastructure which might affect safety risks.

This arrangement impacted on the state's ability to deliver major rail projects, including the fast rail initiative, and meant that the lease with FAL was critical for the successful delivery of the initiative. The fast rail initiative, and particularly the required upgrade of the rail infrastructure, could not proceed until DoI reached agreement with FAL on the access arrangements and the proposed scope.

### 2.2.5 Objective of the audit

The objective of the audit was to review the adequacy of the management of the fast rail initiative to deliver fast rail services.

The audit examined the adequacy of:

- the feasibility studies to properly inform the government's decision to proceed
- the development phase to put in place contracts which provided a sound basis for the delivery of the agreed infrastructure upgrade outcomes within the agreed timelines and budgets
- the delivery phase to manage all the fast rail components to deliver the planned improvements within the planned time lines and budgets.

The infrastructure upgrade has been subject to 4 previous reports by our Office. Where appropriate these reports are discussed in this part of the report<sup>6</sup>.

## 2.3 Feasibility phase: Adequacy of the information provided to government

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### 2.3.1 Introduction

Comprehensive planning in the initial stages is essential to provide a sound basis for the government to decide whether it should make good its initial commitment and proceed with the fast rail initiative. The feasibility work was captured in a number of volumes on various aspects of the fast rail initiative and summarised in the feasibility studies final report published in March 2000.

Feasibility studies are a critical part of effective capital planning. A feasibility study should include:

- an explanation of the objectives and how they align with the government's strategic aims

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<sup>6</sup> *Reports on the Finances of the State of Victoria*, 2001-02 - October 2002; 2002-03 – November 2003; 2004-05 – November 2005, Victorian Government Printer, Melbourne, Victorian Auditor-General's Office, *Results of 30 June 2005 financial statement and other audits* – December 2005.

- the scope and cost of options to achieve the objectives
- an analysis of the option impacts and benefits
- the identification and analysis of risks and any differences in this respect between options
- the comparative appraisal of the options in terms of their costs, benefits and risks to provide the basis for deciding which, if any, option to pursue.

Following the government's December 1999 announcement of its (\$80 million) commitment towards the fast rail initiative, DoI commenced a number of feasibility studies. The feasibility studies examined options for reducing travel times using fast trains between Melbourne and Ballarat, Bendigo, Latrobe Valley and Geelong. The studies:

- considered 3 options for fast train services (partial delivery of government journey time targets, full delivery of government targets and delivery of faster journey times preferred by local councils along the 4 corridors)
- scoped and costed the engineering solutions to deliver these alternative journey times
- estimated increases in demand for fast rail services and the associated fare revenues for the government's full journey time targets
- estimated costs of rail infrastructure upgrade and benefits from the government's target journey times, and the ratio of benefits to costs as a measure of the economic viability<sup>7</sup>.

### 2.3.2 The Auditor-General's previous review

The Auditor-General's October 2002 report on the *Finances of the State of Victoria, 2001-02*, reported on the results of a review of the early stages of the rail infrastructure upgrade. In respect of the feasibility studies report, we concluded that:

"The Department of Infrastructure advised that the journey times for trains that stop at some or all stations along the corridor will not be known until the final design for the entire track corridors is completed in March 2003.

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<sup>7</sup> *Work begins on fast rail projects*, Media release, Melbourne, Office of the Premier and Treasurer, 16 December 1999.

Given that the majority of current timetabled train services for these rail lines are not express, in particular peak hour services, the concentration of the feasibility analysis of the costs and benefits of the project predominantly as express journey times could be considered narrowly focused - not providing a meaningful analysis of the time savings potentially available to many of the passengers utilising the rail services in these corridors”<sup>8</sup>.

In response to the above conclusion, the Minister for Finance advised that:

“Regional centres presently have a mix of express, semi-express and ‘stopping all stations’ services. A primary objective of the Fast Rail Project is to reduce the current express travel time, and for comparative purposes the greatest benefits flow when express travel times are reduced. That is, access to the metropolitan areas from regional country areas, is generally enhanced through the faster travel times. The Auditor-General has not acknowledged that the improved travel times flow to the semi-express and ‘stopping all stations’ services as well. Consequently, the project provides similar benefits to commuters along the fast rail corridors. It is incorrect to assert that the analysis was ‘narrowly focused’ ”<sup>9</sup>.

In the light of this response, as part of this audit, we undertook a further review of the feasibility studies report.

### 2.3.3 Adequacy of the feasibility studies

#### Risk management

An important part of project planning is the identification and classification of risks according to likelihood and severity. These should be addressed in a feasibility study. The types of risks typically dealt with include:

- commercial risks with business relationships (the risk that the contractor fails)
- operational risks with business activities (such as key people leaving)
- technical risks with assets (such as equipment failure)
- financial risks with financial controls and systems (such as budgets being overspent)
- compliance risks with meeting regulatory obligations (such as actions not complying with requirements).

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<sup>8</sup> Victorian Auditor-General’s Office, October 2002, *Report on the Finances of the State of Victoria, 2001-02*, Victorian Government Printer, Melbourne, p. 102.

<sup>9</sup> Ibid, p. 106.

We would have expected the feasibility studies to have included at least a preliminary risk management plan. However, a preliminary risk management plan was not part of the feasibility studies. We understand that the addition of a 30 per cent plus or minus onto the estimated costs of the rail infrastructure upgrade represented the initial estimation of the cost of the likely risks. Notwithstanding the above, it is not unreasonable to expect that the feasibility studies report would have addressed the typical risks for a project of this nature.

Further comment on risk management is addressed in section 2.5.2 of this report - Upgrading the rail infrastructure.

### Feasibility studies final report - Review of costs and benefits

The feasibility studies final report<sup>10</sup> of March 2000, estimated the economic costs and benefits of delivering fast rail services achieving the government's preferred travel time targets. For this option, the feasibility studies report included the "most likely" estimate of the ratio of benefits to costs and the basis for these estimates. These are shown in Figure 2E.

**FIGURE 2E: ORIGINAL RATIO OF BENEFITS TO COSTS<sup>11</sup>**

Line – corridor	Benefit-cost ratio
Ballarat	1.8
Bendigo	1.7
Latrobe Valley	2.0
Geelong	4.7

Source: *Fast rail links to regional centres, Feasibility Studies: Final Report*.

These remain the only estimates of the economic benefits expected to be delivered through the introduction of fast rail services and are based on the estimated cost of \$810 million. They have not been adjusted to reflect the revised government investment of \$556 million and should have been.

<sup>10</sup> Department of Infrastructure, March 2000, *Fast rail links to regional centres, Feasibility Studies: Final Report*.

<sup>11</sup> An economic cost-benefit analysis calculates the cost and benefit impacts on society over an extended period and discounts these to a present day value to compare them as a ratio of benefits to costs. Costs typically include the infrastructure, operating and maintenance costs needed to deliver upgraded services. Benefits usually include impacts on the existing and new public transport travellers of the improvement and any secondary impacts on other travellers (for example where road travellers experience less congestion when more some travellers move to train).

The government relied on the feasibility studies estimates to indicate that “... the Government’s decision to proceed with the Fast Rail Links Project followed detailed feasibility studies into each route. The studies confirmed that there is significant economic benefit associated with reducing travel times between Melbourne and the four provincial centres”<sup>12</sup>. Given their importance to the government’s decision-making process, we expected that these estimates were based on a rigorous cost-benefit analysis with robust, supporting assumptions.

We determined the reliability of the economic analysis by examining:

- the feasibility studies final report and its supporting documentation
- DoI’s guidelines for assessing capital projects<sup>13</sup>
- the supporting documentation used to calculate the costs and the benefits for the Bendigo corridor (DoI provided these calculations only for the Bendigo corridor).

DoI’s capital assessment guidelines provided general guidance on the principles for the appraisal of capital projects and some specific guidance for transport projects. We found the following inconsistencies between the fast rail appraisals and the guidelines. The guidelines required:

- the use of a 30-year appraisal period<sup>14</sup>, while the feasibility studies report assumed a 20-year period. Using the longer appraisal period would have led to a small increase in the benefit to cost ratio. The use of a lower discount rate inflates the benefit cost ratio
- “... that, as a minimum, consideration be given to a base case, and to existing asset, non-asset and new asset options”<sup>15</sup>. The guidelines acknowledge that “... for some projects a full evaluation will not be appropriate for all of the option categories [e.g. a non-asset option may not be feasible] ... However, reasons for excluding apparently feasible options prior to full evaluation should be stated”<sup>16</sup>. The feasibility studies did not evaluate an option to use the existing commitment to new 145 km/h rolling stock to improve passenger services. This would have clearly illustrated the value-for-money by comparing the benefits and costs of the fast rail initiative against the benefits of simply making best use of the committed trains.

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<sup>12</sup> Office of the Premier, media release, Melbourne, *Historic boost to revive Victoria’s rail network*, 5 September 2000.

<sup>13</sup> Department of Infrastructure, *Capital Project Priority and Program Process Guidelines for 1998-99*, Melbourne, June 1997.

<sup>14</sup> Ibid., p. 10.

<sup>15</sup> Ibid., p. 11.

<sup>16</sup> Ibid., p. 11.

We also found that the feasibility studies report overstated the quantifiable economic returns expected from the delivery of fast rail services because:

- the assumptions used to calculate the projected travel time benefits for existing rail users were unrealistic
- the costs included for the proposed new fast trains were underestimated
- the range of the other benefits included and the methods used to calculate some of these benefits were optimistic.

Each of these is addressed below.

### *Assumptions about travel time benefits for existing rail users*

The travel time benefits to rail users are the direct impacts flowing from the improved fast rail services. The remaining economic impacts are correlated with, and dependent on, these direct impacts. There are 2 reasons why we consider the travel time benefits included in the feasibility studies report were optimistic:

- the calculation of time savings was based on the \$810 million option when, subsequently, the government only approved funding for \$556 million with reduced travel time targets
- the time savings for all rail travellers throughout the fast rail corridors were calculated as if they would benefit from using express fast rail services when only a small percentage of the services would be express.

The government's approved \$556 million only provided for reduced travel time targets. This meant that the feasibility studies report overstated the express journey travel savings by about 10 per cent for the Ballarat, Bendigo and Latrobe Valley corridors.

Applying savings consistent with express journey times to every passenger on the fast rail corridors was overly optimistic. These services are designed to run express from the towns at the regional end of the corridor to Melbourne with a small number of stops in between. Achieving the journey time targets is dependent on the use of upgraded, faster sections of the track and only having limited stops on the journey.

It is not realistic to apply express savings to all passengers on the corridor because:

- the need to serve passengers at intermediate corridor stations means that it is unlikely that all services from the Bendigo, Ballarat, Latrobe Valley and Geelong will run as express services

- the express services that do run will need to bypass many intermediate stations, meaning that these passengers will travel for the most part on stopping or semi-express services
- most of the infrastructure upgrades are on the country sections of the corridors so the potential for journey time improvements is greatest for longer journeys and diminishes for journeys closer to metropolitan Melbourne.

This finding is best illustrated for the Bendigo corridor where DoI provided us with the detailed benefit calculations. The time savings in the feasibility studies report were calculated as follows:

- the journey time from Bendigo was assumed to fall from 110 minutes to 77 minutes assuming express trains running at speeds of up to 180 km/h
- the 30 per cent reduction in journey times was applied to the average journey time for all trips on the corridor (80 minutes) to give a saving per trip of 24 minutes
- the time benefits were calculated assuming that every trip saved 24 minutes.

Table 5.2 in the feasibility studies final report<sup>17</sup> lists the passenger boardings and alightings for services from Spencer Street Station (now Southern Cross Station) on a weekday in February. This shows that: 54 per cent of passengers travel no further than Sunbury, just beyond the metropolitan boundary; a further 15 per cent travel to and from Bendigo; and the remainder use the 10 stations between Sunbury and Bendigo. So most travel is to destinations within or near to Melbourne.

Figure 6.2 in the feasibility studies final report<sup>18</sup> shows that fast rail will reduce express journey times by 22 minutes on the country section of the corridor and by 3 minutes across the metropolitan section. The 54 per cent of passengers travelling between Sunbury and Melbourne will, therefore, save a maximum of 10 minutes because of the infrastructure upgrades and faster trains. This potential saving falls to 3 minutes for the 19 per cent of passengers using other metropolitan stations on the corridor. For these passengers, assuming that they will save 24 minutes on average journey times of 40 minutes or less is a significant overestimate.

Indeed Figure 6.2 shows that a 24-minute journey time saving is only achieved for the 15 per cent of passengers travelling between Bendigo and Melbourne. In this case, the express journey time falls by 25 minutes and the average journey time by 30 minutes.

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<sup>17</sup> Department of infrastructure, *Fast rail links to regional centres, Feasibility Studies: Final Report, Linking Victoria*, Victorian Government, March 2000, p. 108.

<sup>18</sup> *Ibid.*, p. 182.

The use of these assumptions significantly overestimated the travel time benefits of the fast rail option tested.

### *Assumptions about costs - New trains*

The previous government committed to purchase 29 new, 2-car trains at a cost of \$169 million through its franchise agreement with the regional rail operator, National Express. These trains would be capable of running services at speeds up to 145 km/h compared with the existing sprinter and locomotive-hauled fleet which could operate at 130 km/h and 115 km/h, respectively. The current government accepted this commitment when it came to office.

Delivering the government's preferred travel time targets needed trains that could sustain maximum speeds of 180 km/h on the Bendigo corridor, 160 km/h on the Ballarat and Latrobe Valley corridors, and 130 km/h on the Geelong corridor.

We raise the following concerns about the train costs used in the economic appraisal:

- there is a mismatch between the train-related costs and benefits included in the appraisal
- the additional fast rail upgrade costs incorrectly assumed that the trains ordered by National Express could practically operate services at speeds of up to 160 km/h.

### *Properly matching train costs and benefits in the economic appraisal*

The purpose of the cost-benefit analysis was to inform the decision to upgrade the infrastructure and the trains to achieve the government's journey time targets. To do this, the economic appraisal should compare the additional costs beyond existing commitments with the benefits that flow from this additional investment.

The preferred option appraisal included the total time saving benefits flowing from the combination of the committed \$169 million train purchase and the further upgrades needed to deliver fast rail, but only the additional fast rail costs.

This results in a mismatch between the costs and the benefits. The introduction of trains capable of 145 km/h operation may have allowed some journey time savings. For example, where a new train replaced a locomotive-hauled service, then for some sections the new train could travel at 130 km/h, rather than the maximum speed of the locomotive service (115 km/h). The purchase of these trains would have also allowed the government to increase service frequencies. The benefits attributable to this investment should have been excluded from benefits included in the government's preferred option.

This would have been clear had DoI compared the preferred option with the base case including the costs and potential benefits of this commitment. DoI did not consider what could be achieved using the committed spending to purchase new trains capable of 145 km/h operation. DoI's capital guidelines required the testing of an "existing asset" option<sup>19</sup>.

#### Costs of upgrading trains to fast rail standards

The 1999 V/Line franchise agreement specified that new trains were to be capable of speeds of up to 160 km/h with sustained operation at 145 km/h. The trains' engine needed to have the capacity to go faster than 145 km/h to make sure it could accelerate to its sustained operating speed. These trains would not have been suitable for running timetabled passenger services reaching speeds in excess of 145 km/h.

Table 3 in the feasibility studies final report<sup>20</sup> includes the maximum train speeds required to achieve the government's preferred travel time targets. Trains would need to be capable of operating at speeds up to: 180 km/h on the Bendigo corridor; 160 km/h on the Ballarat and Latrobe Valley corridors and 130 km/h on the Geelong corridor.

Our review of the detailed cost-benefit calculations for the Bendigo corridor and the background material supporting the final report shows that the feasibility studies incorrectly assumed that the committed rolling stock could deliver 160 km/h operating speeds<sup>21</sup>. As a result, the economic appraisal underestimates the costs of upgrading the trains for fast rail operation.

The background feasibility material calculates the costs of upgrading trains above the 1999 franchise commitment and purchasing new trains in the future as passenger demand outgrows the existing fleet.

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<sup>19</sup> Ibid., p. 11.

<sup>20</sup> Ibid., p. xvii.

<sup>21</sup> Department of Infrastructure, *High Speed Passenger Services to Bendigo Infrastructure Review*, Volume 1 of 2, Section 7.5, pp. 33-5.

Figure 2F shows our estimate of the amended train upgrade costs. This adds an additional \$48.2 million to the feasibility studies costs.

**FIGURE 2F: FAST RAIL TRAIN UPGRADE COSTS**

Corridor	Maximum train speed	Upgrade cost (a)	Appraisal costs (b)	Revised costs (c)	Upgrade cost (f)
	(km/h)	(\$m)	(\$m)	(\$m)	(\$m)
Ballarat	160	-	-	12.0 (d)	12.0
Bendigo	180	28.8	28.8	55.0 (e)	26.2
Latrobe Valley	160	-	-	10.0 (d)	10.0
Geelong	130	Not calculated	6.0	6.0	-
<b>Total</b>			<b>34.8</b>	<b>83.0</b>	<b>48.2</b>

(a) Source: Department of Infrastructure, *High Speed Passenger Services to Bendigo Infrastructure Review*, Volume 1 of 2, Section 7.5, pp. 33-5.

(b) Appraisal assumed that the committed train order was for trains capable of operating at 160 km/h.

(c) Revised costs assuming that committed train order was for trains capable of operating at 145 km/h.

(d) Assuming it costs an additional \$1 million per car to upgrade 145 km/h trains to operate at 160 km/h.

(e) Assuming it costs an additional \$3 million per car to upgrade 145 km/h trains to operate at 160 km/h.

(f) Trains upgrade cost = Revised cost – Appraisal cost.

### *Reliability of the benefit calculations*

Figure 2G summarises the feasibility studies report cost-benefit analysis and outlines the costs, benefits and the ratio of benefits to costs.

**FIGURE 2G: FAST RAIL COST, BENEFIT AND RATIOS**

Corridors	Ballarat	Bendigo	Latrobe Valley	Geelong	Total	Total costs-benefits
	(\$m)	(\$m)	(\$m)	(\$m)	(\$m)	(%)
<b>Costs (present values) -</b>						
Capital	(284)	(270)	(144)	(91)	(789)	87
New trains for fast rail start-up	-	(26)	-	(6)	(32)	4
New trains to cater for growth	(9)	(9)	(5)	(28)	(51)	6
Additional train running costs at start-up	-	-	-	(13)	(13)	1
Additional train running to cater for growth	(6)	(4)	(3)	(9)	(22)	2
<b>Total costs</b>	<b>(299)</b>	<b>(309)</b>	<b>(152)</b>	<b>(147)</b>	<b>(907)</b>	<b>100</b>
<b>Benefits (present values) -</b>						
Benefits for existing rail travellers	49	93	42	45	229	11
Benefits for travellers attracted to rail (a)	68	106	68	104	346	17
Benefits for remaining road travellers and the environment (decongestion)	32	48	30	48	158	8
<b>Direct traveller benefits – subtotal</b>	<b>149</b>	<b>247</b>	<b>140</b>	<b>197</b>	<b>733</b>	<b>36</b>
<b>Effect of capital spend on local economy – subtotal</b>	<b>57</b>	<b>54</b>	<b>29</b>	<b>18</b>	<b>158</b>	<b>8</b>
Additional state economic growth	131	60	39	193	422	21
Travel benefits from relocating road trips from Melbourne	45	40	26	29	140	7
Travel benefits from more local rather than regional trips	122	94	60	222	498	24
Fall in infrastructure costs from relocation of new housing	22	17	11	28	78	4
<b>Effect of changes in population and economic activity – subtotal</b>	<b>320</b>	<b>211</b>	<b>136</b>	<b>472</b>	<b>1 138</b>	<b>56</b>
<b>Total benefits</b>	<b>526</b>	<b>512</b>	<b>305</b>	<b>687</b>	<b>2 029</b>	<b>100</b>
<b>Ratio of benefits to costs</b>	<b>1.8</b>	<b>1.7</b>	<b>2.0</b>	<b>4.7</b>	<b>2.2</b>	<b>-</b>

- (a) The benefits for travellers attracted to rail include the time savings and the vehicle operating cost savings for those who switch to rail and the vehicle operating cost savings for remaining car users (we did not have the detailed spreadsheets for all corridors to exclude the benefits to remaining road travellers. However, we did have this information for the Bendigo corridor and these benefits represent less than 10 per cent of the total in this category.

Source: Department of Infrastructure and Victorian Auditor-General's Office.

The overall ratio of benefits to costs for the 4 corridors combined is 2.2, with discounted project costs of \$907 million and discounted benefits of \$2.029 billion. Benefits are around double the costs for the Ballarat, Bendigo and the Latrobe Valley corridors, and are nearly 5 times the costs for the Geelong corridor.

Figure 2G breaks down the benefits into 8 components and shows the percentage each contributes to the total benefit. These 8 components represent:

- the estimates of the direct traveller benefit (rows 1 to 3 of the benefits)
- the secondary benefit of recirculating the capital spending through the economy (row 4 of the benefits)
- the benefits based on forecast population changes (rows 5 to 8 of the benefits).

Each of these is commented on below.

### *Direct traveller benefits*

The most important and measurable source of direct economic impact are the direct travel-related benefits to:

- existing public transport users
- those travellers who are attracted to the improved public transport services
- remaining road users who experience lower congestion levels and accident risks because some road travellers have moved to public transport. This decongestion may also provide some environmental benefits to the wider community through lower vehicle emissions.

Figure 2G shows that the direct travel benefits accounted for 36 per cent of the total benefits made up of 11 per cent for existing rail travellers, 17 per cent for travellers attracted to rail and 8 per cent to remaining road travellers.

Figure 2G also shows that the benefits to new train travellers switching their journey from car were 51 per cent higher than those for existing train travellers (we added the travel time savings and reduced vehicle operating costs for new train travellers (\$346 million), and this compared with the benefits to existing rail travellers of \$229 million). The feasibility studies forecast a 26 per cent increase in patronage as previous car travellers are attracted to use rail<sup>22</sup>.

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<sup>22</sup> Ibid., Table 5.14, p. 122.

It is an economic convention to value the net benefit of a transport improvement to a traveller who changes their mode of travel as half the benefit of an existing traveller on the improved mode (this is known as “the rule of a half”)<sup>23</sup>. However, the feasibility studies report indicates that the total benefits to existing rail users (\$229 million) are smaller than the benefits to car users that switch to rail (over \$300 million). These new users are less than 30 per cent of the existing rail market and this implies that the benefits per new user greatly exceed those accruing to existing rail users.

We found the explanation for this by reviewing the detailed benefit calculations for the Bendigo corridor. DoI did apply the “rule of a half” to estimate the time saving benefits to former car users and these were of the right relative magnitude (under 10 per cent of the existing rail user benefits). However, DoI then calculated the vehicle operating costs saved by these former drivers and added them to these time-related benefits. This practice, while consistent with DoI’s guidelines<sup>24</sup>, overestimates the net economic benefits<sup>25</sup>.

When these vehicle operating costs are included, the benefit per trip by a former car user is about 10 times the benefit per trip for an existing public transport user.

Correctly calculating these benefits will reduce the benefits by about 17 per cent of the total.

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<sup>23</sup> There is a clear economic rationale for the benefits to existing public travellers exceeding those calculated for new public transport users. If an improvement lowers public transport journey times by 20 minutes we reasonably assume existing rail users benefit by the full amount. We assume that new travellers did not use rail before the improvement because another form of travel was, in their perception preferable, taking into account the relative costs and convenience. For those travellers who switch to rail, some would have been prepared to change with a much smaller reduction in journey costs while others would just be persuaded to change by the full 20 minute improvement. This difference is based on the varying perceptions of the relative costs. When comparing the new and old costs of travel, new travellers’ perception of the benefits would range from the full 20 minutes to a very small amount where someone was just persuaded to change travel mode. Economists, therefore, value the average change per new traveller as half the benefit accruing to an existing rail traveller. This is a measure of the net economic benefit taking account of the fact that they no longer have to run a car but do have to pay public transport fares. It is, therefore, incorrect to add in as a benefit the vehicle operating costs avoided by changing to rail. The following document explains this and provides further references.

<[http://www.aeat.co.uk/com/webtag/webdocuments/3\\_Expert/5\\_Economy\\_Objective/3.5.3.pdf](http://www.aeat.co.uk/com/webtag/webdocuments/3_Expert/5_Economy_Objective/3.5.3.pdf), part 2>.

<sup>24</sup> Department of Infrastructure, 1997, *Capital Project Priority and Program Process Guidelines for 1998/99*, Victorian Government, p. 14.

<sup>25</sup> PW Blackshaw, *The Treatment of Cross Modal Effects in Transport Evaluation in Transport Economics and Operational Analysis*, No.1, Bureau of Transport Economics, Canberra, March 1975, pp. 34-44.

### *Secondary benefits of recirculating the capital spending through the economy*

Figure 2G includes as a benefit, the effects of the capital spending on the economy. This makes up 8 per cent of the total benefits. This assumes that the money spent on the project will be recirculated through the local economy purchasing further goods and services.

The inclusion of these “multiplier effects” in a cost-benefit analysis is no longer included in DoI’s guidelines as these multiplier effects are difficult to measure<sup>26</sup>.

A cost-benefit analysis is prepared to assist decision-makers allocate scarce resources between projects. The inclusion of the “multiplier effect” inflates the performance relative to other projects.

### *Forecasting population and wider economic impacts*

Figure 2G indicates that 56 per cent of the benefits arise because of population and business growth. These include:

- a net growth in the state’s economy because more people are attracted to live in the state (21 per cent)
- the benefits of lower congestion because those people who move to regional areas reduce the level of traffic on Melbourne’s more congested roads (7 per cent)
- the benefits of lower congestion because those people in regional areas substitute local trips to more extensive and varied regional facilities for trips to more distant equivalents (24 per cent)
- some house building will be transferred from Melbourne’s outer suburbs to regional towns where infrastructure costs for houses and utilities is lower (4 per cent)<sup>27</sup>.

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<sup>26</sup> DoI’s latest cost-benefit analysis guidelines specifically excludes these effects (Department of Infrastructure, 2005, *Guidelines on economic, social and environmental cost benefit analysis*, Melbourne, p. 24).

<sup>27</sup> Department of Infrastructure, 2001, *Fast rail links to regional centres, Feasibility Studies: Final Report, Linking Victoria*, Victorian Government.

All of these benefits are based on the assumption that improving regional rail services to and from Melbourne will lead people to relocate to regional Victoria, and to the growth of business activity in these regions. These are secondary impacts resulting from the direct travel time improvements and may well double-count the direct traveller benefits. Because of this and the difficulty in their measurement, they are normally excluded from the cost-benefit analysis<sup>28</sup>.

DoI's latest cost-benefit analysis guidelines exclude the economic and distributional impacts from the cost-benefit analysis and recommends that they are assessed as part of a separate regional economic impact analysis<sup>29</sup>. This was not the case in 2000<sup>30</sup>. Even if it was appropriate to include "secondary benefits" in 2000, the greater unreliability of these estimates and the risk of double-counting the direct traveller benefits should have been known and flagged.

The feasibility studies final report acknowledged the difficulties in calculating reliable estimates of these benefits stating that: "There is a well accepted method for measuring transport user benefits, for example. However, many of the potential effects are contingent on a wide variety of other influences (underlying rates of population and economic growth, entrepreneurial activity etc). The impact of improved rail services on population and business growth can only be estimated within relatively wide confidence levels. Some of the potential effects can only be described and perhaps given an order of magnitude value. Nevertheless, estimates of these impacts can be made based on the best available information and within the time constraints for the project"<sup>31</sup>.

When reviewing the international evidence on the impacts of very high-speed trains on population growth, the final report noted that "... it is not clear to what extent high-speed rail projects are the primary cause of growth in the regions researched".

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<sup>28</sup> The most extensive examination of the relationship between transport and economic growth was in the UK. The Standing Advisory Committee on Trunk Road Assessment (SACTRA) concluded that the cost-benefit analysis (of the direct transport impacts) might over or underestimate the economic benefits where markets were not operating competitively. Because of the unpredictability of these impacts and the difficulty in measuring them, SACTRA recommended that these should be separately considered from the cost-benefit analysis. The UK Government partly accepted this recommendation by preparing a separate report on the wider economic impacts if their geographical distribution is a key policy outcome of a specific infrastructure investment (Reference: <[http://www.webtag.org.uk/webdocuments/2\\_Project\\_Manager/8\\_Economic\\_Impact/2.8.pdf](http://www.webtag.org.uk/webdocuments/2_Project_Manager/8_Economic_Impact/2.8.pdf)>).

<sup>29</sup> Department of Infrastructure, 2005, *Guidelines on economic, social and environmental cost benefit analysis*, Melbourne, p. 25.

<sup>30</sup> Department of Infrastructure, June 1997, *Capital Project Priorities and Program Process Guidelines for 1998/99*, Melbourne, p. 12.

<sup>31</sup> Department of Infrastructure, 2001, *Fast rail links to regional centres, Feasibility Studies: Final Report, Linking Victoria*, Victorian Government, p. 58.

The feasibility studies estimated the population change for the 4 fast rail options using 3 methods<sup>32</sup>:

- by interviewing 400 Melbourne workers to find out the likelihood that they would move to regional Victoria if their daily commute to work took no longer than their present journey
- by comparing past population growth rates by travel time to Melbourne and applying higher rates to areas further from Melbourne where fast rail would significantly reduce the travel times
- by looking at the relationship between travel time to Melbourne and forecast population growth.

In determining the final forecasts used to generate benefits, the studies discarded the market research estimates and took the average of the forecasts based on past growth rates and future growth. The consultants that completed the detailed work made it clear that many things drive population change and improved rail services are only of moderate importance. Indeed the market research respondents rated “good road access to Melbourne” and “good local employment opportunities” well above “rapid train service to Melbourne”<sup>33</sup>.

The consultant’s report stated their belief that the rail upgrade would increase the rate of population growth in the 3 corridors. They stated that “We believe the main forecast to be logical and plausible. However, we caution that the actual population outcome resulting from the train project will depend on a host of factors, and that the real result could fall within a wide range”<sup>34</sup>.

The feasibility studies used this main forecast as the basis for estimating that 21 per cent of the benefits are due to additional state economic growth. The report “... assumed that the net (state) growth will be 10 per cent of the total additional growth expected under each of the travel time scenarios”<sup>35</sup>. There is no evidential basis for this assumption provided in the report. The report uses this figure to calculate the number of additional households and their spending as a measure of the fast rail-related net growth in the state economy.

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<sup>32</sup> Essential Economics 2000, *Upgrading Regional Train Services – Economic Impacts*, pp. 55-72.

<sup>33</sup> Ibid., Figure 7, p. 57.

<sup>34</sup> Ibid., p. 72.

<sup>35</sup> Department of Infrastructure, 2001, *Fast rail links to regional centres, Feasibility Studies: Final Report, Linking Victoria*, Victorian Government, p. 95.

While the report acknowledges the net addition to the population of Victoria is difficult to predict with certainty<sup>36</sup>, it is of concern that this significant secondary impact was included without evidence to support its calculation. In addition, this measure of net economic growth does not equate to a net economic benefit because it makes no allowance for the costs additional residents impose on the state.

In our view, these benefits should not have been part of the cost-benefit analysis. These benefits are not calculated with the same level of rigour and confidence as the direct transport benefits and to combine them in a single measure of economic value obscures this very important fact. At the very least, they should have been subject to sensitivity testing to illustrate the extent to which the robust economic outcomes reported relied on the wider and less certain economic benefits.

## Conclusion

From our review of DoI's cost-benefit analysis, we concluded that:

- the cost of upgrading trains to achieve the government's preferred travel time targets was underestimated by \$48.2 million
- the benefits to existing rail users were significantly overestimated because it assumed that all passengers along the corridor would benefit from the fastest express services
- the benefits to travellers transferring from road to rail were also significantly overestimated because the appraisal incorrectly calculated these benefits
- the wider economic benefits were much more difficult to measure, were based on insufficient evidence and were out of all reasonable proportion when compared with the direct traveller benefits.

While the cost-benefit analysis was substantially consistent with the DoI guidelines in place at the time, the analysis made a number of incorrect assumptions and calculations. A number of the components of the guidelines used at the time have now been changed.

The cost-benefit analysis used to support the recommendation to government to proceed with the fast rail project significantly overestimated the benefits and also underestimated the costs of the project.

In these circumstances, the feasibility studies report did not provide an adequate basis for the recommendation to government to approve the upgrade and allocate the funding.

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<sup>36</sup> Ibid., p. 70.

### 2.3.4 Government approval

The feasibility studies report indicated that:

- the government's travel time targets could be achieved in full in each of the 4 corridors at a total estimated cost of \$810 million
- partial delivery of the travel time targets, to the lesser requirements investigated in the report, would reduce costs to an estimated \$500 million
- delivery on the higher travel time targets preferred by the regions would increase costs to an estimated \$1.750 billion<sup>37</sup>.

Figure 2H summarises the options.

**FIGURE 2H: FAST RAIL UPGRADE OPTIONS**

	Ballarat	Bendigo	Latrobe Valley	Geelong
Current transit times	85-104 min.	105-125 min.	115-145 min.	52-67 min.
Partial delivery of government targets	70 min. express	90 min. express	100 min. stopping Dandenong only	
Total estimated cost \$500m (+/-30%)	160 km/h Country works only \$170m	140 km/h Country works only \$140m	140 km/h Country works only \$100m	
Full delivery of government targets	60 min. express	80 min express	(a) 90 min. stopping Dandenong only	45 min. stopping Nth Geelong & Nth Melbourne
Total estimated cost \$810m (+/-30%)	160 km/h Extensive works \$300m	180 km/h Extensive works (b) \$270m	160 km/h Extensive works \$150m	130 km/h Extensive works \$90m
Full delivery of targets preferred by local councils	55 min. express	60 min. express	60 min. stopping Dandenong only	
Total estimated cost >\$1750m (+/-30%)	225 km/h Extensive works \$390m	225 km/h Extensive works >\$670m	225 km/h Extensive works >\$600m	

(a) No government target originally set. Ninety minutes agreed by the Minister for Transport and reference group as equivalent to Ballarat and Bendigo targets.

(b) Excludes \$19 million cost of third track between Sunshine and Footscray already included in the Ballarat corridor.

Source: Department of Infrastructure, 2001, *Fast rail links to regional centres, Feasibility Studies: Final Report, Linking Victoria*, Victorian Government, Melbourne, p. xvii.

Detailed train scheduling did not form part of the feasibility studies report because the proposed works in the metropolitan area may be sensitive to detailed timetabling issues and, therefore, needed to be known before being taken to the design stage. Cost estimates were prepared to a +/-30 per cent level of accuracy and included an allowance for project management and contingencies.

<sup>37</sup> Ibid., p. xvi.

The feasibility studies report proposed that the following major tasks were required so that the rail infrastructure works could proceed:

- investigate the potential for Public Private Partnership (PPP) delivering the upgrades
- engaging the existing franchisee, infrastructure lessee and other private sector bodies in determining the most effective means of achieving all fast rail objectives
- resolving engineering and technical policies and standards relating to the track, signalling requirements, level crossings and fencing
- further scoping of works to refine the feasibility study cost estimates
- assessment of property acquisition requirements
- undertake environmental effects statements where required.

The feasibility studies report indicated that the minimum realistic time period to upgrade all lines would be around 5 years. However, implementation could be staged to allow progressive improvements in travel times.

In August 2000, DoI advised government that the feasibility studies report estimates were preliminary and required a substantial amount of additional technical investigation to firm up the costs and related travel times.

In August 2000, the government approved funding of up to \$550 million to facilitate the upgrade of rail infrastructure on the fast rail corridors, with the intention of attracting private funding of \$260 million to achieve its target express journey times. In announcing the decision, the Premier indicated that the government's decision to proceed followed detailed feasibility studies which confirmed that: "... there is significant economic benefits associated reducing travel times between Melbourne and the four provincial centres ..." <sup>38</sup>.

In April 2001, the government endorsed the following (Figure 2I) reduced deliverables, which were subject to further refinement, based on total infrastructure works funding of \$550 million. The government went to the market on this basis and awarded contracts in June 2002 committed to delivering the upgraded rail infrastructure to facilitate fast rail services with reduced express times for \$556 million.

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<sup>38</sup> Office of the Premier, *Historic boost to revive Victoria's rail network*, Melbourne, 5 September 2000.

**FIGURE 2I: FAST RAIL INFRASTRUCTURE UPGRADE DELIVERABLES – APRIL 2001**

Corridor	Time	Speed	Estimated cost
	(mins)	(km/h)	(\$m)
Ballarat	64	160	170
Bendigo	84	160	140
Latrobe Valley	91	160	100
Geelong	45	160	90

Source: Department of Infrastructure.

This decision was made without:

- information on all risks relevant to the rail infrastructure upgrade delivery and appropriate mitigation strategies. Risk management did not become a focus for DoI until June 2002
- consideration that the benefits in the feasibility studies report may have been overstated. The August 2000 advice to government had already noted that the benefits may have been overstated
- confirmation that critical agreement with the infrastructure lessee on access arrangements to the track had yet to be secured. The August 2000 advice to government noted that the lack of control over access placed a serious limitation on the ability to implement not only infrastructure works, but the whole fast rail initiative
- recognition that the infrastructure lessee would need to approve any new works, as would the DPTS. Reference to the critical importance of the role of the DPTS was included in the Primary Infrastructure Lease between the Director of Public Transport and FAL signed in April 1999, and the Alliance Agreement between DoI and FAL signed in December 2001
- detailed information on the scope and cost of the rail infrastructure upgrade. The development of the expression of interest documentation proposed in May 2001 was the first occasion when an early indication of the scope of rail infrastructure works was available.

## Conclusion

DoI's advice to government in August 2000, recommending approval and funding for the upgrade of the rail infrastructure on the fast rail corridors was incomplete and, as a result, contributed to some of the delays in timing and cost overruns that emerged during the construction of the rail infrastructure.

In addition, the advice to government did not provide an adequate basis for the recommendation to government to approve the rail infrastructure upgrade and allocate funds because critical operational issues had not been resolved. These included the agreement with FAL on access arrangements and arrangements to approve the contractors' infrastructure designs with both FAL and the DPTS. Risk management mitigation strategies also had not been developed.

Decisions on the rail infrastructure upgrade, in the absence of resolution of these issues, were premature and presented a significant risk to successful delivery.

## 2.4 Development phase (December 2000 to June 2002)

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### 2.4.1 Introduction

In September 2000, the government established the Rail Project Committee of Cabinet and the Rail Projects Steering Committee. In December 2000, DoI and DTF formed the RPG as a "joint venture" between the 2 departments. We described the roles and activities of each of these groups in section 2.2.3 earlier in this report.

The RPG was responsible for the agreement of contracts for the design and construction of the rail infrastructure upgrade.

### 2.4.2 Feasibility studies refinement

The feasibility studies final report indicated that several major tasks needed to be completed before the rail infrastructure upgrade could proceed. These included:

- investigation of the potential for PPPs delivering the upgrades
- engaging the existing franchisee, infrastructure lessee and other private sector bodies in determining the most effective means of achieving all fast rail objectives
- resolving engineering and technical policies and standards relating to track, signalling requirements, level crossings and fencing
- further scoping works to refine the feasibility study cost estimates
- assessment of property acquisition requirements<sup>39</sup>.

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<sup>39</sup> Department of Infrastructure 2001, *Fast rail links to regional centres, Feasibility Studies: Final Report, Linking Victoria*, Victorian Government, Melbourne, p. xxii.

When the RPG was established, its focus was on taking the feasibility work forward to the point where the state could decide on the awarding of contracts for the design and construction of the infrastructure upgrade. We note below how the RPG responded to the feasibility study recommendations between its establishment (in December 2000) and the signing of the infrastructure upgrade contracts (in June 2002).

The RPG investigated the potential for delivering the upgrade as a PPP. It found that the private sector was not willing to invest and concluded that the infrastructure upgrade was not viable as a PPP.

The RPG consulted with the key stakeholders during this period by setting up working groups with some including representatives from the passenger operator and the lessee. However, it is clear from the subsequent difficulties in accrediting the fast rail designs that this consultation did not adequately “determine the most effective means of achieving all fast rail objectives”. Many scope changes described in section 2.5.2 of this report, can be linked to the level of design detail available when the contracts were signed in June 2002.

In a similar way, the RPG was not successful in resolving issues relating to engineering, technical policies and standards. This also led to some of the contract scope changes and variations described in section 2.5.2 of this report.

The RPG, however, further refined the feasibility studies works and cost estimates. Specifically, the RPG recommended:

- keeping both lines open on the country sections of the Bendigo corridor but only upgrading one for high-speed operation, with the second line used for low-speed freight traffic and as a passing loop to allow express services to overtake non-express services. The impact of this decision is addressed in section 2.5.2 of this report
- upgrading only one of the 2 lines to fast rail standards (the feasibility studies recommended upgrading both lines) because this would save \$23 million and would still meet passenger requirements for the foreseeable future. The outcome of this decision is addressed in section 2.5.4 of this report.

The RPG also estimated the cost of land acquisitions as part of the overall infrastructure upgrade budget. We show in section 2.5.2 of this report how the scope of these estimates was inadequate and led to a significant underestimate of the actual costs.

## Conclusion

The work of the RPG did not adequately complete the tasks identified in the feasibility studies final report as an essential precursor to the delivery of the infrastructure upgrade. Most importantly, the RPG did not obtain agreement from the key stakeholders on the most effective means of delivering all fast rails objectives, and it did not resolve the issues about engineering, technical policies and standards.

The absence of agreement on detailed design issues led to many of the scope changes described in section 2.5.2 of this report.

### 2.4.3 Rail infrastructure lease and the regional fast rail Alliance Agreement

#### Role of the infrastructure lessee

As indicated previously, in 1999 the Victorian country intrastate (largely broad gauge) rail infrastructure was leased for 15 years (with options for 2 further 15-year lease extensions) to a private operator, Freight Australia Limited (FAL) now Pacific National (PN). The Primary Infrastructure Lease was transferred to PN in September 2004. FAL and then PN, were responsible for managing the infrastructure so it was fit for the purpose of safely running freight and passenger train services.

In discharging this responsibility, the lessee:

- controlled access to the infrastructure by third parties
- had to be accredited under the safety accreditation regime administered by DoI's Safety and Technical Services Branch (STSB), now the Director of Public Transport Safety (DPTS). While DPTS sat within DoI, it had to fulfil its statutory duties in regard to rail safety independently from DoI.

#### *Importance of these functions to the delivery of fast rail infrastructure*

Section 5 of the lease gives the Director of Public Transport rights to gain access to the infrastructure to carry out new infrastructure works.

However, in practical terms, DoI understood that it would be difficult to access the rail infrastructure to build the rail infrastructure without the cooperation of the lessee.

In Victoria, managers of rail infrastructure and operators of rolling stock must be accredited under the rail safety accreditation regime established by Victorian legislation. To achieve accreditation, a company must demonstrate: its competency and capacity to manage infrastructure or rolling stock safety; its financial capacity to meet potential liabilities; and the use of an appropriate safety management system.

If an accredited rail operator makes or agrees to a material change<sup>40</sup> to the rail infrastructure, rolling stock or train operations that affects its safety management system, it must submit a material change application to the DPTS for approval to demonstrate how increased risks are mitigated. The application must describe the change in risk and the updated safety management system, and controls proposed to keep the risk as low or lower than the current level of risk. The applicant must also show how the change will not increase the risk for interfacing rail activities.

As with the government's Rail Gauge Standardisation Project, DoI recognised from the early planning stage that the cooperation of the lessee was critical to the successful implementation of fast rail services. To manage the lessee's primary roles in approving access to the rail infrastructure and applying for revised infrastructure accreditation, DoI entered into an "Alliance Agreement" with FAL in December 2001.

#### *Dol's Alliance Agreement with FAL*

The Alliance Agreement acknowledged the state's and FAL's rights and obligations under the lease in relation to the completion of new works. It established a cooperative framework to work together to facilitate the rail infrastructure upgrade in a manner which met the objectives of both parties. Among other things, the agreement set a framework and guidelines for the provision of access to the infrastructure and the accreditation of the upgraded rail infrastructure.

The agreement included protocols and a process for FAL to provide access to the rail infrastructure. The contractors must produce track occupation plans and pay FAL agreed rates for these occupations. FAL must facilitate these planned occupations and manage their safe implementation.

The agreement also set out the stages during the design and construction process where FAL would need to apply to the DPTS on issues regarding its accreditation. These included:

- 3 stages in the design process covering the contractors' concept design, preliminary design and final design proposals for the upgrade of the rail infrastructure
- several post-design stages covering the testing and commissioning of the upgraded infrastructure.

The agreement was clear in stating that contractors would not be allowed to start work within a corridor "... until FAL has received written confirmation from the DPTS that DPTS has no objection to the accreditation documentation which relates to the final design"<sup>41</sup>.

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<sup>40</sup> A material change is one that may negatively alter the risk profile for railway operations.

<sup>41</sup> FAL Alliance Agreement, November 2001, p. 17.

The agreement specified the maximum times FAL had to review design and accreditation material, and to pass complete and reviewed material to the DPTS. Having reviewed the draft accreditation material, FAL had 3 options when reviewing the contractors' accreditation submissions:

- to pass this on to the DPTS within 15 days of receiving the information
- to request further information from DoI within 10 days (and DoI had to provide this information within 5 days)
- to flag issues not complying with FAL's accreditation requirements within 15 days. DoI would either instruct the contractors to change the documentation if it thought the change was justified or, negotiate a resolution with FAL, or put the issue to binding arbitration.

The Alliance Agreement did not specify how long the DPTS should take to confirm accreditation.

## Conclusion

The Alliance Agreement was an attempt to manage the risks associated with FAL's key access and accreditation roles. Its successful operation still relied on a high level of cooperation from FAL because:

- there were clear and legitimate avenues for delaying accreditation by requesting information or identifying, what FAL considered were, inadequacies in the contractors' accreditation applications
- there were no clear sanctions in the agreement if the parties to the agreement did not comply with its requirements.

### 2.4.4 Design and construction

Our October 2002 *Report on the Finances of the State of Victoria, 2001-02*, reported on the results of a review of the design and construction process. In respect of the process, we reported that:

“The successful contractors are to design and construct the upgraded rail infrastructure in accordance with the requirements of a contract and proposal brief. The design stage of the contract requires submissions by the contractors to the Department of Infrastructure for the preliminary corridor design, the final corridor design and the deferred design packages, to be completed within specified time frames from the date of the signing of the contract”<sup>42</sup>.

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<sup>42</sup> Victorian Auditor-General's Office, 2002, *Report on the Finances of the State of Victoria, 2001-02*, Victorian Government Printer, Melbourne, p. 104.

In June 2002, the state awarded fixed-fee contracts which included the requirements to:

- develop final, accredited infrastructure designs from the concept designs submitted in the successful bids
- construct infrastructure in accordance with the final (accredited) designs to deliver the contract outcomes.

This type of contract places the responsibility for delivering infrastructure that achieves the contract outcomes with the contractors. For example, if the implemented design does not work because of a miscalculation or poor construction, then the contractors must remedy this at their own cost.

However, a fixed-fee design and construct contract is less effective in allocating certain risks to the contractors where other stakeholders are also able to enforce changes to the project scope and amend previously agreed design decisions. Under these circumstances, the state may bear the time and money impacts of scope changes as commercial contractors seek to vary the contract.

The risks of design and scope changes are lessened where stakeholders have been effectively consulted on detailed designs before the state has committed to these designs.

## Conclusion

We consider that the use of fixed-fee design and construct contracts, based on a conceptual design, increased the risk of failing to deliver the rail infrastructure upgrade on time and within budget. From the information available at the time of awarding the contracts, the RPG should have realised that the risk to the projected timelines and budget was substantial and needed to be effectively mitigated.

### 2.4.5 Tender evaluation and selection process

When the RPG was established, its responsibilities included putting together the tender documentation, the evaluation of tenders and the selection process.

Our October 2002 *Report on the Finances of the State of Victoria, 2001-02*, reported on the tender evaluation and selection process. In respect of that process, we reported that:

- In May 2001, the RPG sought expressions of interest for the design, construction and delivery of metropolitan and country infrastructure works packages. For each country infrastructure works package, the private sector participants were provided with the flexibility to develop and bid for a scope of works that would provide the best journey time estimates and optimal value-for-money within the specified standards.
- In September 2001, the secretary of DoI approved the recommendation of the RPG in relation to the short-listed selection process.
- Three tenders, in response to a Request for Tender, were received in February 2002 and the initial evaluation process revealed a number of strengths and shortcomings in all tenders.
- In May 2002, the best 2 tenderers for each corridor were invited to submit revised tenders.
- In June 2002, the government endorsed the RPG's recommendation of the preferred tenderers for each of the country works infrastructure packages with an estimated project cost of \$556 million<sup>43</sup>.

#### 2.4.6 New trains

When the RPG was established, its responsibilities included putting in place the contracts and contract variations for rolling stock.

The previous government announced in June 1999 the purchase of 29 high-speed trains for country rail passenger services as part of its V/Line franchising arrangements with National Express<sup>44</sup>.

The feasibility studies report indicated that the base demand for rail services in all corridors had been increasing over the last 5 years and expectations were for growth in the future. As a consequence of this increased demand, peak capacity issues were likely to be exacerbated. The feasibility studies report indicated that the new trains acquired by National Express would provide adequate capacity in the short-term<sup>45</sup>.

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<sup>43</sup> Ibid. p. 103-4.

<sup>44</sup> In December 2002, National Express withdrew from the franchise agreement. In October 2003, the state decided to transfer back to state control V/Line passenger services. (Between December 2002 and October 2003, V/Line was in administration and was operated by the government-appointed receiver and manager).

<sup>45</sup> National Express was, at the time, the franchisee for V/Line passenger services. FAL was the lessee of the state's country rail infrastructure. The state retained ownership of the rail infrastructure, except for rolling stock.

The franchise agreement required National Express to introduce 29 new double unit sprinter-style trains into service by June 2003. In recognition of the need to improve the speed of country trains in the future, the agreement specified that the trains were to be capable of speeds of up to 160 km/h with sustained operation at 145 km/h. In practical terms, this meant the trains could run services at speeds of up to 145 km/h. The train engine needed to have the capacity for higher speeds than this to make sure it could accelerate to its sustained operating speed.

In February 2001, the RPG advised the government that the purchase of these trains would compromise the delivery of travel time targets because they were only capable of operating at 145 km/h. The travel targets would be missed by 6 minutes on all corridors unless the government funded additional, costly rail infrastructure works. The RPG recommended that the government purchase trains capable of sustained operation at 160 km/h. In February 2001, the government endorsed this recommendation and the negotiations to amend the rolling stock started with the supplier.

In November 2001, the government announced that 29 high-speed trains would be built to run regional fast rail services<sup>46</sup>.

In June 2002, DoI advised the government that additional trains were needed to provide capacity to deliver rail services to Mildura and South Gippsland by December 2004, and to sustain the Warrnambool service after 2006. There was no surplus capacity within the V/Line Passenger fleet to meet these service requirements. The existing arrangement used to purchase the 29 fast trains included an option to purchase additional trains. DoI recommended that this option be exercised to purchase an additional 9 trains.

The option would secure new trains capable of operating at 160 km/h. These would be used for the most part on the fast rail corridors, allowing older rolling stock to be cascaded to the other routes.

The 38 new fast trains were to be progressively delivered from the end of 2004, with final delivery in late 2006. The first trains started testing in early 2005 and have since been progressively introduced to run existing passenger services.

The V/Line franchise agreement dated 1999 and the amended agreement dated 2003 contain the costs of the original and amended train orders. We summarise the costs as follows:

- the 29 new 2-car sets capable of operating at 145 km/h would have cost \$169 million

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<sup>46</sup> Media release, Manufacturing jobs boost in \$410 million fast train contract, Office of the Premier, November 2001.

- the 29 new, 2-car sets capable of operating at 160 km/h cost \$215.6 million (an added cost of \$46.6 million)
- the extra 9 new, 2-car sets capable of operating at 160 km/h cost \$66 million
- the contract maintenance costs remained unchanged
- the total cost of upgrading the trains and extending the order for regional fast rail was \$46.6 million.

This cost of the 29 new, 2-car sets is directly attributable to the fast rail initiative.

## Conclusion

It is evident that the new trains are available for the planned commencement of the fast rail passenger services in mid-2006. However, this would not have been the case had the original infrastructure completion dates for the rail infrastructure works of between March 2004 and June 2005 been achieved.

The total costs of the fast rail initiative should include the \$46.6 million cost of upgrading the original order for 29 trains to operate at speeds of up to 160 km/h.

## 2.5 Delivery phase (June 2002 to the present)

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### 2.5.1 Introduction

To deliver the faster and more frequent train services to the communities along the 4 corridors required:

- upgraded rail infrastructure on the country sections of the corridors to allow trains to travel safely at speeds of up to 160 km/h
- 29 new velocity trains (addressed in section 2.4.6 of this report)
- installation of a new fibre optic network as part of the upgraded rail signalling and communications systems
- a revised 2006 V/Line timetable incorporating some faster and several additional train services
- a package of improvements to connecting regional bus services.

Collectively, these 5 components formed the fast rail initiative.

We expected DoI to plan and manage each of these elements to contribute to the outcomes on time and within budget.

In addition, there are clear dependencies between some of these elements, for example:

- The new, faster trains and improved infrastructure together provide the potential for train services to achieve faster and more frequent journey times. We expected that the infrastructure design would take account of the new trains' characteristics and that both these elements would be managed so that they were ready at the same time.
- The timetable is the mechanism through which the enhanced train service potential is translated into better customer services. We expected the infrastructure design would take account of the likely pattern of timetabled services.
- We expected that regional bus services would be realigned to maximise the benefits of the investment.

Each of these components of the project is addressed in the following pages.

## 2.5.2 Upgrading the rail infrastructure

### Introduction

On 25 June 2002, the government awarded contracts<sup>47</sup> to design and construct the fast rail infrastructure upgrades to the:

- John Holland and Transfield joint venture for the Latrobe Valley and Bendigo corridors
- Thiess-Alstom consortium for the Ballarat and Geelong corridors.

The contract deliverables are shown below in Figure 2J.

**FIGURE 2J: INFRASTRUCTURE CONTRACT DELIVERABLES**

Corridor	Cost	Infrastructure completion dates	Revised express journey times	Train service paths (in addition to the July 2001 timetable)
	(\$ million)		(minutes)	
Ballarat	130.7	June 2005	64	2 in the peak direction and one in the counter-peak direction
Bendigo	182.9	October 2004	84	
Latrobe Valley	114.8	March 2004	95	
Geelong	69.1	February 2005	45	No additional paths
<b>Total</b>	<b>497.5</b>			

Source: Office of the Premier and Department of Infrastructure, Media release, *Record construction contracts for regional fast rail project to create 5 000 jobs*, June 25, 2002.

<sup>47</sup> Office of the Premier and Department of Infrastructure, Media release, *Record construction contracts for regional fast rail project to create 5 000 jobs*, June 25, 2002.

In addition to the contract costs, the state allowed for further project costs of \$58.6 million (net) making a total budgeted cost of \$556.1 million. This included a reserve for contingencies (\$21.4 million) and capital risks (\$12.3 million) totalling \$33.7 million or 6 per cent of the total.

In committing to these costs and timelines, we expected DoI to have understood the rail infrastructure upgrade risks and put in place contractual arrangements and other measures to manage these risks.

### **Design and construct contracts**

Once the construction contracts were signed, DoI understood that there remained a significant amount of work to develop the contractors' concept designs to final designs. Indeed, the concept designs and the following preliminary designs had insufficient detail to form the basis for the submission of any meaningful accreditation documentation to the DPTS. It was not until the final design that the level of design detail allowed stakeholders to carry out a comprehensive review of the implications. While key stakeholders were consulted soon after the contracts were awarded in June 2002, the minimal level of design detail prevented a full review for some considerable time.

### **Risk management**

Section 2.3.1 of this report indicated that a preliminary risk assessment was not prepared as part of the feasibility studies report, although +/- 30 per cent was noted in the report.

At the time the contracts were awarded, the RPG had completed an initial assessment identifying the main risks that later materialised to delay the rail infrastructure upgrade. The RPG's initial risk management assessment was deficient because this exercise happened in the absence of:

- a formal process for identifying and assessing risks
- clear accountabilities for risk management
- mitigation plans for the risks identified
- a mechanism to review and update the project risks.

The total value attributed to these risks in June 2002 was \$8.95 million or 1.6 per cent of the total infrastructure costs of \$556 million. In the original approved budget for the rail infrastructure upgrade, a total of \$33.7 million, or 6 per cent of the total cost, was allocated for capital risks or contingency.

In January 2003 (7 months after the contracts were awarded), DoI applied an improved risk management framework to assess the infrastructure-related risks. This identified and more fully described a wide range of risks. The potential exposures (totalling \$89 million) included:

- contract scope changes and variations
- claims for delays caused by scope changes
- higher land acquisition and compensation costs
- compensation to the access provider for disruption to business.

DoI used this improved assessment as the basis for its risk management going forward.

The RPG's early assessment of the likely risks was incomplete up to the awarding of the infrastructure contracts in June 2002. The RPG did not adequately inform government of the significant risks inherent in the awarding of fixed-fee contracts based on a conceptual design and without effective prior consultation with the key stakeholders. We considered that the use of fixed price and design construction contracts and the Alliance Agreement with FAL would not have been able to protect the state from the risks identified by DoI.

### **Contract variations**

In March 2006, the total cost of the infrastructure upgrade contracts was \$608 million, \$124 million more than the June 2002 budget of \$497.5 million. DoI's current forecast of the total cost of these contracts has not been included because of the current negotiations between DoI and the contractors. DoI also expected construction work to begin on all corridors in November 2002 after the acceptance of final designs; some 4 to 5 months after the announcement of the successful tenderers. Depending on the corridor, construction actually started between 9 months and 16 months after this target.

It became clear to DoI from a very early stage that it was going to be much more difficult to achieve an accredited final design than had been planned because:

- the accreditation process included in the Alliance Agreement was proving complex
- the infrastructure lessee, the train operator, the safety regulator, the train drivers' union and DoI all raised significant scope and design issues.

In this section of the report we examine the reasons for the contract variations to date.

***Design and accreditation process***

In DoI's view, the main reason for the delays in starting construction was the time taken to gain approval of the contractors' designs and accreditation documents. DoI's documentation records a history of concerns that FAL was:

- not completing document reviews and submissions in accordance with the Alliance Agreement
- not able to easily assess the accreditation documentation because it did not have a defined risk profile to use as a basis to assess the impact of the designs on its safety accreditation
- not providing the contractors with access to its safety management system which was important to properly frame their accreditation documentation.

DoI reported in March 2003, some 4 months after the planned commencement of construction, that there were 71 accreditation issues under active consideration, resulting in delays in the commencement of construction. Given the volume of design and scope issues and accreditation process difficulties, it became clear that it was going to take much longer to provide documentation that met the accreditation requirements.

DoI broke with the agreed process in the Alliance Agreement in an attempt to start construction works by using external consultants to help navigate specific interim works packages through the accreditation process.

The consultants were experienced in the accreditation process from overseas and interstate railways. They worked with DoI and FAL, assisting with the collection and preparation of data to use in its material change applications. However, the process was still slow and labour intensive.

The accreditation process in the Alliance Agreement, which provided for up to 300 days to arrive at a final design, was unlikely to deliver within DoI's time frame of 4 to 5 months unless there was positive cooperation from all the parties involved. This included both FAL and the DPTS.

The extent and the scope and design changes are referred to in the following section.

### Scope changes

The stakeholders (including FAL and the DPTS) raised a wide range of scope issues which resulted in significant changes to the contract costs and time lines to complete the construction. Figure 2K details these scope variations by corridor and the actual payments made to April 2006. The contractors have made further variations and claims totalling \$24.96 million, and DoI has yet to negotiate a settlement amount.

**FIGURE 2K: INFRASTRUCTURE CONTRACTS SCOPE VARIATIONS – ACTUAL PAYMENTS TO APRIL 2006 (\$MILLION)**

	Ballarat corridor	Geelong corridor	Bendigo corridor	Latrobe Valley corridor	Total project payments to April 2006
Original contract budget (June 2002)	130.75	69.09	182.85	114.82	497.51
Actual payments to April 2006 against original contract budget	130.39	68.79	182.81	102.00	483.99
Scope variations -					
Global agreements for track works and time-related claims	14.35	7.05	6.63	4.10	32.13
Diverge signalling	-	-	10.68	8.83	19.51
Signalling changes	4.92	1.91	6.71	1.13	14.67
Extended passing loops	-	-	10.27	-	10.27
Concrete sleepers	-	-	-	9.00	9.00
Overhead electrical infrastructure	-	-	-	6.74	6.74
Turnouts	1.70	3.00	-	-	4.70
Other	7.84	3.75	11.70	3.70	26.99
<b>Variations sub-total</b>	<b>28.81</b>	<b>15.71</b>	<b>45.99</b>	<b>33.50</b>	<b>124.01</b>
<b>Actual totals</b>	<b>159.20</b>	<b>84.50</b>	<b>228.80</b>	<b>135.50</b>	<b>608.00</b>

Source: Department of Infrastructure.

Below we describe the reasons for these variations.

#### Global agreements for track works and time-related claims

Global agreements were struck with the 2 contractors across the 4 corridors, to settle contractual issues, including claims for extension of time and additional infrastructure works, and payments to April 2006 totalled \$32.13 million.

By the third quarter of 2003, the contractor on the Ballarat and Geelong corridors had lodged notices for delays experienced in the consideration of the contractors' infrastructure proposals during the design phase, and other claims related to the interpretation of the contract. After a significant period of negotiations, these claims were resolved for \$14.35 million for the Ballarat corridor and \$7.05 million for the Geelong corridor.

Similar global agreements for the Bendigo and Latrobe Valley corridors were executed in November 2003 and totalled \$6.63 million and \$4.1 million, respectively.

#### Diverge signalling

The extensions to the safety stopping system for the operation of fast rail services, as recommended by the DPTS, to areas where trains transition from low to high-speed track (speeds of between 130 km/h and 160 km/h), led to significant reworking of the contractors' signalling designs.

Approved variation payments for this purpose across the Bendigo and Latrobe Valley corridors are currently \$19.51 million. The Train Protection and Warning System (TPWS) is discussed in further detail below.

#### Changes to signal spacing and sight distances

The Signal Sighting Committee (SSC)<sup>48</sup> recommended changes to the signal design agreed between DoI and the contractors. This included the minimum spacing of signals and the minimum distance from which a train driver could see a signal.

The SSC also wanted pathways constructed next to where tracks cross. These pathways allow improved and safer access when drivers needed to manually change the points controlling the train's path through these crossing points.

The SSC insisted on these changes. While these requirements were in excess of current operational and standard practices, DoI's approved scope changes to avoid further delays. To April 2006, this has cost \$14.67 million.

#### Changing the project scope for the Bendigo corridor

DoI agreed to a design and construction contract which had a single track with 3 short passing loops replacing the existing double track between Kyneton and Kangaroo Flat near Bendigo. This proposal was deemed by government to lower the cost and risk of the project because it limited the necessary works on the many heritage bridges and tunnels on the Bendigo line.

At the time, DoI thought this approach would deliver the additional services and minimum journey times set out for the corridor.

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<sup>48</sup> The SSC comprised train drivers and advised DoI on safety and operational issues related to the placement of rail signalling infrastructure.

Following the signing of the contracts in June 2002, DoI:

- reviewed the contractors' design proposals (between late 2002 and early 2003)
- started community consultation to determine the form of the fast rail timetable.

DoI's review found that the target travel times and additional train services could not be delivered under the single track configuration with 3 short passing loops agreed to in the design contract.

Subsequently, DoI required the contractor to redesign and extend the passing loops. The cost of this change in scope was \$10.27 million.

We found that the evaluation of the contractor's tender design which was undertaken at the tender, preliminary and final design stages was inadequate because this issue should have been identified. In saying this, it is also evident that the review of designs was focused more on construction issues than outcomes associated with delivery of fast rail services.

Further, early timetable development would have assisted DoI to establish whether the infrastructure solutions would achieve the outcomes, and may have highlighted this issue earlier.

### Concrete sleepers

The contractor's final design proposals for the Latrobe Valley corridor developed in January 2003 were based upon the use of a resilient rail-fastening system for timber sleepers that would avoid the higher cost alternative of replacing existing sleeper plates. These fastenings were not the type approved for use on FAL's network and FAL objected to their use.

DoI identified that maintenance costs associated with timber-sleepered track were almost 3 times those for concrete-sleepered track at fast rail operations of 160 km/h. Hence, the use of concrete sleepers would result in savings on maintenance costs over time. On this basis, the higher capital cost of constructing a new concrete-sleepered track was justified by DoI from a "whole-of-life cost savings" basis, and the fact that the state was liable for any change to the maintenance costs of FAL as a result of the rail infrastructure upgrade.



*Upgraded rail infrastructure on a fast rail corridor.*

In November 2003, the contractor was directed to substitute timber sleepers with concrete sleepers for the fast track upgrade on the Latrobe corridor, and in December 2003, the Minister for Transport approved this decision. To the end of April 2006, the cost of this scope change was \$9 million.

Given that the final infrastructure design for the Latrobe Valley corridor was submitted by the contractors in January 2003, a substantial period of 11 months elapsed before a decision was taken regarding the use of concrete sleepers. Again, this highlights the issues that could have been identified and considered had corridor designs been subject to better consultation earlier in the initiation phase.

#### Latrobe Valley corridor overhead infrastructure

To allow the contractor to complete works on the Latrobe Valley corridor, VicTrack was supposed to remove the electrical overhead infrastructure upgrade between Pakenham to Warragul before work started on the rail infrastructure. Although tenders were called in March 2002, the work did not proceed.

The contractor and DoI looked at an alternative to removal of the overhead infrastructure. This work delayed the project and led to some cost variations. To prevent further delays, DoI approved a variation for the contractor to remove and subsequently replace the electrical overhead infrastructure. To date, payments of \$6.74 million have been made for this variation.

### Turnouts on the Ballarat and Geelong corridors

The contractor for the Ballarat and Geelong corridors designed turnouts<sup>49</sup> around March 2003 and May 2003, respectively. These designs were to the existing standard, which included the use of reconditioned turnouts as part of the upgrading of the fast rail corridors. However, FAL requested that only new turnouts be used. In January 2004, DoI decided that the turnouts to be used would be upgraded to 60 kg rail-on-concrete bearers, which were the type that were already approved for operation on the FAL network. This was done at a cost of \$4.7 million.

### Other scope variations

Payments for a multitude of other contractual variations across all 4 corridors, as at April 2006, totalled \$26.99 million: \$11.7 for the Bendigo corridor; \$7.84 million for the Ballarat corridor; \$3.75 million for the Geelong corridor and \$3.7 million for the Latrobe Valley corridor. These variations were for bridge strengthening and level crossing works, contamination management, vegetation removal, fencing, extended track occupations, and other track and signalling works.

### Changing the scope of the train safety system

The infrastructure contracts recognised the need to provide an upgraded safety system for running new trains at speeds of up to 160 km/h. Previously, the fastest trains on the network had a top speed of 130 km/h. The contracts included the costs of installing the TPWS. The TPWS had been used in the United Kingdom to provide additional protection to a train when it incorrectly passed a stop signal and ran the risk of derailment or collision with other trains.

The TPWS comprises equipment fitted to the track and inside the train driver's cabin. The trackside equipment detects excessive speeds and triggers the cabin mounted equipment to stop the train. The contracts included funding to fit trackside equipment and cabin units to 29 of the new fast trains. The cost of the purchase and fitting of the TPWS in cabin units was \$3.8 million. Trackside units were only fitted on sections where the infrastructure would allow trains to reach speeds of 160 km/h. The costs of this equipment were not separately identified in the bids.

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<sup>49</sup> Turnouts are junctions in a train track that enable trains to move between different lines.

After reviewing the contractors' design proposals, the passenger rail operator (V/Line) and infrastructure lessee (FAL) questioned the scope and application of TPWS. The Director of Public Transport Safety (DPTS) then independently reviewed the proposals and concluded that TPWS was the most cost-effective approach to safety for the 4 corridors. The DPTS also developed a draft policy based on its review that required a broader application of TPWS than was included in the contracts. The development of the draft policy was influenced by DPTS's involvement in the Special Commission of Inquiry into the Waterfall accident in New South Wales. This was one of several factors prompting a review of the application of TPWS in Victoria<sup>50</sup>.

Specifically, the policy applied to the installation of TPWS on:

- Victorian country broad gauge lines used for country passenger train services, excluding electrified suburban lines
- all trains accredited to run on these lines.

The draft policy stated that TPWS line-side equipment be fitted to stop signals protecting passenger lines within a designated train protection area where:

- the line speed on the approach to the signal is greater than 130 km/h (so this now applied to parts of the fast rail corridors where trains travelled at speeds in excess of 130 km/h)
- the signal is assessed as requiring this equipment as a result of applying the risk assessment process set out in the policy
- directed by the safety regulator.

The extension of TPWS on the 4 corridors to cover areas where trains travel between 130 km/h and 160 km/h is directly attributable to the fast rail initiative. DoI agreed a common approach to the extension of TPWS across the 4 corridors and issued variation orders to install the additional units at an estimated cost of \$33 million. The adoption of a common TPWS approach required the substantial redesign of the signal system on 2 corridors at a further cost of \$19.51 million, as at April 2006, which is described earlier within this section under "Diverge signalling".

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<sup>50</sup> Department of Infrastructure, Media release, Leading train safety system for regional rail, December 14, 2004.

The funding for the extension of TPWS was requested and provided for in DoI's separate Country Train Safety System (CTSS) project. Total funding approved under this DoI initiative is \$91.5 million<sup>51</sup>, including the \$33 million directly attributable to the fast rail initiative.

## Conclusion

The contractual arrangements for the design and construction and the RPG's failure to properly assess, value and manage key risks resulted in a substantial number of contract variations which impacted on the time to complete the rail infrastructure upgrade and its cost. DoI put in place an improved risk management framework in January 2003.

In our view, the primary cause of the time delays and additional costs incurred under the infrastructure contracts were due to a lack of proper planning and consultation by the RPG before the contracts were awarded. The practical problems with the accreditation process and the actions of some of the participants exacerbated, but did not cause, these time delays and additional costs. Most of the additional delays and costs can be directly linked to scope changes that mostly arose from legitimate stakeholder concerns.

The need to reconsider the suitability of TPWS by FAL and the DPTS led to additional costs for the redesign of signal systems on 2 corridors and significant, unplanned time delays on all corridors.

We also consider that the \$33 million cost of TPWS is directly attributable to the fast rail initiative.

## Other cost variations

As at April 2006, total other infrastructure-related costs were \$88.3 million, \$37.39 million more than the original June 2002 budget of \$50.91 million. Figure 2L details the other cost variations to the regional fast rail project.

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<sup>51</sup> Victorian Government, *2005-06 Budget Paper No. 3 – Service Delivery*, Appendix A, Victorian Government Printer, p. 295. The CTSS is described in the budget papers as a separate department initiative to provide for a country train safety system to be fitted to all V/Line passenger trains, and builds on the government's commitment to improve rail safety in regional Victoria.

**FIGURE 2L: OTHER COST VARIATIONS (\$MILLION)**

Variation description	Original budget June 2002	Actual costs April 2006
<b>State administration -</b>		
Additional project management - Contractor costs	9.21	20.99
Additional project management - Staff costs	10.09	13.99
Other	10.33	15.12
<b>Subtotal</b>	<b>29.63</b>	<b>50.1</b>
Project insurance	2.10	12.5
<b>Other costs -</b>		
Land acquisition	7.57	10.8
On Board Train Control	3.80	0
Fibre optic cable	4.08	0
<b>Access provider impact -</b>		
FAL/PN reimbursable project costs	3.73	14.9
<b>Total</b>	<b>50.91</b>	<b>88.3</b>

Source: Department of Infrastructure.

In the following paragraphs we examine the reasons for these variations.

### ***State administration costs***

The budget for administration costs rose by \$20.47 million from the June 2002 estimate of \$29.63 million to an April 2006 actual of \$50.10 million.

The reasons for this increase were:

- additional contractor and DoI staff costs to manage the material change issues raised by FAL, help with the infrastructure accreditation process, and review the contractors' activities on-site
- additional accommodation and support charges associated with this extra labour.

This higher budget reflected the complexity of the rail infrastructure upgrade, and DoI's need to secure external expertise to manage a range of issues that were beyond its resource capacity.

### ***Higher insurance premiums***

The state provided insurance for the 2 infrastructure contractors to cover liabilities arising from their activities which may have affected firms using or managing the infrastructure or the general public. It made this decision on the basis that the state was best able to manage these risks. In early 2002, insurance brokers estimated the cost of this insurance at \$2.1 million.

In August 2002, the Victorian Managed Insurance Authority (VMIA)<sup>52</sup> was appointed as the rail infrastructure upgrade insurance adviser. The VMIA advised that the cost of this insurance would be significantly greater than the original \$2.1 million estimate because of:

- the impact on insurance capacity and premiums arising from the September 2000 terrorist strikes in the USA
- rising public liability premiums for rail-related activities due to a number of rail crashes worldwide.

The insurance costs has risen from an estimated \$2.1 million in June 2002 to \$12.5 million in April 2006, an increase of \$10.4 million. Most of this change is associated with the changes in the global insurance market.

### *Land acquisition costs*

The feasibility studies report indicated that one “major task” to be completed was the assessment of property acquisition requirements.

The June 2002 project budget included an estimate for land acquisitions of \$7.57 million. This was based on an assessment of the value of land and properties likely to be acquired for the project. This underestimated the costs of compensating property owners for disruption and loss of business, and legal and surveying services. At the time that this estimate was developed, the conceptual design (an early overview of the nature of works required) was being used and, as a result, a better estimate of the likely land required and its acquisition cost was not available.

The cost of land acquisitions (including compensation to land owners) at April 2006, was \$10.8 million, \$3.23 million above the original budget estimate.

### *FAL costs and compensation claims*

The infrastructure lessee (FAL and then PN from September 2004) was responsible for managing the regional, broad gauge rail infrastructure. The lessee is entitled to:

- payment for its fast rail-related costs, including the time involved in reviewing designs, completing the accreditation and commissioning of new infrastructure, attending meetings, providing the contractors with access to the infrastructure
- compensation for any fast rail-related disruption to its existing freight business.

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<sup>52</sup> The Victorian Managed Insurance Authority provides the Victorian Government with risk management and insurance services.

In the June 2002 budget, the lessee's cost estimates were budgeted at \$3.73 million. By April 2006, payments in regard of these costs was \$14.9 million, an \$11.17 million increase.

In addition, the June 2002 budget did not include provision for FAL compensation. This is despite the fact that the RPG had made provision for compensating FAL in the December 2001 Alliance Agreement with FAL.

The absence of any recognition in the budget to cover FAL's compensation costs is of concern given the awareness within DoI that the project would substantially disrupt FAL's commercial activities. By April 2006, compensation costs amounted to \$2.9 million.

### **Conclusion**

We found that the most important reason for the overrun in costs was DoI's underestimation of the resources needed to administer the rail infrastructure upgrade and negotiate the safety accreditation requirements.

## **2.5.3 Fibre optic cable**

When contracts for the rail infrastructure upgrade were signed in June 2002, \$4.1 million was allocated towards the cost of connecting the fibre optic cable network (FOC) into the fast rail signal systems on the Bendigo, Ballarat and Latrobe Valley corridors. No budget allocation was made towards these costs for the Geelong corridor. The original infrastructure upgrade budget made no allowance for the actual purchase and installation of the trunk FOC along the fast rail corridors, as this cost was yet to be determined.

In October 2001, VicTrack advised the government that the installation of the FOC was necessary to provide rail signalling and communications infrastructure to deliver fast rail services. The FOC was being developed separately to capture any value from commercialising the spare capacity available in the FOC.

The initial \$810 million project estimate included a \$15 million allowance for the installation of the FOC along the 4 fast rail corridors. At this time, the private sector was expected to fund the installation of the FOC so it could sell the excess capacity to generate a commercial return.

However, the bidders for the installation of the FOC network indicated that there were limited opportunities to commercialise the spare capacity in the FOC, citing the poor investment climate in the telecommunications industry. The government agreed to a revised budget of \$550 million with the estimated \$15 million cost of the FOC removed. The government was advised that any funding required to install the FOC would be additional to the committed sum of \$550 million.

In June 2002, the government was advised that the estimated cost of meeting the fast rail upgrade minimum FOC requirements was \$13.9 million. This covered the installation of the FOC so that it had sufficient capacity for regional fast rail's needs. The cost of providing additional capacity for other commercial uses was estimated at \$4.6 million. This gave a total estimated cost of \$18.5 million, with 75 per cent directly attributed to the rail infrastructure upgrade. The material we reviewed made it clear that these costs were not covered in the project's existing budget.

In June 2002, the government endorsed VicTrack providing the full capital funding required for the installation of the FOC along the fast rail corridors. Any fast rail budget savings or unspent contingency would be used to contribute to the cost of installing the FOC.

In August 2002, the government announced that VicTrack had signed a \$21.5 million contract with a private sector company to design, build and maintain for 25 years a new 500 kilometre FOC network for regional Victoria along the fast rail corridors.

The FOC's primary purpose is to form a critical part of the fast rail signalling and communications systems. Although fast rail will only use 20 per cent of the FOC's capacity, the project remains the key reason for the installation of the FOC. The commercial opportunities appear limited as is evidenced by the failure to attract private finance to fund the installation.

Installation of the network was scheduled to commence by December 2002, and was to be completed by early 2004. The installation of the cable was not, however, completed until the middle of 2005.

### **Conclusion**

It is our view that the fast rail initiative should bear its share of the costs of creating the FOC, consistent with it being the key driver for installation. Following the advice given to the government in June 2002, we have estimated this cost as 75 per cent of the total cost of \$21.5 million, or \$16.1 million. This is in addition to the \$4.1 million allocated to connect the completed FOC to the fast rail signalling and communication systems on the Bendigo, Ballarat and Latrobe Valley corridors. We note that funding for this activity was omitted for the Geelong corridor.

## **2.5.4 Developing the new fast rail timetables**

In this section we compare the new draft (July 2006) fast rail timetables with those operating in July 2004 to understand:

- how the new timetable makes use of the enhanced rail infrastructure to provide faster express journey times and additional services for travellers between Melbourne and the stations at the ends of the fast rail corridors (Ballarat, Bendigo, Geelong and Traralgon)
- the extent to which the fast rail initiative benefits other rail travellers using intermediate stations within the corridors.

We compared the draft fast rail timetables of July 2006 with the last timetables where services were unaffected by the project (July 2004). The final timetables may be different from these draft timetables as DoI continues to refine the fast rail services before they commence operation. The July 2006 draft timetables were not available for the Latrobe Valley corridor, and we used the previous drafts publicly released by the government in December 2004.

### **Definitions**

The peak direction is towards Melbourne in the morning commuter peak and away from Melbourne in the afternoon commuter peak.

We have defined peak and off-peak time periods based on the time train services arrive at, or depart from, Southern Cross Station as follows:

- morning peak: 6.30 am and 9.00 am
- afternoon peak: 4.00 pm and 6.30 pm
- the inter-peak: 9.00 am to 4.00 pm
- evening: after 6.30 pm
- early morning: before 6.30 am.

## Impacts on rail travel between Melbourne and the 4 regional fast rail centres

Figure 2M compares the number of weekday services and journey times for services running the full length of the 4 fast rail corridors.

**FIGURE 2M: IMPACTS ON SERVICES BETWEEN MELBOURNE AND BALLARAT, BENDIGO, GEELONG AND LATROBE VALLEY (SERVICES ON A TYPICAL WEEKDAY)**

	July 2004	Draft timetable July 2006	Improvement (%)
<b>Between Ballarat and Melbourne</b>			
Number of services in both directions	20	33	65
Average journey time (mins)	92	79	14
Lowest journey time (mins)	82	64	22
Highest journey time (mins)	103	98	5
Target journey time (mins)	na	64	na
Services achieving target	na	2	na
Percent of services achieving target	na	6	na
<b>Between Bendigo and Melbourne</b>			
Number of services in both directions	22	36	64
Average journey time (mins)	116	110	5
Lowest journey time (mins)	101	84	17
Highest journey time (mins)	126	127	1
Target journey time (mins)	na	84	na
Services achieving target	na	2	na
Percentage of services achieving target	na	6	na
<b>Between Geelong and Melbourne</b>			
Number of services in both directions	51	56	10
Average journey time (mins)	61	58	5
Lowest journey time (mins)	51	45	12
Highest journey time (mins)	67	67	0
Target journey time (mins)	na	45	na
Services achieving target	na	2	na
Percentage of services achieving target	na	4	na
<b>Between Traralgon and Melbourne</b>			
		December 2004	
Number of services in both directions	24	35	46
Average journey time (mins)	130	125	4
Lowest journey time (mins)	117	95	19
Highest journey time (mins)	171	139	19
Target journey time (mins)	na	95	na
Services achieving target	na	1	na
Percentage of services achieving target	na	<1	na

(a) Latrobe Valley journey times measured between Flinders Street and Traralgon. All other times measured to and from Southern Cross.

Source: Victorian Auditor-General's Office based on data provided by DoI.

We note that for weekday travel, the draft timetables deliver:

- a significant increase in the number of services between Melbourne and Ballarat (65 per cent), Bendigo (64 per cent), Geelong (10 per cent) and Traralgon (46 per cent)
- modest reductions in average journey times between Melbourne and these regional centres range from 4 per cent for Traralgon to 14 per cent for Ballarat
- the government's target journey times for all the fast rail corridors but only on a small number of services. There are significant reductions in the lowest journey times between Melbourne and Ballarat (22 per cent), Traralgon (19 per cent), Bendigo (17 per cent) and Geelong (12 per cent). However, these only apply to a small percentage of the train services travelling between these regional centres and Melbourne (less than one per cent for Traralgon and up to 6 per cent for Bendigo and Ballarat).

In addition, the draft timetables:

- double the number of weekend services between Melbourne and Ballarat, Bendigo and Traralgon
- provide earlier morning services to Melbourne and the regional centres
- provide later services on weekdays and at weekends.

We conclude that the draft timetables deliver the government's minimum journey time requirements on all of the fast rail corridors. The small number of services achieving this target means that there is a significant difference between the maximum and the average journey time savings. The draft timetables increase the number of trains connecting Melbourne and the regional centres and extend the hours of service both for weekday and weekend travel.

### **Impacts on rail travel for all stations in the fast rail corridors**

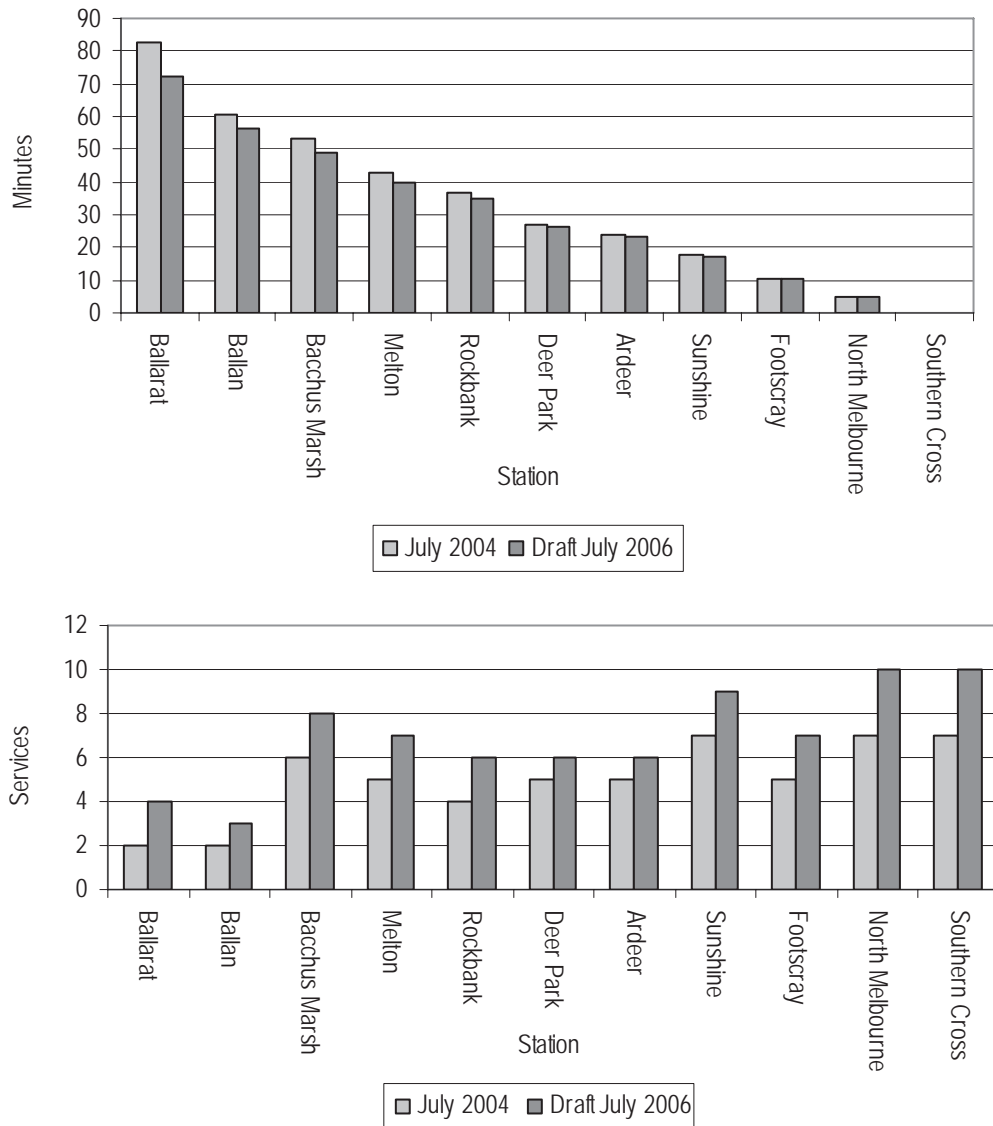
In the following pages we illustrate the impacts of the draft timetables for all rail travellers in the 4 corridors (not just those using services to and from the fast rail regional centres). For each corridor, we compare average journey times and the number of services from each station on the corridor to Melbourne in the morning peak period.

Some of the stations on each corridor are also served by metropolitan rail services. We identify these stations for each of the corridors.

## Ballarat

Figure 2N compares the Ballarat corridor journey times (July 2006) with those in the July 2004 timetable.

**FIGURE 2N: COMPARING AVERAGE JOURNEY TIMES AND NUMBER OF TRAIN SERVICES FOR MORNING PEAK PERIOD TRAVEL, BALLARAT TO MELBOURNE**



*Note:* Sunshine, Footscray and North Melbourne stations are also served by metropolitan rail services.

*Source:* Victorian Auditor-General's Office, using the July 2004 country timetable and the draft July 2006 timetable.

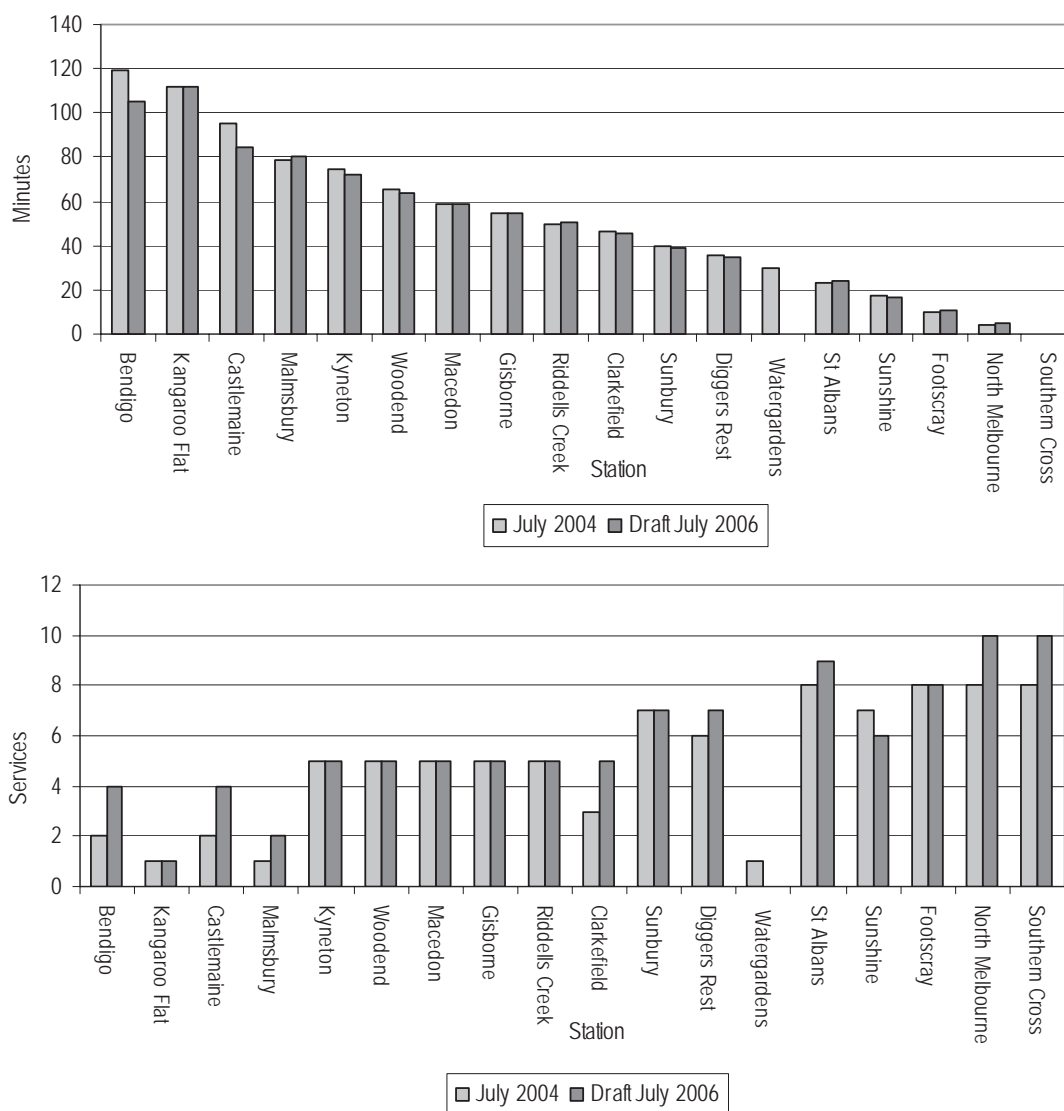
Figure 2N shows for the Ballarat corridor that:

- the most significant journey time gains are confined to Ballarat, with smaller gains for Ballan, Bacchus Marsh and Melton, and negligible changes for other stations closer to Melbourne
- all stations receive an extra 2 services except for Ballan, Deer Park and Ardeer, which gain an extra peak period service.

**Bendigo**

Figure 2O compares the Bendigo corridor journey times (July 2006) with those in the July 2004 timetable.

**FIGURE 2O: COMPARING AVERAGE JOURNEY TIMES AND NUMBER OF TRAIN SERVICES FOR MORNING PEAK PERIOD TRAVEL, BENDIGO TO MELBOURNE**



*Note:* Watergardens, St Albans, Sunshine, Footscray and North Melbourne stations are also served by metropolitan rail services.

*Source:* Victorian Auditor-General's Office, using the July 2004 country timetable and the draft July 2006 timetable.

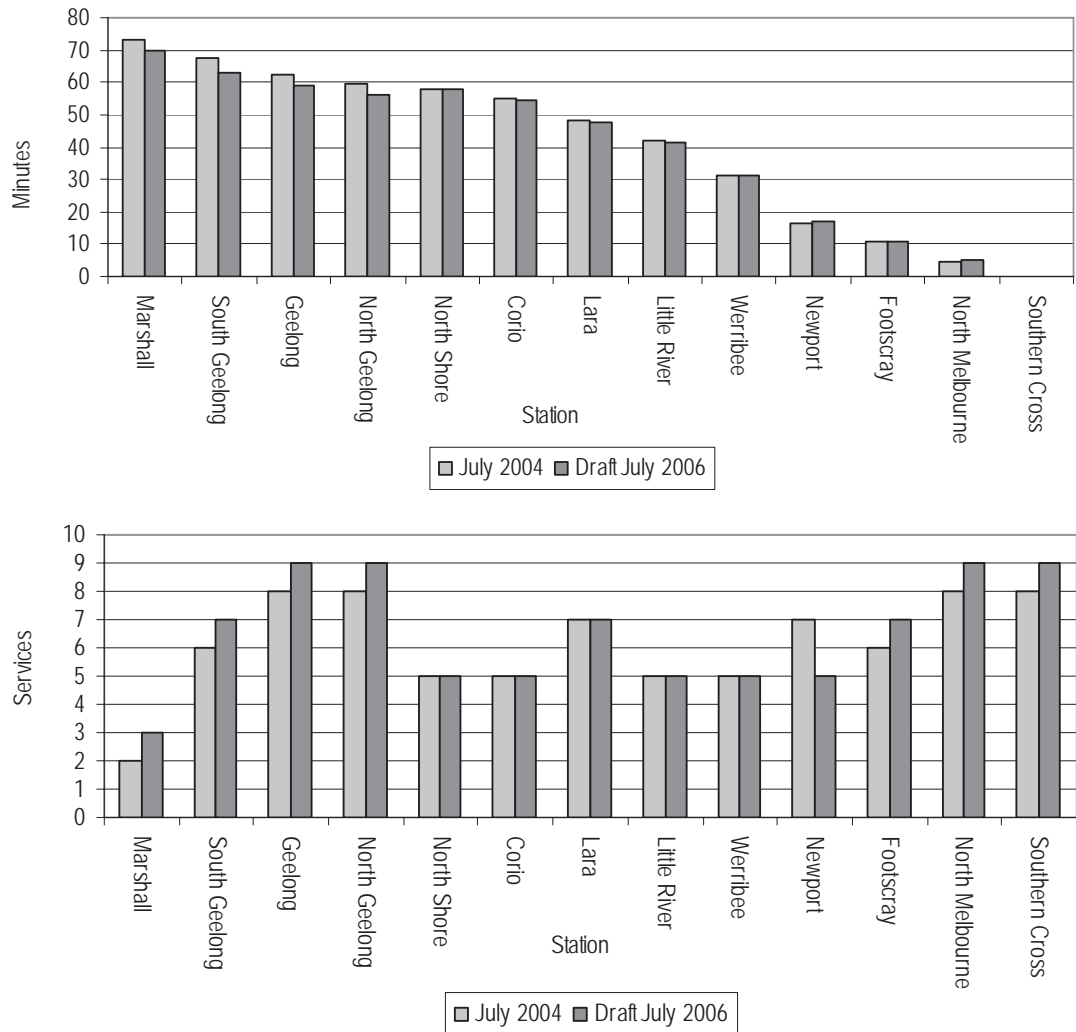
Figure 2O shows for the Bendigo corridor that:

- the significant journey time gains are confined to Bendigo and Castlemaine, with negligible reductions for the remaining stations on the corridor
- 8 stations receive one or 2 extra services; 2 stations, at Watergardens and Sunshine, lose a single existing service; and the number of services at the remaining 8 stations remains unchanged.

## Geelong

Figure 2P compares the Geelong corridor journey times (July 2006) with those in the July 2004 timetable.

**FIGURE 2P: COMPARING AVERAGE JOURNEY TIMES AND NUMBER OF TRAIN SERVICES FOR MORNING PEAK PERIOD TRAVEL, GEELONG TO MELBOURNE**



*Note:* Werribee, Newport, Footscray and North Melbourne stations are also served by metropolitan rail services.

*Source:* Victorian Auditor-General's Office, using the July 2004 country timetable and the draft July 2006 timetable.

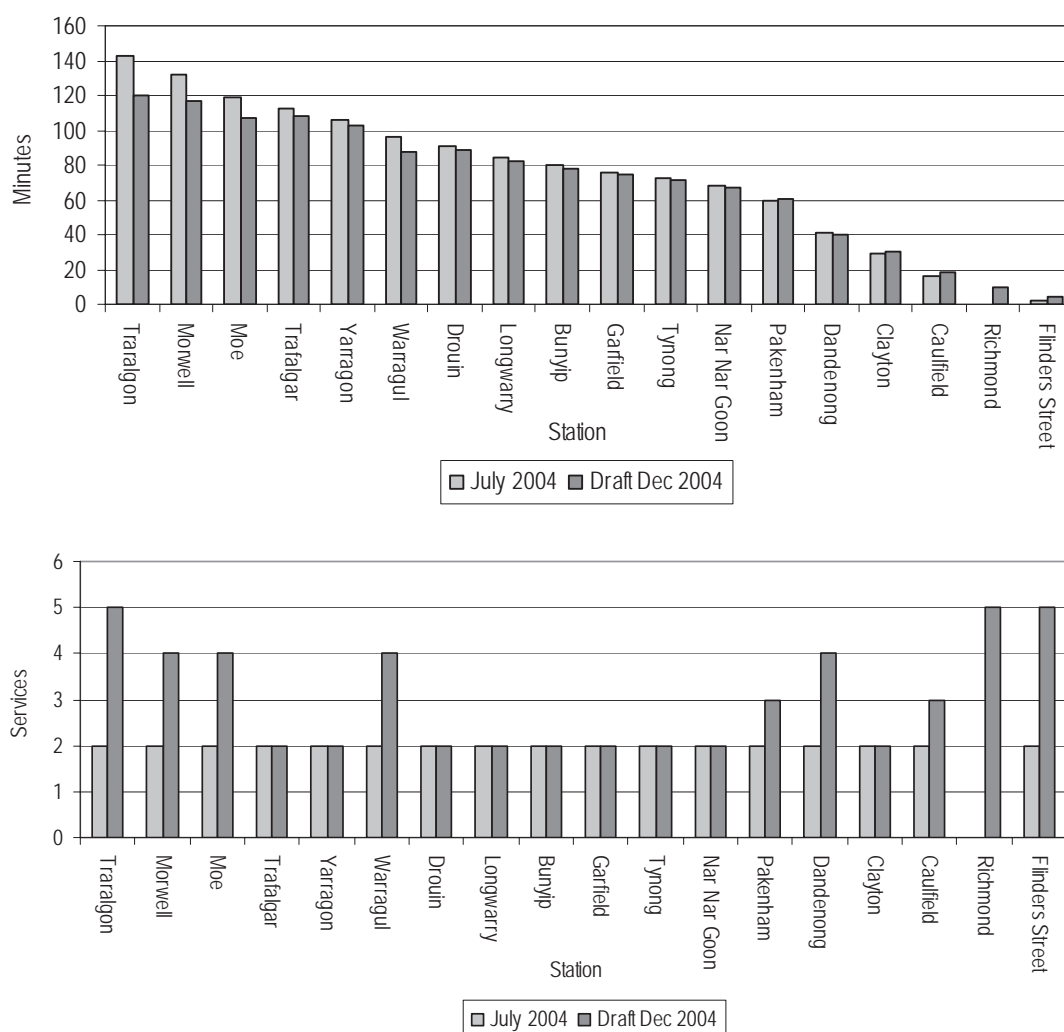
Figure 2P shows for the Geelong corridor that:

- the journey time gains are greatest for Geelong, South Geelong and Marshall stations, and taper off to very modest gains for stations between Geelong and the Melbourne terminus
- there is an extra service for stations between Marshall and North Geelong, and between Footscray and North Melbourne. Other stations have the same number of services, except Newport where 2 fewer trains stop.

### *Latrobe Valley*

The July 2006 draft timetable for the Latrobe Valley corridor was not available, so our analysis is based on the December 2004 draft timetable. Figure 2Q compares the Latrobe Valley corridor journey times (December 2004) with those in the July 2004 timetable.

**FIGURE 2Q: COMPARING AVERAGE JOURNEY TIMES AND TRAIN SERVICES FOR MORNING PEAK PERIOD TRAVEL, LATROBE VALLEY TO MELBOURNE**



*Note:* Pakenham, Dandenong, Clayton, Caulfield and Richmond stations are also served by metropolitan rail services.

*Source:* Victorian Auditor-General's Office, using the July 2004 country timetable and the draft July 2006 timetable.

Figure 2Q shows for the Latrobe Valley corridor that:

- the journey time gains are greatest for Traralgon, Morwell and Moe, and modest for stations beyond this point
- travellers using Traralgon, Morwell, Moe, Warragul, Pakenham, Dandenong and Caulfield receive up to 3 additional services. Services now also stop at Richmond.

## Conclusion

The draft July 2006 timetables deliver a significant increase in the number of end-to-end, weekday and weekend train services on the regional fast rail corridors. It also delivers the government's express journey times for the Ballarat, Bendigo, Geelong and Latrobe Valley corridors. The average, weekday journey time improvements between the regional centres at the end of these corridors and Melbourne are much more modest because so few of these services (less than 7 per cent in all cases) achieve the government's target express times.

When we looked in detail at the morning peak changes for travel to Melbourne, it is clear that the journey time savings for most of the stations between the main regional centres and Melbourne are modest or negligible.

These journey time outcomes are more modest than we would have expected. Only those travellers at the end of these corridors benefit from significant journey time improvements. For those at intermediate stations, most of the benefits come in the form of additional train services. For example, on the Bendigo corridor for peak services to Melbourne, only Bendigo and Castlemaine passengers gain significant, average journey time savings of up to 13 per cent. These passengers make up only 23 per cent of the rail passengers on this corridor.

Given the size of the average journey time savings, we conclude that a large portion of the potential project benefits have not been achieved.

### 2.5.5 Integrated regional bus services

As part of its 1999 election platform, the current government stated, "... to ensure the benefits of the [regional fast rail] project are maximised for residents who live in nearby towns, Labor will also ensure that connecting bus services are coordinated with train timetables on the upgraded service"<sup>53</sup>.

In November 2005, the government announced that new bus services are being introduced throughout regional Victoria as part its commitment to improve regional transport connections detailed in its *Moving Forward* strategy. DoI advises that new bus links will be established to connect patrons from smaller communities to regional centres so that they are able to access fast rail services<sup>54</sup>.

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<sup>53</sup> The Australian Labor Party 1999, *Rebuilding the transport network, A better transport network for all Victorians, Fast rail links to regional Victoria*, Melbourne. p. 13.

<sup>54</sup> Department of Innovation, Industry and Regional Development, November 2005, *Moving Forward: Making Provincial Victoria the Best Place to Live, Work and Invest*, Melbourne, p. 55.

The development of better integrated services (timetables) is currently in progress.

### 2.5.6 Fast rail infrastructure upgrade expenditure

Figure 2R summarises DoI's original and revised project budgets, and the actual expenditure to April 2006.

Based on DoI's budget, expected costs have increased by \$194.5 million (35 per cent) from \$556 million in June 2002 to a forecast \$750.5 million in December 2004. No further budget changes have occurred. The overall increase may be summarised as follows:

- November 2003: a \$60.8 million increase to \$616.8 million
- March 2004: a further \$68 million increase to \$684.8 million
- December 2004: a further \$65.7 million increase to \$750.5 million.

To April 2006, actual infrastructure costs had increased by \$140.3 million over the original estimate (25.2 per cent), with the cost of the design and construct contracts increasing by \$110.5 million (22.2 per cent) and a \$37.4 million (73.4 per cent) increase in other costs giving a total increase of \$147.9 million. However, netting-off the June 2002 risk and contingency allocation of \$33.7 million and recognising that expected maintenance savings of \$26.1 million did not materialise, reduces this to the total net change of \$140.3 million. At this time, contractors had made further variation claims totalling \$24.96 million, which were yet to be settled by DoI.

FIGURE 2R: REGIONAL FAST RAIL PROJECT ELEMENTS

Costs and risks	Original forecast (June 2002)	Revised forecast (November 2003)	Revised forecast (March 2004)	Actual expenditure (April 2006) (a)	Current forecast (December 2004)	Change April 2006 on original
	\$million	\$million	\$million	\$million	\$million	(%)
<b>Construction contracts -</b>						
Ballarat	130.7	130.7	130.7	159.2	-	-
Bendigo	182.9	202.9	202.9	228.8	-	-
Geelong	69.1	69.1	69.1	84.5	-	-
Latrobe	114.8	114.8	114.8	135.5	-	-
<b>Subtotal</b>	<b>497.5</b>	<b>517.5</b>	<b>517.5</b>	<b>608.0</b>		<b>22.2</b>
Land acquisition	7.6	11.0	11.0	10.8	-	-
On-board train control	3.8	3.8	3.8	-	-	-
Fibre optic cable	4.1	4.1	4.1	-	-	-
State administration	29.6	29.6	44.9	50.1	-	-
Insurance	2.1	13.4	13.4	12.5	-	-
FAL/PN project costs	3.7	3.7	3.7	14.9	-	-
<b>Subtotal</b>	<b>50.9</b>	<b>65.6</b>	<b>96.2</b>	<b>88.3</b>		<b>73.4</b>
<b>Project reserve -</b>						
Capital expenditure risks (a)	12.3	12.3	54.1	na	-	-
Contingency (a)	21.4	21.4	32.3	na	-	-
<b>Access provider risks -</b>						
Additional infrastructure (a)	-	-	-	-	-	-
Other identified risks (a)	-	-	-	-	-	-
<b>Subtotal</b>	<b>33.7</b>	<b>33.7</b>	<b>71.1</b>	<b>-</b>		<b>-</b>
<b>Total</b>	<b>582.1</b>					
Less maintenance savings	-26.1	-	-	-	-	-
<b>Grand total</b>	<b>556.0</b>	<b>616.8</b>	<b>684.8</b>	<b>696.3</b>	<b>750.5</b>	<b>25.2</b>

Capital budget of \$556 million was net of expected maintenance savings of \$26.1 million which did not materialise.

(a) These amounts have been allocated as actual payments to contractors for works undertaken across the fast rail corridors.

Source: Victorian Auditor-General's Office based on Department of Infrastructure records.

## 2.5.7 Fast rail initiative expenditure

In this report we have referred to a number of costs associated with the delivery of fast rail services to the community. In addition, ongoing operating costs have been affected by the infrastructure upgrade. This is detailed below.

### *Revision of recurrent costs*

The original budget in June 2002 included an assumption that there would be savings in the costs of maintaining the upgraded rail infrastructure of \$26.1 million over the period 2003-04 to 2009-10. DoI advised the government in March 2003 that these maintenance savings were at risk. The budget was revised to exclude these potential maintenance savings.

In addition, the June 2002 budget did not include an allowance for additional train operation costs. DoI assumed that fast rail services could be delivered without additional V/Line costs.

In April 2003, DoI estimated that it would cost V/Line \$72.5 million in operational costs to provide fast rail services. This higher operating cost included a more complete allowance for labour costs, insurance, driver training and track access costs. Figure 2S shows the impact of these changes on recurrent costs.

**FIGURE 2S: ESTIMATED OPERATING COSTS FOR THE REGIONAL FAST RAIL (\$MILLION)**

RFRP operating expenditure	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	Total
Approved budget	4.7	-16.7	2.3	1.1	-1.7	-1.1	-14.7	-26.1
Revised budget	4.7	1.8	7.8	14.7	14.9	14.5	14.1	72.5
Additional budget	-	1.5	5.5	13.6	16.6	15.6	28.8	98.6

Source: Department of Infrastructure.

From Figure 2S it is evident that, instead of a saving \$26.1 million, there was a requirement for an additional \$72.5 million resulting in a budget extension of \$98.6 million. The budget was revised to include the change in maintenance saving, but did not include any provision for the additional operating costs of \$72.5 million.

DoI was willing to balance potential maintenance savings against its costs and amended the budget when it realised these savings would not materialise. However, it has not included in the project budget (and costs) the net increase in operating costs and, for consistency, should do so.

These costs are directly attributable to the fast rail initiative.

### 2.5.8 Summary of fast rail initiative expenditure

In this report we have referred to a number of costs associated with the delivery of fast rail services to the community. These were:

- the forecast cost of delivering the rail infrastructure of \$750.5 million
- the \$46.6 million spent to upgrade the 29 slower trains ordered under the 1999 V/Line franchise agreement
- the \$33 million needed to extend the new train safety system on the fast rail corridors
- the additional \$16.1 million cost of the fibre optic cable used for fast rail signal communications (this is an estimate of the share of the total cost of \$21.5 million)
- the additional \$72.5 million over 7 years that V/Line Passenger would need to operate fast rail services.

#### Conclusion

DoI failed to adequately develop the budget for the rail infrastructure upgrade. The increase in the estimates for the design and construction component of the budget is directly attributable to the inadequate initial work on the design by the RPG. Little change in the budget was required as a result of poor estimating by the contractors engaged to construct the rail infrastructure. DoI did not do the preparatory work required to set a reasonable budget with contingency tailored to the contracts' risk profile.

The rail infrastructure upgrade is forecast to cost \$750.5 million. The other components of the fast rail initiative cost \$95.7 million, with additional ongoing operating costs over 7 years of \$72.5 million.

### 2.5.9 Rail infrastructure upgrade timelines

Figure 2T summarises the infrastructure upgrade's original and revised time lines for completion of the corridor works, together with the number of days lost between planned and actual completion.

**FIGURE 2T: RFR PLANNED AND REVISED TIMELINES**

	Milestone dates				Lost days (revised – planned)			
	Ballarat	Bendigo	Geelong	Latrobe Valley	Ballarat	Bendigo	Geelong	Latrobe Valley
Contract award	Jun. 2002	Jun. 2002	Jun. 2002	Jun. 2002	na	na	na	na
<i>Construction</i>								
Planned start	Nov. 2002	Nov. 2002	Nov. 2002	Nov. 2002	na	na	na	na
Revised start	Sep. 2003	Jan. 2004	Feb. 2004	Nov. 2003	304	426	457	365
Original planned completion	Jun. 2005	Oct. 2004	Feb. 2005	Mar. 2004	na	na	na	na
Revised completion	Mar. 2006 (a)	Apr. 2006 (a)	Apr. 2006 (a)	Sept. 2006	273	426	393	640
Train services	Jul. 2006	Jul. 2006	Jul. 2006	Sept. 2006	na	na	na	na

(a) The Department of Infrastructure has issued the contractors a certificate of practical completion in regard to upgrade works undertaken on these corridors.

Source: Victorian Auditor-General's Office, based on Department of Infrastructure records.

Figure 2T shows:

- the planned and revised start of construction works and the number of days between these (for example, works started on the Ballarat corridor 304 days after the planned start date)
- similar information for the planned and revised completion of the infrastructure upgrade (for example, the Ballarat upgrade is expected to be completed 273 days after the planned completion date).

The infrastructure completion dates are between 9 months (for Ballarat) and 19 months (Latrobe Valley) behind schedule. For the Ballarat, Bendigo and Geelong corridors, this delay is explained by the initial delay in starting construction works.

For all the corridors, the major causes of delay were:

- the scope issues raised by stakeholders at an early stage of the contract which delayed the start of construction as detailed in section 2.5.2 of this report
- issues which started in this period, but took longer to fully resolve. The most important example of this is the expanded scope of the train protection warning system and the consequent signalling redesign work.

## **Conclusion**

DoI failed to effectively manage the delivery of the rail infrastructure upgrade to the planned timelines. Taking account of the risks and the level of planning and preparation, we conclude that the completion timelines set in mid-2002 were unachievable.

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### 3. Rail Gauge Standardisation Project



### 3.1 Audit conclusion

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The government's May 2001 commitment to convert 13 prioritised broad gauge Victorian freight lines across 4 rail corridors to standard gauge by late 2005 has not been achieved. Expenditure to 28 February 2006 (\$14.2 million) has largely involved project development and management costs and purchase of materials. At the time of preparing this report, no physical work had commenced on any of the originally announced line conversions.

In January 2003, the Department of Infrastructure (DoI) estimated the full risk-adjusted cost of the Rail Gauge Standardisation (RGS) project to be more than double the original 2000 estimate of \$140 million, and the expected benefits to the state to be less than half the original 2000 estimate. Based on work undertaken for DoI by external specialists in 2004-05, the estimated cost to standardise lines in the 4 rail corridors is now around \$359 million.

DoI's advice to government in 2000-01 recommending approval and funding of the project was incomplete and directly led to many of the issues concerning cost and timing that emerged later. The feasibility study prepared for the project in October 2000 did not provide an adequate basis for DoI's recommendation to government to approve the project and allocate funding. The government approved the project in March 2001 before detailed scoping and costing had been done, and before critical operational and financial issues had been resolved. Furthermore, a rigorous cost-benefit analysis had not been undertaken at the time of government approval. These issues presented significant risks to project delivery.

A number of the rail corridors approved for conversion do not meet the test of "where cost-effective and practical" as provided for in the government's 2000 *Linking Victoria* initiative.

The most crucial factor in successful implementation and delivery of the RGS project is the cooperation of the private sector party which controls the state's broad gauge intrastate regional rail network. The project involves the state changing rail infrastructure assets controlled by the private sector. Under lease arrangements entered into in 1999, control over these assets passed to Freight Australia (now Pacific National). The initial intrastate lessee (Freight Australia) has adopted a commercial position which largely negated the state's ability to advance the project under the existing lease agreement.

Over the period in which DoI has been seeking to progress the RGS project, it has also been undertaking a number of other major rail projects. These projects, together with the RGS project, have all involved ongoing complex commercial negotiations with the intrastate rail infrastructure lessee.

Despite a protracted period of negotiation following approval of the RGS project in March 2001, DoI has not reached agreement with the intrastate regional rail infrastructure lessee on the project scope, or arrangements for access to rail track to enable work to commence on the project. For this reason, since early 2003, DoI has attempted instead to progress components of the project as separate stand-alone projects.

Some (\$2.5 million) of the \$5.7 million of materials purchased to date for the RGS project are proposed to be used on the Port of Geelong Rail Access Improvement Project.

It is unreasonable for DoI to expect bidders to go to the trouble and expense of tendering for the provision of material and then to be advised nearly one year later that the process would not be proceeding.

Our audit examined DoI's development, planning and management of this project between 2000 and 2005. DoI has taken action to address identified weaknesses in its project development and management capabilities over recent years.

The government has periodically considered the status and progress of the RGS project and, in May 2003, announced that it had been delayed. Most recently, in mid-2005, the status of the project was considered but no decision to change the original scope or timetable for the project has been announced.

DoI's website continues to indicate that all 13 prioritised broad gauge lines (announced in 2001 to be converted to standard gauge) will be converted.

There is a need for a decision on the future of the project in the context of other rail projects and commitments announced by government which impact on the regional rail network.

***RESPONSE provided by the Secretary, DoI***

*The department has long recognised the importance of detailed scoping and costing, rigorous cost-benefit analysis and the evaluation of project risks in projects. Significant steps have been taken since 2002 to address these issues, including the establishment of a Project Review Committee and the development of cost estimating, business case and risk evaluation guidelines, which is recognised in your report.*

*However, these measures were not in place in the lead-up to the announcement of the Rail Gauge Standardisation (RGS) funding in 2001.*

*The most critical risk to this project was the need to have the formally committed cooperation of the track lessee (Freight Australia prior to September 2004) to the project. In particular, Freight Australia was opposed to the conversion of the track from broad gauge to standard gauge because this, coupled with the access regime in place from mid-2001, would have meant that there was a far greater likelihood that competitors (virtually all of whom operated standard gauge services) could seek access to commercial opportunities on Victoria's country rail network.*

*The department continues its work to progress the government's commitment to improving the rail network through RGS and other rail projects. We will take into account the analysis and conclusions that your review has been able to produce.*

## 3.2 Background

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### 3.2.1 Introduction

Reliable and efficient transport infrastructure is vital to the state's economy and to linking Melbourne and regional Victoria. Road and rail links to regional Victoria and interstate are critical to ensuring efficient transport of freight to and from Melbourne.

Around 90 per cent of freight in regional Victoria is transported by road. Grain, cement, petroleum and shipping containers are the most common types of freight carried by rail<sup>1</sup>. The majority of rail freight (85 per cent) is centred on the Victorian ports, with the greatest flow toward the Port of Melbourne (75 per cent), and the remainder on the Ports of Geelong (18 per cent) and Portland (7 per cent). Nearly all current rail freight (90 per cent) is transported from rural areas to Victoria's ports, with minimal movement in the reverse direction, or from rural areas to interstate destinations.

The national rail network which runs from Perth through Adelaide, Melbourne and Sydney to Brisbane is standard gauge (1.435 metres wide). Historically, Victoria has had a broad gauge (1.6 metres wide) rail network, including the metropolitan network. Today, as a result of some conversion, Victoria's country and interstate rail network is a mixed "2 gauge" network comprising broad gauge and standard gauge lines<sup>2</sup>.

Work undertaken by rail specialists in 1998 on the costs and benefits of standardising the Victorian rail network, highlighted the inefficiencies and higher costs arising from the need to double-handle freight (particularly grain) through the ports as a result of different gauges<sup>3</sup>.

### 3.2.2 Government policy and decision on rail gauge standardisation

Before the 1999 state election, the current government undertook to "convert all broad gauge Victorian rail freight lines to standard gauge over time"<sup>4</sup> and indicated that "standard gauge rail should eventually operate on all of Victoria's rail freight lines as the current dual gauge rail freight system is inefficient and wasteful"<sup>5</sup>.

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<sup>1</sup> In 2000, approximately 6.5 million tonnes (11 per cent) of the total 60 million tonnes of freight handled in regional Victoria, was transported by the rail system. Source: DJA Maunsell, *Assessment of the Victorian Freight Network*. Prepared for the Department of Infrastructure, Melbourne, 2000.

<sup>2</sup> In addition to the interstate rail corridors linking Melbourne with Adelaide, and Melbourne with Sydney, the standard gauge rail lines include the link to the port of Portland and the Hopetoun and Yapeet branches in the Wimmera region of Victoria.

<sup>3</sup> DJA Maunsell. *A Preliminary Evaluation of Standardising the Victorian Rail Network*. Prepared for the Department of Infrastructure, Melbourne, January 1998; The Municipalities of South West Victoria, The City of Geelong and John Holland Construction and Engineering Pty Ltd. *Standardisation of Victorian Country Rail Lines*. A submission prepared for the Department of Infrastructure, Melbourne, July 1998.

<sup>4</sup> Victorian Government, *Rebuilding a Transport Network*, Melbourne, 1999.

<sup>5</sup> Victorian Government, *Building Victoria*, Melbourne, 1999.

In the government's *Linking Victoria* initiative, launched in February 2000, this policy was changed to "Rail lines will be converted to standard gauge where cost-effective and practical within the constraints of passenger train operations"<sup>6</sup>.

The government's 2001 *Growing Victoria Together* statement reiterated its commitment to standardisation of the Victorian regional rail network as part of its work toward ensuring a fast, reliable and efficient transport infrastructure<sup>7</sup>.

Following completion of a feasibility study, the government approved \$96 million in March 2001 for the conversion of 13 prioritised broad gauge lines across 4 rail corridors to standard gauge. When announcing the RGS project in May 2001, the government indicated that it would seek \$44 million from the private sector and the Commonwealth Government to meet the estimated total project cost of \$139.3 million.

The state government's objectives for the project were to:

- achieve a seamless freight and logistics network
- reduce freight and road costs
- attract higher levels of freight to rail from the road sector
- increase inter-port competition<sup>8</sup>.

Figure 3A shows the Victorian rail network and the prioritised broad gauge lines (including regional corridors) approved to be converted to standard gauge in 2001.

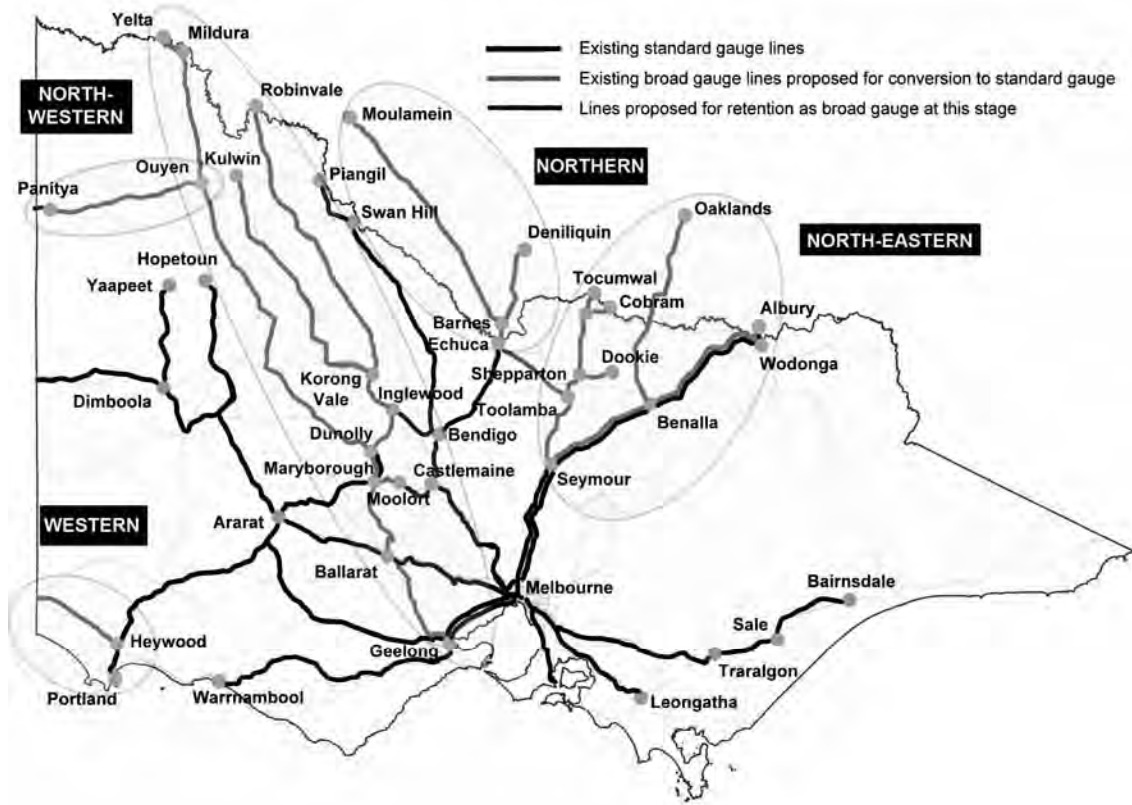
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<sup>6</sup> Victorian Government, *Linking Victoria, Labor's plan for safe, efficient and reliable transport*, Melbourne, February 2000.

<sup>7</sup> Victorian Government, *Growing Victoria Together, Innovative State. Caring Communities*, Melbourne, November 2001.

<sup>8</sup> State budget press release from the Minister for Transport, Melbourne, 15 May, 2001.

**FIGURE 3A: BROAD GAUGE LINES PROPOSED FOR CONVERSION TO STANDARD GAUGE IN 2001**



Source: Department of Infrastructure and the Victorian Auditor-General's Office.

The approved RGS project involved:

- conversion of 2 000 kilometres of broad gauge track in the North-Eastern (Seymour to Albury, Tocumwal and branch lines to Oaklands and Dookie), North-Western (North Geelong to Yelta, Ouyen to Panitya, Dunolly to Korong Vale, Kulwin and Robinvale), Northern (Toolamba to Echuca, Deniliquin and Moulamein) and Western (Heywood to the South Australian border)<sup>9</sup> rail corridors
- associated works<sup>10</sup> in the Melbourne and Geelong areas
- conversion of rolling stock, e.g. locomotives, freight wagons and passenger carriages.

<sup>9</sup> Government endorsement of gauge standardisation of the Western rail corridor was subject to development of an acceptable business case by DoI and agreement with the South Australian Government regarding reopening and conversion of the connecting lines in south-east South Australia. The Heywood to Mt Gambier line has not been operational since 1995.

<sup>10</sup> Associated works refer to works which support the conversion of the main rail freight corridors. These include the linkage of sidings, terminals and marshalling yards to the standard gauge network by gauge conversion or dual gauging. Associated works in Melbourne and Geelong included track works in North Geelong yard, establishment of a new dedicated freight line from North Geelong to Corio (CIGL), and track works in Tottenham, Sunshine, Dynon and Kensington. In general, these works are intended to ensure that current services to and from established locations can be maintained as the rail corridors are progressively converted from broad gauge to standard gauge.

In subsequent policy announcements, the government indicated that (as part of its \$96 million investment in the standardisation of priority freight lines), “its first priority would be to complete the standardisation of rail lines between Portland and Mildura. This will enable the export of mineral sands through Victorian ports, creating jobs and export opportunities for Victoria whilst also making rail lines more efficient for grain transport”<sup>11</sup>.

### 3.2.3 Project context

Primary responsibility for developing and managing the project was assigned to DoI.

Planning and management of the project took place from 2000 when DoI was concurrently developing 2 other major rail projects: the restoration of country passenger rail services, and the regional fast rail project. This required careful planning and coordination of project schedules to minimise disruption to delivery schedules. This particularly related to works associated with the proposed restoration of passenger services on the Mildura line and the Bendigo fast rail service. The standardisation of the North-Western corridor as part of the RGS project could have impacted on both of these projects if it had proceeded at the planned time.

A further challenge for DoI arose from rail privatisation arrangements introduced by the previous government in the late 1990s. Under these arrangements, the intrastate and interstate rail infrastructure was leased to third parties. This meant that the state did not control access to the rail corridors it had committed to convert from broad gauge to standard gauge. These arrangements also impacted on the state’s ability to undertake other major rail projects. Since 2000, DoI has been involved in ongoing complex commercial negotiations with the intrastate rail infrastructure lessee to progress these projects.

The lessee of the intrastate rail infrastructure is responsible for ensuring that:

- a safety management system is in place and that the required safety standards are met by any third parties who are given access to the infrastructure
- any works undertaken on the infrastructure meet the safety standards. This also includes approval of any renewed, upgraded or new infrastructure that forms part of the intrastate network.

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<sup>11</sup> Victorian Government, *Linking Victoria, Labor’s plan for safe, efficient and reliable transport*, Melbourne, February 2002.

Two rail infrastructure lease arrangements are relevant to the project:

- In 1999, the Victorian country intrastate (largely broad gauge) rail network was leased for 15 years (with options for 2 further 15-year lease term extensions) to a private operator, Freight Victoria Limited<sup>12</sup> (now Pacific National). This lease, known as the Primary Infrastructure Lease Agreement, means that access to all Victorian country and southern New South Wales broad gauge lines is controlled by a private operator.
- In 1999, the interstate (standard gauge) rail network was leased for 5 years (with a subsequent extension to 15 years) to a Commonwealth agency, the Australian Rail Track Corporation (ARTC). This lease, known as the Interstate Infrastructure Lease Agreement, means that access to the interstate line from Albury to Melbourne and then via Geelong to the South Australian border, is controlled by the ARTC.

Of these 2 lease arrangements, the intrastate rail network lease with Freight Australia was the most critical for the RGS project. This was because the project could not go ahead until DoI obtained agreement with Freight Australia on access arrangements and project scope.

Agreement with ARTC under the lease was required to proceed with the North-Eastern component of the RGS project. However, agreement with ARTC alone would not allow this component of the project to be advanced until an agreement with Freight Australia was in place.

### 3.2.4 Objective of the audit

The objective of the audit was to review the adequacy of DoI's planning and management of the RGS project.

Our audits of government projects include examination of each project's lifecycle. A project lifecycle encompasses the initial idea and development of a business case, government decision point(s), pre-implementation activities, implementation and post-project implementation activities.

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<sup>12</sup> Freight Victoria Limited subsequently took on the business name of Freight Australia. Throughout this report we refer to this company as Freight Australia.

### 3.3 Advice underpinning project approval

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Comprehensive planning in the initial stages of a project is essential to provide a sound basis for government decision-making on its commitment and allocation of funding to a project.

#### 3.3.1 Adequacy of the feasibility study for the project

Feasibility studies are a critical part of effective capital project planning. A feasibility study should include:

- identification of project objectives and need and alignment with government's strategic aims
- assessment of project scope and costs
- consideration of project impact and benefits
- analysis of options for project delivery
- identification and analysis of project risks.

Following the government's February 2000<sup>13</sup> announcement of its intention to convert broad gauge freight lines to standard gauge, DoI engaged specialists in May 2000 to undertake a feasibility study for the project. DoI's main objective for the feasibility study was to produce a practical and feasible implementation strategy for the project, involving outlining the required scope of work and cost estimates.

An important part of project planning is the identification and classification of risks according to likelihood and severity, and this should be addressed in a feasibility study. The types of risks typically dealt with include:

- commercial risks with business relationships (such as a contracted company will cease to trade)
- operational risks with business activities (such as key people will leave)
- technical risks with assets (such as equipment will fail)
- financial risks with financial controls and systems (such as budgets will be overspent)
- compliance risks with meeting regulatory obligations (such as action will not comply with requirements).

We would have expected the feasibility study to have included at least a preliminary risk management plan. However, DoI did not require such a plan to be developed as part of the feasibility study.

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<sup>13</sup> Victorian Government. *Linking Victoria, Labor's plan for safe, efficient and reliable transport*, Melbourne, February 2000.

The results of the feasibility study, completed in October 2000, included advice on anticipated project outcomes including market and freight demand issues, stakeholder issues and concerns, expected benefits and efficiency gains from gauge standardisation, operational impacts and interfaces with other projects and studies.

The feasibility study proposed an implementation program which set out the sequence in which works on the rail corridors should be completed.

This program was based on:

- an order of completion which would produce the highest benefit
- an easily achievable and practical implementation sequence
- a staging which would minimise any operational disadvantages during construction.

Given the feasibility study was to be a key input into the government's decision-making process for the RGS project, we expected that it would also have included a rigorous cost-benefit analysis. The feasibility study indicated that the analysis of benefits and costs could not be construed in any fashion to represent the viability of any lines, groupings or branch lines. However, it did indicate that a rigorous cost-benefit analysis would be undertaken as part of a subsequent pre-implementation study for the project. Notwithstanding this, the feasibility study did include a broad assessment of the costs and benefits of gauge conversion of rail corridors in 7 different geographical areas of the state. These included the North-Western, North-Eastern, Northern, Eastern, Western, South-Western and combined North-Eastern/Northern rail corridors.

The feasibility study cost-benefit ratios<sup>14</sup> were calculated using a range of assumptions about the extent to which standardisation of rail lines would have a positive impact on freight volumes and transport costs. The study presented no evidence to justify these critical assumptions. The feasibility study indicated an upper and lower cost-benefit ratio for each of the corridors. Cost-benefit ratios across the 7 rail corridors ranged from 0.1 to 12.0. This means that for every \$1 invested in particular corridors it was expected that between 10 cents and \$12 in benefits would be produced.

The cost-benefit ratio calculations in the feasibility study assumed that the costs involved would be restricted to conversion costs alone and did not include costs associated with addressing any required investment in track maintenance. For example, DoI has advised that the cost-benefit ratio for the Western corridor was subsequently found to be unrealistic because any future gauge conversion on this corridor would also require substantial rebuilding of the track at a significant cost.

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<sup>14</sup> Cost-benefit ratio is defined as the benefits over the life of the project divided by the costs over the life of the project discounted to a common price base.

Based on these results, the feasibility study recommended that gauge conversion proceed on only 2 of the 7 rail corridors - the North-Eastern and parts of the Northern corridor.

The Western and North-Western rail corridors were recommended for *conditional* implementation<sup>15</sup>. Gauge conversion of the South-Western, Eastern and other parts of the Northern were *not recommended to proceed at that time*<sup>16</sup>.

For all 7 rail corridors, the feasibility study recommended that the following steps be undertaken *before* implementation of the proposed gauge conversion program:

- more detailed operational and economic evaluation
- scope determination
- consideration of financing, legal, access regime and franchise implications.

Following completion of the feasibility study, DoI calculated the most likely overall cost-benefit ratio for the RGS project to be 2.6 against an estimated project cost of \$139.3 million.

In 2000, based on the feasibility study, DoI estimated the project scope to cost \$139.3 million and considered it would deliver a number of significant benefits. These included transfer of traffic from road to rail, reduced freight rates<sup>17</sup>, improved access to domestic markets, direct access from north-western Victoria to the port of Portland and integrated freight movement from Victoria to key Australian markets.

The estimated project cost of \$139.3 million included the costs of track and rolling stock conversion, and associated works in the Melbourne and Geelong areas. The project cost estimate did not include provision for escalation costs, compensation payments to the infrastructure lessee<sup>18</sup> or the costs of replacing railway sleepers<sup>19</sup>.

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<sup>15</sup> Gauge conversion of the Western rail corridor was recommended subject to negotiation with the South Australian Government and confirmation of the potential freight tonnage. Gauge conversion of the North-Western rail corridor was recommended subject to confirmation of potential rail freight requirements of the mineral sand industries.

<sup>16</sup> The feasibility study recommended that these rail corridors be subject to ongoing monitoring of prevailing industry, market and strategic forces that would impact on gauge conversion in order to determine a more appropriate time to proceed with gauge conversion.

<sup>17</sup> The expected benefit of reduced freight rates was also dependent on an open access regime to promote competition on Victoria's regional rail network.

<sup>18</sup> Under the terms of the Primary Infrastructure Lease, the lessee was entitled to compensation payments in the event that works on government projects caused disruption to the lessee's operations.

<sup>19</sup> This was based on a view that track condition is not adversely affected by gauge conversion, and as a result sleeper replacement requirements are more likely to be due to a maintenance backlog.

The findings and recommendations of the feasibility study were based on information and data obtained from consultation with key stakeholders and review of relevant reports held by DoI. The specialists acknowledged their inability to verify the accuracy and completeness of this third party information and data due to time and cost constraints of the study.

### 3.3.2 Approval of the project

As indicated previously, the feasibility study recommended that:

- gauge conversion proceed on only 2 rail corridors – the North-Eastern corridor and parts of the Northern corridor
- conditional gauge conversion proceed on the North-Western and Western corridors
- gauge conversion of the South-Western, Eastern and other parts of the Northern corridors not proceed in the immediate future.

However, in December 2000, DoI advised government that the feasibility study had concluded that a rail gauge conversion program on 4 of the 7 rail corridors assessed - the North-Eastern, Northern, North-Western and Western, at an estimated cost of \$139.3 million, would generate significant economic benefits.

In recommending that government endorse this conclusion, DoI did not inform government that the feasibility study had concluded that further assessment of relevant industry and market forces was necessary in order to determine a suitable time to proceed with gauge conversion of the North-Western and Western corridors. Nor did it inform government that the feasibility study included only a broad assessment of the costs and benefits of the conversion program, and not a rigorous cost-benefit analysis and no risk assessment and mitigation plan.

DoI advised government that, prior to project implementation, it intended to undertake:

- more detailed planning work, including detailed scope determination and costing, development of cost sharing and financing proposals, identification of legal and franchise arrangements, development of a detailed implementation plan and projected cash flows
- detailed negotiations with a range of key stakeholders in relation to potential funding and operational implications associated with the project.

DoI advised government that it expected these tasks and negotiations could be completed between January and March 2001, after which time the project would be capable of immediately progressing into an implementation phase.

In December 2000, DoI further advised government that the holder of the intrastate rail infrastructure lease had expressed reservations about the project because gauge conversion combined with a proposed Open Access Regime<sup>20</sup> on Victoria's intrastate rail lines was expected to result in significant "on-rail" competition. Government was also advised that the lessee was unwilling to financially contribute to the costs of any infrastructure conversion as part of the project. Given that the infrastructure lessee had control over the track, obtaining an agreement with the lessee on track access was critical to project delivery.

In March 2001, the government approved a budget of \$96 million<sup>21</sup> for a gauge standardisation program comprising the North-Western, Northern and North-Eastern rail corridors. Approval of the Western corridor was subject to the development of a business case by the department<sup>22</sup>. This decision was made without:

- detailed information on the scope and cost of the project
- a rigorous cost-benefit analysis
- information on all risks relevant to project delivery and appropriate mitigation strategies
- confirmation that the required additional funding from the private sector and the Commonwealth Government had been formally secured
- confirmation that critical agreement with the infrastructure lessee on access arrangements to the track had been secured.

In May 2001, the government announced its decision to approve the project and allocate \$96 million over 5 years to standardise priority lines in the 4 corridors, including the Western rail corridor.

## Conclusion

DoI's advice to government recommending approval and funding of the RGS project was incomplete and directly led to many of the issues concerning cost and timing that emerged later.

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<sup>20</sup> The Victorian Rail Access regime is provided for in Part 2A of the *Rail Corporations Act 1996*. Under this regime, introduced in July 2001, rail operators must apply to the intrastate rail infrastructure lessee to operate services on these lines and are required to pay a fee to the lessee (as access provider) for use of the lines.

<sup>21</sup> Funding allocation of \$96 million comprised \$76 million from appropriations and \$20 million from the Regional Infrastructure Development Fund. This fund was established in 2000 under the *Regional Infrastructure Development Fund Act 1999* to facilitate investment, employment and export opportunities in regional Victoria providing infrastructure funding for capital works projects.

<sup>22</sup> Government endorsement of gauge standardisation of the Western rail corridor was subject to development of an acceptable business case by DoI and agreement with the South Australian Government regarding reopening and conversion of the connecting lines in south-east South Australia. The Heywood to Mt Gambier line has not been operational since 1995.

While the feasibility study addressed all matters specified by DoI, on its own, it did not provide an adequate basis for the recommendation to government to approve the project and allocate funding. Detailed scoping and costing had not yet been done, nor had critical operational and financial issues been resolved. In particular, DoI had not obtained agreement with Freight Australia on access arrangements to the track, nor had it obtained formal commitments to financial contribution from third parties, prior to recommending the project to government for funding.

In addition, DoI should have advised government that the feasibility study did not include a rigorous cost-benefit analysis. The significant economic benefits cited by DoI in recommending approval of the project were based only on a preliminary and broad cost-benefit analysis.

Decisions on the project in the absence of resolution of these issues presented a significant risk to project delivery.

A number of the rail corridors approved for conversion did not meet the test of “where cost-effective and practical”.

## 3.4 Project development

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Successful project delivery is dependent upon sound planning, development of an effective implementation strategy, and effective management of project risks and variations in scope, cost and time targets.

### 3.4.1 Pre-implementation study

As indicated earlier, in December 2000, DoI advised government that it expected to implement the project in March 2001 following completion of more detailed planning work and negotiations with key stakeholders. This work was not, however, completed, nor were negotiations with key stakeholders finalised within the indicated time.

In March 2001, DoI engaged specialists to undertake a detailed pre-implementation study, including extensive consultation with key stakeholders. The major objectives of the study were to provide a detailed scope of works, finalised pre-design cost estimates, and an implementation and staging program, as well as an assessment of project risks.

The objectives set for the pre-implementation study did not include the conduct of a rigorous cost-benefit analysis of the project. This is despite the fact that the earlier feasibility study had only included a broad assessment of the costs and benefits of the project on the basis that it would be done later.

The majority of the 16 key stakeholders consulted during the pre-implementation study were supportive of the project. Two of the key stakeholders, however, expressed concerns about the project:

- The intrastate lease holder had concerns about the likelihood of increased competition from other freight operators and the expected costs of disruption to its freight services as a result of construction works for the project (the government had been advised of these concerns prior to its approval of the project).
- The interstate lease holder had concerns about its capacity to accommodate additional traffic on its standard gauge interstate line when trains transferred from the broad gauge lines following conversion.

The pre-implementation study concluded that prompt resolution of these concerns was critical to implementation of the project.

Completed in October 2001, the pre-implementation study confirmed the scope and initial cost estimates for physical works (line conversion), provided in the feasibility study. However, the study highlighted that the overall project cost had been underestimated due to the exclusion of full costs of:

- associated works in the Melbourne and Geelong areas
- rolling stock conversion
- compensation payable to the infrastructure lessee under the provisions of the Primary Infrastructure Lease
- other costs which would be incurred in delivering the project such as insurance and legal costs.

The pre-implementation study concluded that an additional \$21 million was needed to complete all the programmed work.

The government had set specific completion dates for the project (ranging from late 2002 to late 2005) in its announcement of the project's approval in May 2001. The pre-implementation study indicated that these completion targets were achievable provided a number of issues were finalised in a timely manner. The most critical of these was the establishment of an agreement with the infrastructure lessee on project scope and arrangements for track access.

The first formal identification and analysis of project risks was undertaken as part of the pre-implementation planning study. Risks identified related to:

- scope (such as obtaining agreement on scope with key stakeholders and scope changes)
- budget (such as a funding shortfall)

- schedule (such as denial of access to site, delay in procurement of materials)
- quality (such as poor materials, poor workmanship).

The pre-implementation study also assessed the severity and probability of occurrence of these risks and identified how these risks might be controlled.

## Conclusion

The pre-implementation study did not include a rigorous cost-benefit analysis as recommended in the feasibility study. As a result, the project commenced without a clear and supportable economic benefit to the state.

### 3.4.2 Rail infrastructure leases

As indicated previously, 2 rail infrastructure lease arrangements are relevant to the project:

- In 1999, the Victorian country intrastate (largely broad gauge) rail network was leased for 15 years (with options for 2 further 15-year lease term extensions) to a private operator, Freight Australia (now Pacific National). This lease, known as the Primary Infrastructure Lease Agreement, means that access to all Victorian country and southern New South Wales broad gauge lines is controlled by a private operator.
- In 1999, the interstate (standard gauge) rail network was leased for 5 years (with a subsequent extension to 15 years) to a Commonwealth agency, the Australian Rail Track Corporation (ARTC). This lease, known as the Interstate Infrastructure Lease Agreement, means that access to the interstate line from Albury to Melbourne, and then via Geelong to the South Australian border is controlled by the ARTC.

#### Agreement with intrastate rail infrastructure lessee

The cooperation of the intrastate rail infrastructure lessee was recognised from the early planning phase as essential to implementation of the project, and, therefore, a high risk to delivery of the project. Government had been advised before approving the project that the lessee had reservations about the project, however, no strategy was in place to manage this substantial pre-existing risk.

DoI's ability to secure the cooperation of the intrastate rail lessee was constrained to some degree by the provisions in the Primary Infrastructure Lease. The original Primary Infrastructure Lease did not provide the state with the power to compel the lessee to provide access to rail infrastructure for the purpose of undertaking state rail projects. This meant that the state needed to reach agreement with the lessee on access to the infrastructure, the scope of works to be undertaken and issues such as compensation.

Recognising the potential risk that this lease agreement posed to the delivery of the RGS project, and other state rail projects, in August 2001, some 3 months after approving the RGS project, the government requested DoI to undertake an assessment of delivery risks and mitigation strategies for rail projects, including the RGS project.

In late 2001, following consideration of DoI's analysis, the government requested that while DoI continues to negotiate agreement on track access, it should develop a risk mitigation strategy.

From late 2001, DoI continued its negotiations with the intrastate rail lessee with the aim of reaching agreement on a number of issues, including overall project scope, detailed track and signalling arrangements, rolling stock conversion and track access arrangements. In early 2002, agreement was reached with the lessee on the need to develop an alliance or partnership agreement to facilitate implementation of the project.

In August 2002, the lessee advised DoI that it required a number of issues to be resolved before finalising an alliance agreement. These issues included aspects of the project scope, sequencing of works, processes for payment of compensation claims and requirements for conversion of rolling stock.

In late 2002, the lessee advised DoI that it required a further commitment from the state to fund the cost of a maintenance "catch-up" program (such as sleeper replacement) and upgrading of its infrastructure before it would agree to provide track access for the RGS project.

DoI did not agree to these conditions and negotiations stalled. In May 2003, the government announced that the RGS project would be delayed due to difficulties in negotiating track access with the intrastate rail lessee and to an inability to secure private funding for the project.

In September 2003, DoI advised government that it was likely that a third party would seek to acquire the intrastate rail lessee's business. This was recognised as an opportunity for government to gain greater control of track access.

In September 2004, the holder of the infrastructure lease changed with the sale of Freight Australia to Pacific National. At that time, a new clause was added to the Primary Infrastructure Lease in an effort to facilitate greater cooperation by the lessee on delivery of government projects. This clause sets out the conditions under which “the state and the lessee will establish a cooperative framework for the delivery of rail projects” and “work together to facilitate the development and implementation of rail projects in a manner which meets the objectives of both parties”.

However, despite improved relations with the lessee, agreement on access arrangements to advance the project had not been secured at the time of preparing this report.

### **Agreement with interstate rail infrastructure lessee**

During project planning it was identified that an agreement with ARTC was required for works (conversion of sections of the Seymour to Albury/Wodonga broad gauge line) to proceed on the North-Eastern/Northern component of the project.

Standardisation of lines in the North-Eastern/Northern corridor would result in a substantial increase in the number of trains using the Melbourne-Sydney standard gauge line controlled by ARTC due to the transfer of trains from the broad gauge lines leased to Pacific National (previously leased to Freight Australia). In order to handle the forecast additional traffic resulting from standardisation, as well as industry forecasts of increased traffic growth, ARTC would need to increase its infrastructure capacity in this corridor.

During planning for the RGS project, ARTC indicated its preparedness to fund works directly associated with capacity enhancement. This was dependent on acceptance by the state of ARTC’s preferred option for these works on the North-Eastern corridor. This option involved the transfer of part of the existing broad gauge line leased to Freight Australia to ARTC.

While initially supportive of this option, in 2003, Freight Australia indicated that it required agreement to an alternative approach to the provision of increased standard gauge capacity on the North-East corridor. This involved the provision and upgrading of an independent standard gauge corridor that would run alongside the existing ARTC standard gauge interstate line between Melbourne and Wodonga. Pacific National’s (formerly Freight Australia) participation in the standardisation of the North-Eastern corridor remains unresolved. DoI has indicated that the construction of an additional standard gauge line that is not incorporated within the existing ARTC lease would not maximise operational benefits.

At the time of preparing this report, ARTC advised that it had established an alliance contract with the Australian Rail Consortium for construction of long passing lanes on the eastern side of the existing standard gauge line in the North-Eastern corridor. Planning and design is currently underway, including environmental approvals, confirmation of start and finish points of the long loops, and constructability.

It is unclear what impact this decision by ARTC will have on the approved RGS project.

## Conclusion

DoI has been undertaking a number of other major rail projects that have involved ongoing complex commercial negotiations with the intrastate rail infrastructure lessee. However, for the last 5 years, DoI has been unsuccessful in completing its negotiations with the intrastate rail infrastructure lessee in relation to the RGS project. The intrastate lessee adopted a commercial position which largely negated the state's ability to advance the project under the existing lease arrangement.

Recent decisions by the interstate rail infrastructure lessee will have a significant impact on the completion of approved rail gauge standardisation works for the North-Eastern/Northern corridors.

Delays in securing agreement with the intrastate rail infrastructure lessee has contributed to cost increases and time delays on the project. Until DoI is able to resolve the outstanding matters with this lessee, there is little chance that the approved RGS project will proceed.

### 3.4.3 Impact of implementation delays on project cost and funding

Figure 3B shows movements in the estimated cost of the project by component between 2000 and 2005.

**FIGURE 3B: PROJECT COST ESTIMATES BY PROJECT COMPONENT 2000-2005 (\$MILLION)**

Project components	Feasibility study estimate October 2000	Pre-implementation study estimate August 2001	Budget submission to government January 2002	Revised estimate January 2003	Revised estimate 2005 (a)
North-Western gauge conversion	42.4	37.0	40.3	34.9	-
North-Eastern/Northern gauge conversion (b)	48.0	39.4	44.2	42.3	-
Western gauge conversion	6.8	4.7	-	5.1	(c)
Melbourne area associated works	15.3	19.3	21.3	45.0	-
Geelong area associated works	10.4	18.0	16.0	26.1	-
Ararat bypass (d)	2.0	2.1	2.3	3.4	-
Rolling stock conversion	14.4	14.4	14.4	29.7	-
Provision for compensation	-	-	11.1	13.5	-
Provision for escalation	-	-	5.8	-	-
Risk adjustment	-	-	-	99.0	-
<b>Total</b>	<b>139.3</b>	<b>134.9</b>	<b>155.4</b>	<b>299.0</b>	<b>359.0</b>

- (a) The estimated costs for the North-Western, North-Eastern/Northern and Western corridors have not been detailed to protect the state's commercial negotiations for future works.
- (b) Cost estimates for the North-Eastern/Northern corridors are preliminary and based on ARTC's initial preferred option for gauge conversion and excludes additional costs of upgrading the capacity of the interstate line likely to be funded by ARTC.
- (c) DoI advised that the Western gauge conversion component of the project is estimated to cost \$74 million and includes works in South Australia (\$41 million).
- (d) Ararat bypass involves construction of a direct bypass and associated new signalling which will allow direct movement of trains between north-western Victoria and the Portland line eliminating the need to reverse in Ararat yard or Pyrenees loop.

Source: Victorian Auditor-General's Office, from Department of Infrastructure data.

Figure 3B shows that while the pre-implementation study estimated slightly lower costs for gauge conversion of the main rail corridors, the scope of associated works in Melbourne and Geelong had been underestimated by \$11.6 million in the feasibility study.

In early 2002, less than 12 months after the initial budget allocation, DoI advised government that the initial allocation of \$96 million to the project was expected to only cover the costs of standardising the prioritised lines in the North-Western corridor and associated works in Geelong and Melbourne, as well as the costs of rolling stock conversion and compensation to the intrastate rail lessee.

In March 2002, less than 12 months after the government had approved the project, DoI requested an additional \$59.4 million in project funding. This was primarily due to an inability to secure funding from the Commonwealth Government and private sector of around \$44 million. The provision of this funding had been assumed by DoI in its initial budget submission to government for the project in 2001. Other factors contributing to the request for additional funding included inadequacies in project scope and cost estimates in the feasibility study.

An external review of transport planning, project development and delivery within DoI in late 2001 concluded that it did not have sufficient resources to undertake adequate project development work<sup>23</sup>. In response, DoI has taken action to address this weakness, including the establishment of a Project Review Committee and the development of cost estimating, business case and risk evaluation guidelines.

Approval of DoI's request for additional project funding would have increased the government's contribution to the project from \$96 million (of a total estimated project cost of \$140 million) to \$155 million (also the total estimated project cost). This request was not approved by government.

The rejection of DoI's request for additional funds in 2002 suggests that less than 12 months after its approval and initial budget allocation, the RGS project was at significant risk of not being delivered.

Figure 3B shows that in January 2003, DoI estimated the total project cost had increased from \$155 million to \$200 million (excluding allowance for the costs associated with project risks). The most significant cost increases were related to associated works in Melbourne and Geelong and rolling stock conversion. In addition, the estimated cost-benefit ratio for the project was revised downwards from 2.6 to 1.6.

An assessment of the risk adjusted estimated cost of the project (on the basis that the state had not gained control of track access) was undertaken jointly by DoI and specialists in January 2003 as part of a formal assessment of project risks. These risks were costed at \$99 million. This meant that the estimated full risk adjusted cost of the approved project was \$299 million in January 2003. The primary risks associated with delivery of the project included reaching agreement on track access, project scope and other issues with the intrastate rail lessee).

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<sup>23</sup> Allen Consulting Group, *Transport Planning, Project Development and Delivery, A Review. Final Report*. Prepared for the Department of Infrastructure, Melbourne, October 2001.

## Most recent cost estimates for the project

At the time of preparing this report, DoI did not have a current cost estimate for delivering the originally approved project. However, DoI did provide recent individual estimates for the gauge conversion of the North-Western corridor, the North-Eastern/Northern corridors and the Western corridor.

## North-Western rail corridor

In June 2004, the Commonwealth Government allocated \$20 million under the AusLink program<sup>24</sup> to the standardisation of the broad gauge line from Geelong to Mildura (North-Western corridor of the RGS project). The estimated cost to standardise the broad gauge line from Geelong to Mildura is significantly higher than DoI's early 2003 estimate which was \$34.9 million. DoI has advised that there are detailed negotiations occurring with Pacific National on the current Mildura line. The resolution of these negotiations has been delayed by the Toll Holdings Limited takeover of Patrick Corporation Limited, these parties being Pacific National's joint equal shareholders.

In April 2005, the state government approved the allocation of \$8.7 million to fund planning, development of scope and cost estimates, and risk assessment for a project involving standardisation of the North-Western corridor and the restoration of Mildura passenger services. In May 2006, the government announced that it would undertake an upgrade of the Mildura rail line for freight purposes. The cost of the upgrade was stated to be \$73 million, with the state government contributing \$53 million. The upgrade was subject to the release of \$20 million funding by the Commonwealth Government. The Minister for Transport indicated that the upgrade was the first major step towards the reintroduction of passenger services.

DoI has advised that the upgrade work will involve use of gauge convertible sleepers. On this basis, the North-Western corridor of the RGS project could be converted to standard gauge at some time in the future. However, it is clear that this corridor will not be converted to standard gauge within the timelines announced by government in 2001.

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<sup>24</sup> Auslink is a major Commonwealth Government initiative designed to improve planning, decision-making and funding for national land transport infrastructure. It is supported by a \$12.7 billion program of investment over a 5-year period from 2004-2009, with partner funding from state and territory governments and the private sector.

## North-Eastern/Northern rail corridor

In June 2004, the Commonwealth Government also allocated \$25 million under the AusLink program towards additional standard gauge capacity on the North-Eastern corridor (Melbourne to Albury/Wodonga).

An assessment, completed in March 2005, of the benefits and costs of standardisation of the North-Eastern/Northern corridors<sup>25</sup> showed that gauge conversion of these corridors as a stand-alone project would produce minimal to modest benefits, against an estimated cost of around \$180 million. This is significantly higher than the most recent DoI estimate of the cost of standardising this corridor which was \$42.3 million in early 2003. The study also concluded that few synergies would result from a joint gauge conversion program on the North-Western, North-Eastern/Northern corridors at an estimated cost of \$326 million.

The government was advised of the findings of this study in June 2005, but no decision has been taken on whether or not to proceed with gauge standardisation on the North-Eastern/Northern corridors.

## Western rail corridor

A study completed by specialists in May 2005<sup>26</sup> estimated that the total capital cost of reopening and gauge converting all rail lines on this corridor<sup>27</sup> and associated works in the region would be approximately \$74 million. Of the total cost, in excess of \$30 million related to works in Victoria. This is significantly higher than the most recent DoI estimate of the cost of standardising this corridor which was \$5.1 million in early 2003, primarily due to the significant maintenance backlog now affecting this line.

DoI is reviewing these findings and, at the date of preparing this report, no government decisions has been made on whether to proceed with gauge conversion of the Western corridor.

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<sup>25</sup> Asia Pacific Rail and Booz Allen Hamilton, *Study of benefits of Rail Gauge Standardisation in the North and North-Eastern regions of the Victorian Rail Network, Final draft report*. Prepared for the Department of Infrastructure, Melbourne, March 2005.

<sup>26</sup> Maunsell Australia Pty Ltd, *Restablishment of Green Triangle Rail Freight Services – Commercial and Economic Feasibility Study, Draft Final Report*. Prepared for the Department of Infrastructure, Melbourne, May 2005.

<sup>27</sup> The study considered that project viability is dependent on reopening the line between Heywood and Penola at a cost of \$74 million, including terminal facilities.

## Other government decisions that impact on the RGS project

By January 2003, no progress had been made in implementing the RGS project. In response to advice of this position, government requested that the Minister for Transport develop an Integrated Regional Rail Strategy assessing desired outcomes against delivery options for a range of rail projects including the RGS project.

The minister responded in March 2003 with a submission to government on *Rail policy priorities and spending pressures*. The submission acknowledged that the RGS project was one of 3 major rail infrastructure projects that showed large additional cost and/or schedule risks. Given this, the submission recommended to government that a review of the original policy objectives and current budget provisions be undertaken for these projects.

In relation to the RGS project (and other rail projects with a gauge standardisation element), the submission recommended that government:

- defer the RGS project (with the exception of the Corio Independent Goods Line)<sup>28</sup> and use the remaining funds (\$71.6 million) to meet cost pressures on other rail projects
- defer the Wodonga rail bypass<sup>29</sup> (since this project was dependent on completion of RGS North-Eastern corridor), and use these funds to meet cost pressures on other rail projects
- approve 2 standardisation-related projects at the Port of Geelong: the Corio Independent Goods Line (at a capital cost of \$13.5 million), previously part of RGS, and the Lascelles Wharf rail connection<sup>30</sup> (funding of \$5.1 million already approved in the 2002-03 budget); and another at the Port of Portland, the Cliff Street overpass<sup>31</sup> (at a capital cost of up to \$15 million). Neither Lascelles Wharf or the Cliff Street overpass were part of the originally approved RGS project.

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<sup>28</sup> The Corio Independent Goods Line, a part of the approved RGS project, is a dedicated dual gauge freight line that will provide a standard gauge rail connection between Corio and North Geelong (west side of the rail corridor) and the North Shore and Corio (east side of the rail corridor).

<sup>29</sup> The Wodonga Rail Bypass involves relocating the rail lines from the city's central business area to a route parallel to the Hume Freeway resulting in decreased traffic congestion.

<sup>30</sup> The Lascelles Wharf rail connection involves the construction of a new dual gauge line which will facilitate a physical connection with the Corio Independent Goods Line. At present, the rail yard is situated a short distance from the wharf, thereby requiring that freight must be moved to and from the wharf by road. The dual gauge rail access will eliminate this double handling of freight.

<sup>31</sup> The Cliff Street overpass involves the construction of an overpass at the Cliff Street entrance to the Port of Portland. The overpass would reduce freight congestion at the entrance to the port by separating trains and trucks accessing the port from local traffic on Cliff Street. The overpass would create a dedicated access route into the port, thereby promoting more efficient movement of freight in and out of the port.

In May 2003, the government allocated \$28.5 million of RGS funding to 2 gauge standardisation-related projects. These were construction of the Corio Independent Goods Line (with a budget of \$13.5 million) and construction of the Cliff Street overpass at the Port of Portland (with a budget of \$15 million). The Corio Independent Goods Line was a part of the originally approved RGS project.

When making this decision, government requested that DoI provide a list of potential RGS-type projects in order to utilise the balance of available RGS funding.

In May 2003, the government announced its funding decisions and indicated that while it remained committed to the standardisation of Victoria's rail freight network, the RGS project would be delayed. The announcement indicated that the delay was due to difficulties in negotiating track access with the intrastate rail lessee, and to a lesser degree, an inability to obtain required project funding from the Commonwealth Government and private sector. Both of these were acknowledged as necessary pre-requisites for the project to proceed.

To date, no physical works have commenced on any components of the originally approved RGS project.

## **Conclusion**

The most recent cost estimate for the entire approved project was \$299 million in early 2003. The increasing estimated cost of the project, DoI's inability to secure an agreement with the rail infrastructure lessees or to obtain required funding from the private sector, and government decisions to reallocate RGS project funding to "parts" of the project, and to new gauge standardisation-related projects, is a clear indication that the project, as originally approved, was no longer viable.

Despite announcing in May 2003 that the project would be delayed, the government has not announced any change to the approved scope of the project, or the timetable for its delivery. There is no evidence that the public was informed of the substantial risk to the completion of the project arising from delays in obtaining agreement with the intrastate rail infrastructure lessee and increasing project costs. DoI's website continues to indicate that all 13 prioritised broad gauge lines (announced in 2001 to be converted to standard gauge) will be converted.

There is a need for a decision on the future of the project in the context of other rail projects and commitments announced by government which impact on the regional rail network.

### 3.4.4 Project expenditure and procurement

Figure 3C shows actual expenditure for the RGS project to 28 February 2006. To date, no expenditure has been incurred on the Western corridor.

**FIGURE 3C: RGS EXPENDITURE TO 28 FEBRUARY 2006**

Component	RGS expenditure (\$'000)				Total
	North-Western corridor	Metropolitan associated works	Geelong associated works	North-Eastern corridor	
Materials	1 887	1 903	1 890	-	5 680
Land acquisition	220	50	-	-	270
Legal and insurance	26	26	87	-	139
Project management and design	1 600	3 009	(a) 3 240	296	8 145
<b>Total</b>	<b>3 733</b>	<b>4 988</b>	<b>5 217</b>	<b>296</b>	<b>14 234</b>

(a) Project management and design expenditure for Geelong-associated works includes costs for the Corio Independent Goods Line (\$1.2 million) since this was part of the originally approved RGS project.

Source: Department of Infrastructure.

Figure 3C shows that \$14.2 million has been spent to 28 February 2006. Of this expenditure, over half (57.2 per cent) relates to consultancies (such as engineering design services) and project management, with nearly all the remainder (39.9 per cent) expended on the purchase of project materials.

In the nearly 5 years since the RGS project was approved and funded, no conversion works have been carried out on any of the 13 prioritised rail lines.

In addition to contracts awarded for materials purchased to date, DoI tendered and evaluated 2 proposals for materials to the value of \$2.6 million. Following submission of proposals in early 2002, DoI advised the tenderers that the contracts would be placed on hold because of lack of progress on the project. In early 2003, the tenderers were advised that DoI would not be awarding the contracts. It is acknowledged that in this type of infrastructure project there are significant lead-times and, therefore, it is important to commence procurement action early. However, it is unreasonable for DoI to expect bidders to go to the trouble and expense of tendering to be then told nearly one year later that the contracts would not be awarded.

In March 2003, DoI advised government that most of the materials that had been purchased (all of which were for the North-Western corridor) could be reused or reallocated if works on the North-Eastern corridor proceeded ahead of the North-Western corridor. DoI further advised that if works on neither corridor progressed, there was little capacity to reuse the materials. At the time of preparing this report, DoI advised that \$2.5 million of the \$5.7 million of materials purchased to date are proposed to be used on the Port of Geelong Rail Access Improvement Project<sup>32</sup>.

## **Conclusion**

While no physical works have commenced on any components of the originally approved project, 14 per cent of the budget has been expended on consultants and purchase of materials.

It is unreasonable for DoI to expect bidders to go to the trouble and expense of tendering for the provision of material and then to be advised that the process would not be proceeding.

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<sup>32</sup> The Port of Geelong Rail Access Improvement Project is a 3 part improvement project which deals with interconnecting components of rail infrastructure. These include the North Geelong Track Modifications, the Corio Independent Goods Line and the Lascelles Wharf rail connection.



## 4. Docklands film and television studios - Status of state's interest



## 4.1 Audit conclusions

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### Increased state support for the studios

In November 2004, the government entered into new contractual arrangements with the developer of the Docklands film and television studios (Melbourne Central City Studios Pty Ltd) to supplement the original contracts agreed in September 2002.

Under the original contracts, the developer was to build and operate film and television studios and a surrounding commercial development at Melbourne's Docklands precinct. The government loaned the developer \$31.5 million to build the studios. The state's key objectives for the studios were to:

- increase Australian and international film and television production in Victoria
- foster an accessible and competitive environment for Australian film and television productions in Victoria
- provide the local film and television production industry with an internationally competitive capability.

The new arrangements adopted some, but not all, of the developer's proposed changes to the previous contractual terms and significantly increased the support provided by the state to the developer. The Department of Industry, Innovation and Regional Development (DIIRD) has advised that the new arrangements aimed to assist the developer to be more competitive in the global market, primarily through increased investment in enhanced studio facilities. They comprised:

- a new state guarantee of the developer's \$14.5 million borrowings, the repayment of which takes precedence over the state's loan
- deferral of the repayment of the state's loan by a further 2 years (to February 2008<sup>1</sup>), with interest accrued over the 2-year period added to the loan principal amount
- suspension of lease payments to the state for the studio site for the first 3 years of the new arrangements, which will become payable by the developer over the following 6 years
- deferral of the start of construction of the supporting commercial development (by 1½ years, to December 2005<sup>2</sup>)

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<sup>1</sup> The original 2002 contractual arrangements had already provided that repayment of the state's loan would not commence until 2 years after completion of the construction of the studios, that is February 2006 (subject to the studios being sufficiently profitable at that time).

<sup>2</sup> DIIRD subsequently extended this deadline in December 2005 by another 6 months, to June 2006.

- funding for an improved perimeter fence for the studios
- charging a peppercorn rent for the use of certain crown land, and transfer of ownership of a warehouse on that land to the developer.

In return, the state strengthened its position in relation to the studios by receiving a right to appoint an administrator or receiver for the studios under certain circumstances. The developer has also given the external lender this right. Further, the developer has committed to increasing their equity in the studios by \$2.5 million.

We found that DIIRD did not assess the likelihood that the state would have to pay out or take over the developer's \$14.5 million borrowing. Neither did it assess how the new contracts would affect the likely extent of repayment of the state's original \$31.5 million loan by the developer, prior to entering into the new arrangements. Consequently, DIIRD did not brief the minister about these matters before executing the new contracts. We consider that this represents a significant shortcoming in the advice provided to the minister in support of the decision to enter into the new arrangements with the developer. Nevertheless, DIIRD did seek independent legal, industry and commercial advice about other aspects of the changed arrangements prior to briefing the minister and included that advice (together with its assessment of project risks) in its briefing to the minister. DIIRD advised us that its overriding consideration was to ensure that the project was best placed to achieve the state's industry development goals.

### **DIIRD's monitoring and management of studio performance**

DIIRD's management regime for the studios has several positive elements. These include the development of a detailed contract administration manual to help guide its internal management arrangements, and a good working relationship with studio management.

However, we found that evidence detailing the results of DIIRD's review of periodic operational and performance information provided by the developer, including the conclusions reached and action taken, was not always available.

DIIRD did not require the developer to comply with the contractual requirements to prepare business plans on a financial year basis, which made comparisons of budget forecasts to actuals difficult. It did not require the developer to prepare a business plan for 2004-05, quarterly operational reports for June and September 2004, or provide an (audited) 2003-04 financial report. This meant that DIIRD did not have all the information it was contractually entitled to during 2004 when it advised the minister to enter into the new arrangements with the developer. DIIRD advised us that it undertook ongoing monitoring of the studios' performance during 2004 as part of its intense negotiations with the developer about the proposed new arrangements.

At the time of our audit, DIIRD had not exercised its contractual right to audit the studios to confirm compliance with the contracts and the key performance indicators (such as the utilisation rates and levels of production spend). In our opinion, it should have done so in order to verify the developer's reports to the department.

Furthermore, DIIRD staff responsible for oversighting the state's interest in the studios had not presented regular formal reports to the minister or the secretary of DIIRD about the financial viability or performance of the studios (including performance against forecasts, cash flows and the general financial health of the developer). DIIRD staff had, however, verbally briefed the secretary. In our view, they should have prepared regular formal reports for the consideration of the secretary and minister. This is particularly important in light of the changed arrangements, the significant public interest in the project, the significant public funds invested in it, and its level of financial and other risk.

### **Performance against the key performance indicators**

We consider that the developer has not achieved 3 of the 7 performance indicators included in the contractual arrangements (relating to the developer not having recourse to any further funding from the state and the level of minimum additional film and television production spending in Victoria). This is because the state is now exposed to the risk of having to provide up to \$14.5 million in extra funding to the project (on top of the other financial concessions it has made) and the sound stages have not serviced film and television productions having an additional production spend in Victoria of at least \$100 million, or serviced Australian productions of at least \$25 million.

We could not assess performance against 2 of the other indicators (relating to whether the studio complex is regarded as an integrated world class facility that provides for an expanded and more efficient and effective film and television production sector in Victoria), mainly because the department had not gathered sufficient and appropriate evidence to assess them. The remaining 2 indicators (relating to studio utilisation rates and the operation of an open access policy) appear to have been met, but we base this conclusion on evidence provided by the developer which had not been verified by DIIRD.

While we acknowledge that the studios are still in their start-up phase, our review of the studios' 2004-05 financial statements identified several indicators of poor financial performance or position. The 2004-05 audited operating result, net asset position and net cash flows were well below the developer's forecasts in the 2002 contracts.

The developer is now projecting, for the period 2006 to 2011, substantially lower operating profits than it had in the 2002 contracts. The developer has made these major reductions in forecast net profit due to a downturn in television and film production during 2003-04. Consequently, we estimate that only around \$12 million<sup>3</sup> of the state's \$33.4 million loan (including the original loan amount of \$31.5 million and estimated capitalised interest totalling \$1.9 million<sup>4</sup>) to the developer may be repaid over the 20-year term of the loan. In these circumstances, the contracts provide that ownership of the studios would transfer to the state at the end of the 20-year loan term (unless the developer elected at that time to fully repay the state's loan and either opted to purchase the site from the state or sought to extend the site lease for a further 10 years at market rates).

## 4.2 Background

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In April 2000, the government appointed a task force to examine the Victorian film and television industry and to develop a strategic framework for industry growth and support. The task force identified the absence of adequate studio facilities as a major infrastructure inadequacy for the industry.

<sup>3</sup> This estimate is based on the developer's projections of state loan repayments over a 5-year period ending in 2010-2011 (included in its 2006-07 business plan) and uses the same approach and assumptions adopted by the department in its April 2005 forecast. The calculation does not take into account the changes in the time value of money. We also note that DIIRD has not verified the developer's forecasts included in its business plans.

<sup>4</sup> Under the new arrangements, interest accrued during the 2-year period ending February 2008 is added to the loan principal. The estimate of interest accrued during this period is based on the developer's projections included in its 2006-07 business plan. We note that DIIRD has not verified the developer's forecasts included in its business plans.

In September 2002, the government (after conducting a tender process) contracted a consortium (the developer) to build and operate film and television studios and a surrounding commercial development at Melbourne's Docklands precinct. The agreements included 7 key performance indicators to measure the achievement of the government's objectives over the 20-year term of the agreements. The government loaned the developer (now known as Melbourne Central City Studios Pty Ltd) \$31.5 million to build the studios, which are owned by the developer, and leased certain state land to the developer for the studio complex.



*The Docklands film and television studios.*  
(Photo courtesy of Melbourne Central City Studios Pty Ltd.)

The government's key objectives for the studios were to:

- increase Australian and international film and television production in Victoria
- foster an accessible and competitive environment for Australian film and television productions in Victoria
- provide the local film and television production industry with an internationally competitive capability.

DIIRD manages the agreements on behalf of the government. The Minister for State and Regional Development is the responsible minister.

Our February 2003 report to Parliament<sup>5</sup> noted a number of shortcomings in the tendering arrangements for this project. It also noted that a detailed process for monitoring the developer's performance against the key performance indicators had not yet been developed.

After that report was tabled, a number of concerns were drawn to our attention by external parties about:

- the extent of additional support provided by the government to the developer
- whether the developer could service and repay the state's loan as forecast.

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<sup>5</sup> Victorian Auditor-General's Office 2003, *Report on Public Sector Agencies, Results of special reviews and 30 June 2002 financial statement audits*, Victorian Government Printer, Melbourne.

Construction of the studios was completed in February 2004. They opened for business in March 2004.

We conducted an audit to establish the extent to which the expected outcomes of the project were being achieved. We assessed:

- changes since September 2002 in the contractual arrangements and level of support provided by the state to the project
- the developer's performance against the key performance indicators established by the government
- the financial viability of the project (to assess whether the developer will be able to repay the state's loan)
- whether the project contributed to an increase in the number of films made in Victoria, which was one of the state's key objectives for the project.

### 4.3 What changes have occurred in the state's support for the project?

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To determine and assess the changes made since September 2002 in the level of support provided by the state to the project, we examined whether:

- changes in the contractual arrangements between the state and the developer had increased the level of state support for the project, or otherwise affected the state's rights, obligations or risks in relation to the project
- any other form of support had been provided by state agencies (Film Victoria and DIIRD) to the developer and, if so, how this effected the state's rights, obligations and risks associated with the project
- any supplementary contracts or other developments adversely affected (or otherwise changed) the key performance indicators contained in the original contractual arrangements.

In December 2003, the developer applied to DIIRD to amend the terms of the September 2002 studio contracts, having revised its revenue and expenditure forecasts for the facility. It did so, in part, so it could seek further funding from an external lender.

The developer had reduced its revenue forecasts due to what it identified as a weakening in the film and television production market, and increased worldwide competition by studios. DIIRD, and its advisers, accepted the developer's assessment of the market.

In November 2004, the state and the developer entered into supplementary contracts which varied the 2002 contracts. These allowed the developer to:

- delay repayment of the \$31.5 million loan from the state (although interest will continue to accumulate and become payable from February 2008). Interest accrued during the 2-year period until February 2008 is added to the loan principal. Under the new arrangements, the earliest the developer is required to start repaying the loan principal is February 2008, compared with February 2006 under the original contracts<sup>6</sup>. Repayments can be further delayed if the developer's other external borrowings remain outstanding at that time, or if the developer is not sufficiently profitable<sup>7</sup>
- suspend lease payments to the state for the studio site for the first 3 years of the new arrangements. These lease payments will, however, become payable by the developer over the following 6 years
- delay the start of construction of a commercial cluster supporting the studio complex by 18 months, until December 2005. DIIRD subsequently extended this deadline in December 2005 by another 6 months, until June 2006
- borrow \$9.5 million from an external lender to further develop the studio complex, and to consolidate this facility with an existing \$5 million borrowing facility - bringing the developer's total non-state debt to \$14.5 million
- use the new borrowings for new capital works completed during 2005, including refurbishment of a state warehouse for use as a craft shop, workshop and storage facility; expansion of cast and crew amenities at the studios; altering the studios' airconditioning and increasing parking for production vehicles and cars
- lease certain additional crown land<sup>8</sup> from the state at a peppercorn rent of \$1 for an initial term of 5½ years (which can be extended with the state's consent), and to receive title to a warehouse on that land to use as a craft shop, workshop and storage facility<sup>9</sup>.

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<sup>6</sup> The original 2002 contractual arrangements provided that repayment of the state's loan would not commence until 2 years after completion of the construction of the studios, that is February 2006 (subject to the studios being sufficiently profitable at that time).

<sup>7</sup> Principal repayments on the state's loan are calculated at 20 per cent of the developer's earnings before interest, tax, depreciation and amortisation (which data are not required, under the contractual arrangements, to be audited).

<sup>8</sup> The land subject to lease was valued by DIIRD at \$1.78 million.

<sup>9</sup> At the end of the initial lease term, the developer is required to remove all improvements made, or the developer can seek the state's consent to continue the leasing arrangements.

Under the new arrangements, the state is required to pay out the external lender or take over the loan (up to \$14.5 million) if the developer defaults. That is, the state in effect has guaranteed the new loan. Further, the agreements give repayment of the external lender's debt priority over repayment of the state's debt and place restrictions over the use of the loan funds and withdrawal of cash from the studios by the developer.

The state also agreed to pay for the increased cost of, and manage, the design and construction of the studios' perimeter fence, estimated at \$1 million. While the developer contributed the amount it originally budgeted for the fence, increased costs arose from a subsequent requirement by a state agency. The September 2002 arrangements require the developer to pay all future maintenance and capital costs of the fence.

In return for the additional support given by the state, the developer has granted to the state and the external lender a fixed and floating charge over the studios' assets, which gives the state and the lender the right to appoint an administrator or receiver under certain circumstances<sup>10</sup>.

The developer has also acknowledged that the state will not provide any further assistance or support, other than as expressly required under the contractual arrangements. However, this has not substantively strengthened the state's position as the developer could always seek further assistance and support in accordance with the contractual arrangements, and has subsequently requested and received approval to a further deferral of the commencement date of the commercial cluster development supporting the studio complex.

The developer has waived and released the state from all existing claims (whether or not notified to the state) that it might have against the state. However, as DIIRD has not received, in its opinion, any valid claims from the developer, this again, in our opinion, did not significantly alter the state's position.

The state did not agree to a number of other proposals from the developer which would have further increased the state's support for the studios.

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<sup>10</sup> The original contracts provided that ownership of the studios would transfer to the state at the end of the loan term, unless the developer fully repaid the state's loan and either opted to purchase the studio complex site from the state or sought to extend the site lease for a further 10 years at market rates. They also included several early termination and default events during the life of the project.

The developer's shareholders have also committed to increase their equity in the studios by \$2.525 million, in addition to their original commitment of \$6.3 million in working capital. This commitment is supported by a new bank guarantee to the state for up to \$2 million until the shareholders contribute their additional equity. At the time of preparing this report, \$200 000 in additional equity had been contributed by the shareholders.

DIIRD sought independent legal, industry and commercial advice about the changed contractual arrangements, including the impacts of the arrangements on the state. The commercial advisors explained the consequences for the state should the developer default on its new external debt.

DIIRD included its assessment of risks for the state, together with the external advice it had received, in its briefing to the minister. DIIRD advised us that, in light of the long-term nature of the state's objectives for the project and that the studios were still in start-up phase, it had sought to strengthen the state's position in terms of being able to ensure that the project was best placed to achieve the state's industry development goals. This represented DIIRD's rationale behind the decision to provide further support to the developer, without weakening the key performance indicators and strengthening the state's call over the studios' assets.

However, DIIRD, or its advisers, did not assess the likelihood that the state would be required to payout or take over the developer's \$14.5 million borrowing. Similarly, an assessment of the implications of the changed arrangements (and revised projections by the developer) on the repayment of the state's original \$31.5 million loan by the developer was not made prior to entering into the new arrangements.

The commercial advisors told DIIRD that they were not in a position to advise on whether the developer's revised revenue or cost forecasts could be achieved. DIIRD did not ask them for such advice.

On the basis of the developer's original 2002 projections, DIIRD had previously estimated that the developer may not be able to repay a substantial proportion of its loan to the state. DIIRD's financial advisors had concluded that the projections were risky and may not be achievable.

Film Victoria (a Victorian public body) funds a number of film productions each year, including productions using the Docklands studios. Film Victoria, and DIIRD, confirmed that they had not provided direct funding or grants to the developer or to the Docklands studios since 2002.

## Conclusions

The level of support provided by the state to the studios has increased significantly since 2002. The increased support comprises:

- a state guarantee of the developer's new \$14.5 million external borrowings (the repayment of which now takes precedence over repaying the state's loan)
- deferral of the repayment of the state's loan (by a further 2 years until February 2008<sup>11</sup>)
- deferral of lease payments to the state for the studio site (by approximately 2 years<sup>12</sup>)
- deferral of the start of construction of a commercial cluster development supporting the studio complex (by 1½ years until December 2005<sup>13</sup>)
- funding for an improved perimeter fence
- charging a peppercorn rent for the use of certain crown land and transfer of title of a warehouse on that land to the developer.

In return, the state has received a right to appoint an administrator or receiver for the studios under certain circumstances (as part of a fixed and floating charge over the studios' assets). The developer has also given the external lender this right.

We consider that DIIRD should have assessed (using internal or independent assessors) the company's financial performance and condition to determine the likelihood of the state having to pay out or take over the developer's \$14.5 million borrowing. It should also have assessed whether the changed arrangements, including the new borrowings and the current financial forecasts and position of the developer, would affect the repayment of the state's original \$31.5 million loan by the developer prior to entering into the new arrangements. Further, DIIRD should have briefed the minister about these matters before executing the new contracts.

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<sup>11</sup> The original 2002 contractual arrangements had already provided that repayment of the state's loan would not commence until 2 years after completion of the construction of the studios, that is February 2006 (subject to the studios being sufficiently profitable at that time).

<sup>12</sup> From the date that studio construction was completed (February 2004).

<sup>13</sup> DIIRD subsequently extended this deadline in December 2005 by another 6 months, until June 2006.

## Recommendation

### 4.1 That DIIRD:

- **assess, and brief its minister about the ability of the developer to meet its loan servicing obligations when they fall due and, therefore, the likelihood that the state will have to payout or take over the developer's borrowings, and the extent to which the developer's loan from the state is likely to be repaid**
- **brief its minister about any changes in its assessments, as it continues to monitor the performance and financial condition of the studios.**

### *RESPONSE provided by the Secretary, DIIRD*

*For a full understanding of the matters raised in this report, the government's overall objectives for the project must be properly taken into account.*

*The government's objectives for the project as stated in Section 7 of the loan agreement are:*

- *increased Australian and international film and television production in Victoria*
- *an accessible and competitive environment for Australian film and television productions in Victoria*
- *a local film and television production industry with an internationally competitive capability*
- *the development of a film and television industry cluster on and around the complex.*

*These objectives define the fundamental purpose of the project, and the studios, after only 2 years of operation, are already contributing significantly to these industry development goals in a challenging operating environment.*

*In this context, it is important to understand the reasons why the government entered into the supplementary agreements. The supplementary agreements enabled the studio operator to seek additional funding from an external lender to enhance and add to the facilities at the studios. Advice to DIIRD from external industry experts confirmed that this would enable the studios to be more competitive within a global market.*

***RESPONSE provided by the Secretary, DIIRD - continued***

*DIIRD notes that the Auditor-General sought and received copies of the supplementary agreements in April 2005. In the absence of any indication to the contrary, DIIRD operated on the basis that there were no serious issues with the new agreements.*

*DIIRD considers that the summary of the costs and benefits of the supplementary agreements does not provide an adequately balanced account of the value of the items obtained by both the operator and the state. The report gives emphasis to items provided to the operator while not reporting most of the benefits the state received from executing the new agreements. Expert opinion sought by DIIRD stated that the state was in a better position as a result of executing the supplementary project deeds.*

*The only item of value received by the state noted in the report is the state's right to appoint an administrator or receiver. This right was granted due to the execution of a fixed and floating charge. A fixed and floating charge provides a degree of security over the assets of the company in the event of a default. Other items of value received by the state not included in the summary are:*

- an equity commitment from MCCA shareholders*
- a waiver of past claims*
- an acknowledgement and agreement that the state will not entertain any further request from the developer – except what is expressly required under the contracts*
- recommitment to the CCS Foundation with a higher contribution*
- recommitment to the project KPIs.*

*Reference to a “guarantee” in respect of the new loan should also mention that the state has security over some of the operator's assets. This inclusion would permit a full understanding of the nature of the new arrangements. The conclusion should also recognise that the arrangements with the external lender achieve a situation under which the external lender is obliged to do everything reasonably possible to recover or secure the debt, which may include finding a replacement operator suitable to the state before the state would be required to take over the loan.*

***RESPONSE provided by the Secretary, DIIRD - continued***

*The conclusion lists the items received by the developer as though these are major concessions on the part of the state. In particular:*

- the deferral of lease payments and loan to the state: these were not a significant item for the state as the lease and loan payments continue to be accrued during the period of deferral*
- the charging of peppercorn rent for the use of certain crown land: it would have been difficult for the state to gain value from the warehouse given its location and condition. The lease is for a period of 5½ years, clause 18.2 of the Warehouse Lease specifically provides that all improvements vest in the state should the Warehouse Lease be terminated early, for any reason. In addition, the operator was required to make substantial improvements to the warehouse at a cost of \$1.65 million. The addition of the refurbished warehouse contributes to the project KPIs, supporting the critical project objective of industry development.*

*DIIRD has undertaken extensive work to minimise risk, including contingency planning in the event of failure by the operator and other possible scenarios. At the time the supplementary agreements were negotiated, operator failure was judged by DIIRD and confirmed by expert opinion to be the most serious risk to the achievement of the overall objectives for the project. In relation to the new agreements, DIIRD obtained advice from commercial advisors that if the developer failed, the state would become owners of a facility with a capital value that would be approximately equal to the original loan plus the \$14.5 million additional borrowing (the majority of which was committed to further capital investment). The new agreements provided additional security and provided a legitimate mechanism to increase the state's influence over the achievement of the industry development objectives.*

*In assessing the new contract arrangements, the risk of operator failure was balanced against increased security over the assets in the context of the broader project objectives of contributing to industry development through a film and television studio capable of attracting significant production into Victoria. DIIRD has disclosed the potential liability of the \$14.5 million borrowing in its financial accounts.*

***Response to recommendation 4.1***

*DIIRD has and will continue to brief its minister about the objectives of the project which relate primarily to industry development, as well as associated matters related to risk and performance and repayment of loans (the purpose of which was to seed industry development).*

***RESPONSE provided by the Secretary, DIIRD - continued***

*The studio operator is a start-up company in an industry which is cyclical. In light of this, the project risks are well known to DIIRD and the minister.*

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

*DTF considers that the original objectives remain fundamentally intact because of the supplementary deeds. The recommitment to the original key performance indicators (KPIs) supports this view.*

*To provide the Auditor-General with further context, DTF advises that in other states, both the New South Wales (NSW) and Queensland governments have made significant contributions to the establishment of their studios in the form of grants, no interest loans and tax concessions. Unlike Victoria however, NSW and Queensland have not tied their funding to an ongoing and stringent performance criteria and the ownership of those assets resides with the private operator.*

*While the nature of the \$31.5 million contribution from the Victorian Government has similar characteristics to a performance bond, it should be noted that if the private operator does not meet the state's performance criteria (KPIs), in addition to meeting the repayments, the state will have the right to call back the \$31.5 million construction contribution by taking control of the studio complex.*

*While the state's total investment is expected to be recouped over the concession period, the state's primary objective in this investment is not a revenue stream from the private operator, but the wider economic benefits of growing the film and television industry in Victoria and creating high value jobs. DTF again emphasises that it is not enough for the private operator to meet its regular payment obligations to the state, it must meet the industry development KPIs.*

***Response to recommendation 4.1***

*While the Auditor-General recognises that the minister was briefed on the project risks prior to executing the new contracts, his report initially states that not assessing the extent to which the new arrangement affects the state's original loan represented a "significant shortcoming in the advice".*

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

*DTF recognises the importance of the quantum of funding provided and the management of the ongoing financial risks in relation to that funding. However, DTF believes the significance of the omission to brief the minister on the likely extent of repayment of the state's original \$31.5 million at the time of signing the supplementary deeds should not be overstated. Given the comprehensive nature of the briefings provided to the minister (identifying and evaluating the project risks) prior to executing the new contracts, DTF considers that the risks of the new arrangements were sufficiently highlighted. Further, DIIRD noted that the supplementary deeds would not affect the private operator's obligation to repay the original borrowings, as interest on the initial \$31.5 million would be capitalised and payments deferred to later in the concession period. DTF also supported this view and noted that the new debt did not expose the government to unacceptable risks, as it largely funded capital investment, which in turn increased the value of the studio assets.*

## 4.4 How is the developer performing against the key performance indicators set by agreement with the state?

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In assessing the developer's performance against the key performance indicators set out in the loan agreement, we examined:

- the studios' performance in 2004-05 against the agreed key performance indicators
- DIIRD's monitoring and reporting regime for tracking and managing the developer's performance
- the developer's compliance with the contractual reporting requirements.

### 4.4.1 Performance against key performance indicators

Figure 4A shows the key performance indicators<sup>14</sup> included in the original contracts. These remained unchanged in the revised contractual arrangements. It also shows DIIRD's, and our assessment of whether they were met in 2004-05.

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<sup>14</sup> The expression of these indicators (in this part of the report) may differ slightly from the words used in the contracts. This has been done to help improve clarity for the purposes of this report.

FIGURE 4A: DEVELOPER'S PERFORMANCE AGAINST THE KEY PERFORMANCE INDICATORS, 2004-05

Key performance indicator	DIIRD's assessment <sup>15</sup>	Our assessment
The delivery of a commercial and sustainable studio complex, without recourse to any further funding from the state (that is, beyond the existing state loan of \$31.5 million).	<b>Achieved.</b> On the basis that the state did not provide any additional direct funding to the studios in 2004-05.	<b>Not achieved.</b> The state has guaranteed a \$14.5 million borrowing by the developer, the repayment of which takes precedence over repayment of the state's loan. It also made other financial concessions (as mentioned earlier in this part of the report). The guarantee exposes the state to the risk that it will be required to provide up to \$14.5 million more funding to the project. Consequently, the developer now has recourse to additional funding from the state. We acknowledge, however, that a call had not been made on this guarantee, and no further such guarantees have been given to the developer, at the time of preparation of this report.  DIIRD should have, but has not, established specific criteria/benchmarks (such as financial viability) nor included criteria in the contractual arrangements to establish whether the studios are "commercial and sustainable" as required by the contracted key performance indicators.
That the studio complex and any commercial development are designed, constructed and fitted-out so as to be regarded as an integrated world-class facility that provides for an expanded and more efficient and effective film and television production sector in Victoria.	<b>Achieved.</b> On the basis that DIIRD has received positive testimonials from some studio users who regard the studios as a world-class facility.	<b>Cannot be assessed at present.</b> The commercial cluster development supporting the studio complex has been deferred. Consequently, it is not currently possible to assess if an integrated world-class facility, as required by the criteria, has been achieved. Further, although some feedback from users has been positive, DIIRD does not have a formal feedback mechanism (such as a survey of users and industry participants) or has not engaged expert consultants, to determine whether regard for the studios is as required by the indicator (that is, an integrated world-class facility that provides for an expanded and more efficient and effective film and television production sector in Victoria).
That the studio complex is operated, managed and maintained in such a manner that it is regarded as providing a world-class facility that provides for an expanded and more efficient and effective film and television production sector in Victoria.	<b>Achieved.</b> On the basis that DIIRD has received positive testimonials from some studio users who regard the studios as a world-class facility.	<b>Cannot be assessed at present.</b> For the same reason as above - while some feedback has been positive, there is no comprehensive and formal mechanism to assess performance against this indicator.

<sup>15</sup> As advised by the Minister for State and Regional Development to the Public Accounts and Estimates Committee of parliament, April 2006.

FIGURE 4A: DEVELOPER'S PERFORMANCE AGAINST THE KEY PERFORMANCE INDICATORS, 2004-05 (CONTINUED)

Key performance indicator	DIIRD's assessment <sup>16</sup>	Our assessment
The sound stages have an utilisation rate of at least 70 per cent for 2004-05 (and beyond).	<b>Achieved.</b> On the basis of the utilisation rates stated in the developer's quarterly operations reports, DIIRD estimated the average utilisation rate to be 72.5 per cent in 2004-05.	<b>Achieved.</b> Although we note that DIIRD has not verified the developer's calculations of the utilisation rates.
The sound stages service film and television productions having an additional production spend <sup>17</sup> of at least \$100 million <sup>18</sup> per annum for 2004-05 (and beyond) <sup>19</sup>	<b>Achieved.</b> On the basis of the developer's advice that productions serviced by the studios in 2004-05 represented a total additional production spend (in Victoria and elsewhere) of about \$140 million.	<b>Not achieved.</b> Productions serviced by the studios in 2004-05 represented an estimated total additional production spend in Victoria of about \$54 million <sup>20</sup> . DIIRD's assessment was based on the total film budgets for productions serviced by the studios, rather than just the estimated total production spend in Victoria for productions serviced by the studios.
At least \$25 million <sup>21</sup> per annum of the additional production spend serviced by the sound stages qualify as Australian production.	<b>Not achieved.</b> As the developer advised DIIRD that \$22 million in additional production spending qualified as Australian production.	<b>Not achieved.</b> We agree with DIIRD's assessment.
The bookings policy allows for open access by all potential hirers and is non-exclusive.	<b>Achieved.</b> On the basis that the studios are required to operate in accordance with the open access policy and that the quarterly reports of the developer said this policy was operational.	<b>Achieved.</b> Although we note that DIIRD has no formal mechanism to verify that the open access policy operates at the studios.

<sup>16</sup> As advised by the Minister for State and Regional Development to the Public Accounts and Estimates Committee of parliament, April 2006.

<sup>17</sup> The contracts define "additional production spend" as expenditure on production that is new to Victoria. This is in line with 3 of the state's 4 objectives for the studios, as well as the other key performance indicators which emphasise the impact of the studios on the local industry. The 3 objectives are to increase Australian and international film and television production in Victoria; establish an accessible and competitive environment for Australian film and television productions in Victoria; and to create a local film and television production industry with an internationally competitive capability. The government's fact sheet about the studios issued on 17 September 2002 said that the government's contribution of \$40 million to the studios would generate over \$100 million of additional film and television production for Victoria. In our view, all aspects of the arrangements focus on the financial and other impacts of the studios on the local industry, rather than their impacts elsewhere.

<sup>18</sup> The "per annum dollar targets" in the indicator are required to be annually adjusted in line with the consumer price index.

<sup>19</sup> It is important to note that while the key performance indicators require the studios to service productions with large production spends in Victoria, the studios themselves to date have only captured a small fraction of that spending as revenue for use of their facilities and services.

<sup>20</sup> Australian Film Commission, *National Survey of Feature Film and Television Drama Production 2004-05*.

<sup>21</sup> The "per annum dollar targets" in the indicator are required to be annually adjusted in line with the consumer price index.

The contracts specify that failure to achieve the key performance indicators is one of several default events which, if not remedied, enable the state to terminate the contract. However, the contracts also state that if external factors (such as poor economic conditions or a general downturn in the Australian or global film and television industries) result in such a default event, the state cannot terminate the contracts.

To date, DIIRD has promptly followed-up instances of non-compliance it has identified with the key performance indicators by sending letters and convening face-to-face meetings with the developer.

#### 4.4.2 DIIRD's regime to manage and monitor developer performance

DIIRD's regime to manage and monitor the developer's performance against the key performance indicators includes the following major features:

- A detailed contract administration manual which specifies how the developer's reporting and other obligations are to be monitored.
- Review of the developer's business plans and budgets and any amendments to these: the contracts require the developer to prepare a business plan (including a rolling 5-year budget) each year.
- Review of the developer's quarterly operations reports. These reports detail the studios' performance against its business plan, including the extent to which the state's objectives and key performance indicators were achieved. DIIRD refers these reports to various stakeholders (including Film Victoria and the Department of Treasury and Finance) for comment. The contracts require the developer to prepare these reports.
- A contractual right of the state (and any independent auditor appointed by the state) to inspect the studios' accounts, asset register and other specified records, to confirm compliance with the contracts; to review compliance with the key performance indicators and the studios' general performance; and to inspect the state of repair of the studios. The state has exercised its right to inspect the studios' records once (in 2002) so that DIIRD's commercial advisor could verify the initial equity that the developer invested in the business. The Department of Treasury and Finance later recommended that DIIRD exercise the right so as to clarify some information in the developer's 2004-05 audited financial statements. On that occasion, DIIRD did not exercise the right.
- The use of legal and commercial advisors to review correspondence and other key documents from the developer.

- The assignment of responsibility for managing the project to sufficiently senior and skilled staff.

A senior, skilled officer is responsible for managing the project on behalf of DIIRD, including the review of the project's financial performance and viability. This officer monitors the financial viability of the project in consultation with the developer.

Since the studios became operational in March 2004, the developer has provided the agreed information and reports required by the contracts (until December 2005) to DIIRD, with the exception of the quarterly operational reports for June and September 2004, an (audited) 2003-04 financial report, a business plan for 2004 and preparation of all business plans on a financial year basis.

The developer did not prepare operational reports for the June and September quarters, but instead prepared a combined March to December 2004 report. During this period, DIIRD was considering amending the contracts in response to the developer's request in December 2003. DIIRD advised us that, during 2004, it was involved in intense negotiations with the developer and undertook ongoing monitoring of the studios' performance during that time.

The reports required by the contracts include the initial and subsequent annual business plans and budgets (including 5-year forecasts of financial performance), annual financial statements, half yearly financial accounts and quarterly operations reports. The developer advised DIIRD of any delays in providing reports and secured extensions to deadlines. DIIRD promptly followed-up the reports.

We could not compare the developer's 2004-05 performance, as presented in its audited financial statements, against the forecasts in its business plans because it did not prepare forecasts on a financial year basis but on a calendar year basis. This is contrary to contractual requirements, which require an annual, financial year budget, including financial targets, presented as pro-forma accounts for the next financial year.

The developer's auditors qualified the developer's 2004-05 financial report because their 2003-04 financial report had not been audited. Consequently, the auditors did not express an opinion about the comparative information included in the 2004-05 financial report or about the opening balance for members' funds at 1 July 2004<sup>22</sup>.

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<sup>22</sup> Further, the financial report states that it is likely that a change in its accounting policy for determining the recoverable amount of assets, on adoption of Australian equivalents to International Financial Reporting Standards in 2005-06, will lead to the more-frequent recognition of impairments in the value of land and buildings. However, the developer had not valued the land and buildings to calculate any possible impairment at 30 June 2005.

### 4.4.3 DIIRD's monitoring and reporting of performance

DIIRD's contract administration manual specifies in detail how the developer's financial health is to be monitored.

We found evidence that DIIRD reviewed some information provided by the developer (such as its initial 2003 and 2005-06 business plans) and drew conclusions and took action on the basis of that information. We found no evidence of any review by DIIRD with respect to some other information provided by the developer. For example, we saw no evidence of conclusions drawn or action taken from the developer's half yearly financial accounts for December 2004. However, DIIRD told us that these accounts were reviewed and issues arising discussed with the developer. As well, DIIRD received the half yearly financial accounts for December 2005 in April 2006, almost 2 months later than agreed.

We found no documentation to indicate that DIIRD had formally assessed the achievement of the key performance indicators in the studios' first full year of operations (2004-05) or up to and including the quarterly report for December 2005. We expected DIIRD would have gathered performance evidence, verified the studios' performance claims (such as the utilisation rates and levels of production spend) and prepared a report with conclusions and recommendations.

In addition, while under the new borrowings arrangement the external lender has obligations to report certain adverse events to DIIRD, the department has not formally sought confirmation that any default or other events (for example, signs of financial distress) have taken place. We were, however, advised that DIIRD maintains verbal contact with the external lender who indicated that no default event has occurred.

DIIRD told us that at the time of finalising our audit it was developing check lists to ensure that the developer's reports are adequately assessed. This should improve the monitoring and management of the developer's performance.

The DIIRD officers responsible for overseeing the state's interests in the studios have not presented written reports about the studios' performance against the agreed indicators to the minister or to DIIRD's secretary for the period since December 2004<sup>23</sup>. The minister did write to the Public Accounts and Estimates Committee of the Parliament of Victoria in April 2006, in response to a committee information request, referring to the studios' key performance indicators and summarised outcomes achieved in 2004-05. DIIRD told us that its senior officers discussed the studios' progress with the secretary during regular weekly meetings.

Similarly, the relevant DIIRD officers have not prepared regular reports for their secretary or minister about the financial performance or viability of the studios (including performance against forecasts, cash flows and the developer's general financial health). Neither did they formerly report the results of a review of the studios' 2004-05 audited financial statements that had been undertaken by the Department of Treasury and Finance to the minister (despite that department's suggestion to do so).

DIIRD has prepared regular papers for the minister, as part of its "possible parliamentary questions" regime, which have included suggested "talking points" in response to actual or possible questions raised in the parliament or the media. The 'talking points' have included suggested comments on the productions underway at the studios (including examples of production spending in Victoria for specified films), feedback received from users of the studios, the key performance indicators set for the studios and other industry statistics.

## Conclusions

In our opinion, the developer had not achieved 3 of the 7 key performance indicators in 2004-05 (relating to the developer not having resource to any further funding from the state and the level of minimum additional film and television production spending in Victoria). This is because the state is now exposed to the risk of having to provide up to \$14.5 million in extra funding to the project (on top of the other financial concessions the state has made) and the sound stages have not serviced film and television productions having an additional production spend in Victoria of at least \$100 million, or serviced Australian productions of at least \$25 million.

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<sup>23</sup> A formal assessment of the achievement of the key performance indicators had been performed by a DIIRD officer for the period March to December 2004.

We could not assess performance against 2 of the other key indicators (relating to whether the studio complex is regarded as an integrated world-class facility that provides for an expanded and more efficient and effective film and television production sector in Victoria), mainly because DIIRD had not gathered sufficient and appropriate evidence to assess them. The remaining 2 indicators (relating to studio utilisation rates and the operation of an open access policy) have been met, but we base this conclusion on evidence provided by the developer which had not been verified by DIIRD.

The arrangements established by DIIRD to manage the state's interest in the studio facility have several positive features, including the development of a detailed contract administration manual, a good working relationship with studio management and the monitoring of quarterly operations reports prepared by studio management. However, documentation evidencing monitoring by DIIRD, the conclusions reached and action taken, was not always available in respect of the key information provided by the developer under the contractual arrangements.

In addition, DIIRD had not exercised its contractual right to audit the studios to confirm compliance with the contracts and review documentation supporting the developer's claimed performance against the key performance indicators (such as the utilisation rates and levels of production spend). In our opinion, it should have done so in order to verify the developer's report to DIIRD and the actual achievements of the studios. We note that the Department of Treasury and Finance had recommended that DIIRD exercise its right to inspect the developer's accounts in order to clarify some of the information contained in the developer's audited financial statements for 2004-05.

The DIIRD officers responsible for overseeing the state's interests in the studios had not presented regular reports to the secretary or minister about the financial viability or performance of the studios (including performance against forecasts, cash flows and the general financial health of the developer). While we note the secretary was verbally briefed about the progress of the studios at regular weekly meetings, regular formal reports have not been prepared. In our opinion, such reports are particularly important in light of the changed arrangements, the significant public interest in the project, the significant public funds invested in it, and its level of financial and other risks.

## Recommendation

### 4.2 That DIIRD:

- establish appropriate processes to periodically verify the developer's claimed performance against the agreed key performance indicators, and financial budgets
- document its analysis and conclusions arising from its review of operational reports and other information provided by the developer under the contract
- establish systems to capture sufficient and appropriate evidence to assess performance against the key indicators, to judge if the developer has establish a "commercial and sustainable studio complex", and that the studios are regarded as "an integrated world class facility that provides for an expanded and more efficient and effective film and television production sector in Victoria"
- ensure that the developer reports on the studios' performance against the key indicators for the entire financial year, as well as on a quarterly basis
- prepare regular and comprehensive reports, at least on an exception basis, to its secretary and minister about the developer's performance
- formally request, on a regular basis, confirmation from the developer's external lender that no default or other adverse events have taken place.

### *RESPONSE provided by the Secretary, DIIRD*

*DIIRD does not agree with the conclusion that the operator has failed to achieve 3 of the 7 performance indicators.*

*In relation to the key performance indicator (KPI) that refers to the studios operating without additional state funding, while the supplementary agreements allowed the provision of additional support to the operator, this support was not in the form of additional state funding. The support enabled the operator to secure additional finance from a bank in a commercial arrangement, and gave the business additional time to reach a sound financial footing before requiring repayments of the loan. The government recognised that the additional costs in relation to the fence were the result of agency requirements and accordingly this contribution is not regarded as additional direct funding to the studios. The operator contributed the original budgeted amount toward the fence.*

***RESPONSE provided by the Secretary, DIIRD - continued***

*In his review of this project, the Auditor-General has concluded that the KPI relating to additional production spend has not been met due to an interpretation by the Auditor-General that the definition of annual production spend means the total amount spent in Victoria by a production. We disagree with this interpretation. The contract defines production spend as being the total production budget of a film or television project and additional production spend as production spend that is new to Victoria (as opposed to the continuation of existing Victorian production).*

*The reporting of additional production spend of \$140 million in 2004-05 was based on total production budgets of productions utilising the Studios. This definition is consistent with that used by the Auditor-General in his 2003 report on the Film and Television Studios Project (page 179), and the operator in his reports to DIIRD. DIIRD will continue to report on additional production spend as the total production budgets of productions hosted by the studios.*

*Given the early stage of the studio's operation, DIIRD believes that sufficient evidence was collected to assess whether the studios are regarded as an integrated world class facility. The success in attracting international films like Ghost Rider and Charlotte's Web to Victoria indicate that the studios have been competing successfully for international productions in a difficult market. Written testimonials collected by DIIRD from users were unfailingly positive. These have been confirmed in meetings with film production companies that have used the studios. DIIRD agrees that in the future, confirmation of this KPI could be enhanced by a more formalised survey.*

*During the period of focus in the review, additional verification was not considered necessary. At this time, officials from DIIRD made regular visits to the studios and it would have been clear to them if the studios were not occupied. In addition, there were regular discussions about the activities of the studios with Film Victoria which covered the level of activity of the studios.*

**RESPONSE provided by the Secretary, DIIRD - continued****Response to recommendation 4.2**

*DIIRD agrees that processes be put in place to periodically verify the operator's claimed performance against the agreed KPIs. DIIRD appreciates the need for external and independent scrutiny of the operator's financial performance. DIIRD is of the view that a key trigger for an audit of the operator's performance against its financial budgets would be where there was concern as to their accuracy or if they showed inconsistent trends in comparison with other information.*

*DIIRD agrees that documentation of its analyses and conclusions arising from its review of operational reports and other services will be included in its files relating to the project.*

*DIIRD agrees to establish systems to capture the data relating to performance against the KPIs, to judge whether the developer has established a "commercial and sustainable studio complex", and whether the studios are regarded as "an integrated world class facility that provides for an expanded and more efficient and effective film and television production sector in Victoria" as recommended, noting that in some cases further refinement of the KPIs may assist in determining the appropriate data and information to capture.*

*DIIRD will continue to ensure that the developer reports as required under the contract.*

*DIIRD will continue to provide regular briefings to the secretary and minister on the film and television project.*

*The external lender is required to advise the government of any such events under the tripartite agreement between the developer, the government and the external lender. The contract manager within DIIRD has and will continue to maintain regular contact with the external lender.*

## 4.5 Is the project financially viable and is it likely the state's loan will be repaid?

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In assessing whether the project is financially viable, and if the state's loan is likely to be repaid, we considered whether:

- the studios were currently performing satisfactorily, with reference to several financial viability indicators
- the developer was expected to repay the state's loan, and not require further funding or other support from the state

- the developer was complying with the conditions of the state's loan agreement and the new \$14.5 million external borrowing.

Where analysis of these issues was performed by DIIRD or another state agency, we took this information into account in completing our assessment.

#### 4.5.1 Studios' 2004-05 financial performance

While the key performance indicators require the studios to service productions with substantial production spends in Victoria, we found that during 2004-05 the studios have only captured a small fraction of that spending as revenue. The studios' total revenue in 2004-05<sup>24</sup> was substantially below the developer's original 2002 projections<sup>25</sup> and significantly less than the production spending of film and television productions serviced by the studios in 2004-05. As well, the audited operating result, net asset position and net cash flows for 2004-05 were well below the developer's projections included in the 2002 contracts.

DIIRD forwarded the studios' 2004-05 audited financial statements to the Department of Treasury and Finance for review. That department analysed the statements and found several unfavourable results. These included a negative return on assets, a high gearing ratio (that is, assets were mainly backed by debt), negative interest cover (that is, net revenue generated by operations was not enough to cover interest expense) and a negative working capital ratio.

We also reviewed the developer's 2004-05 performance against certain key financial viability indicators. Our findings were consistent with those of the Department of Treasury and Finance: that there are several indicators of poor financial performance or position. These include a negative operating result; a high gearing ratio (that is, the developer's assets are mainly backed by debt); negative interest cover (that is, net revenue generated by operations is not enough to cover interest expense); negative operating cash flows; a negative working capital ratio (current liabilities exceeded current assets); marginal net assets; accumulated losses; and negative earnings before interest, tax, depreciation and amortisation<sup>26</sup>.

We note, however, that 2004-05 was the first full year of operation for the studios, having opened in March 2004.

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<sup>24</sup> Audited 2004-05 financial statements.

<sup>25</sup> The developer's projected financial model was contained within the 2002 contractual agreements between the state and the developer.

<sup>26</sup> After February 2008, principal repayments of the state's loan are calculated at 20 per cent of the developer's earnings before interest, tax, depreciation and amortisation.

In January 2006, some 5 months after having received the 2004-05 financial report, DIIRD presented the analysis to the developer to discuss how in its opinion the studios could have been more financially successful in 2004-05 year. DIIRD also met with the developer in February 2006 to discuss the analysis, and strategies and financial forecasts for the next one to 2 years.

DIIRD did not compare the audited financial results for the 2004-05 financial year with the revised 2004-05 forecasts<sup>27</sup>. Nor has a similar analysis been undertaken for the subsequent quarterly reports (September and December 2005).

#### **4.5.2 Forecast loan repayments**

In April 2005, DIIRD updated its forecast of the timing and value of repayments of the state's loan over its 20-year term, in response to a request for this information from our Office. DIIRD's forecast was based on the developer's revised forecasts at that time. DIIRD did not independently verify the developer's forecasts, or request its commercial advisers to do so.

In 2002, DIIRD engaged commercial advisers to review the developer's initial financial forecasts. The commercial advisers told DIIRD that there was a significant risk that the developer might not meet its forecast repayments.

Using the developer's 2002 forecasts, DIIRD estimated at that time that repayments of the state's original loan of \$31.5 million would total \$23.7 million over its 20-year term – resulting in a shortfall of \$7.8 million.

The developer's revised forecasts for the 5 years to 2010-11 (in its 2006-07 business plan) predict substantially lower operating profits than previously, based on the downturn in television and film production in 2003-04. This results in much lower repayments of the state's loan than estimated in the 2002 contracts.

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<sup>27</sup> DIIRD officers during August 2004 did undertake comparisons of the developer's various forecasts included in the financial model attached to the 2002 contractual arrangements, the 2003 business plan and the draft 2005-06 business plan. However, a formal report on this analysis was not prepared for the consideration of the secretary or minister, rather this information was part of the officers' internal working papers.

The developer's 2006-07 business plan forecasts the state loan repayments over a 5-year period ending in 2010-11. Using the developer's projections and the same approach and assumptions used by DIIRD<sup>28</sup>, we calculated that some \$12 million<sup>29</sup> of the state's \$33.4 million loan (including the original \$31.5 million loan and estimated capitalised interest totalling \$1.9 million<sup>30</sup>) to the developer may be repaid over the 20-year loan term – resulting in a shortfall of \$21.4 million. In these circumstances, the contracts provide that ownership of the studios would transfer to the state at the end of the 20-year loan term (unless the developer elected at that time to fully repay the state's loan and either opted to purchase the site from the state or sought to extend the site lease for a further 10 years at market rates).

## Conclusions

We concur with the Department of Treasury and Finance's analysis of the studios' 2004-05 financial statements, which identified several indicators of poor financial performance or position. Further, the 2004-05 audited operating result, net asset position and net cash flows were well below the developer's forecasts in the 2002 contracts. However, we acknowledge that the studios are still in their start-up period.

There are significant risks around the likelihood of the state's loan being fully repaid. They require ongoing and careful oversight and management by DIIRD.

## Recommendation

### **4.3 That DIIRD engage commercial advisors (or otherwise utilise appropriate expertise available within DIIRD or other agencies) to:**

- **prepare revised financial forecasts over the 20-year life of the studio project – to assess the likelihood that they will repay the loan to the state and their external borrowings**
- **review and monitor the current and projected financial position and performance of the studios – to assess the project's ongoing financial risk to the state.**

<sup>28</sup> DIIRD's April 2005 forecast assumed that the developer's estimated repayments would escalate by 4 per cent a year over the remainder of the 20-year term.

<sup>29</sup> This calculation does not take into account the changes in the time value of money. We also note that DIIRD has not verified the developer's forecasts.

<sup>30</sup> Under the new arrangements, interest accrued during the 2-year period ending February 2008 is added to the loan principal. This estimate of interest accrued during that period is based on the developer's projections included in its 2006-07 business plan. We note that DIIRD has not verified the developer's forecasts included in its business plans.

***RESPONSE provided by the Secretary, DIIRD***

*DIIRD is aware of the operator's financial position, noting that the business is still in the start-up phase in a difficult and cyclical industry. The state has always recognised that there are significant financial and operational risks associated with the project.*

***Response to recommendation 4.3***

*DIIRD will continue to assess all aspects of this project against the government's objectives, which relate to industry development, including repayment of the loan (the purpose of which was to seed such development).*

*DIIRD has consistently worked with the assistance of expert legal and commercial advisers to assess and manage the risks associated with the project, both in terms of likelihood and consequence. This will continue.*

*DIIRD will continue to monitor the operator's projected and current financial position.*

## 4.6 Did the studios contribute to the number of films made in Victoria?

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In assessing whether the studios have contributed to an increase in the number of films being made, we considered the studios' performance against the relevant key performance indicators under the contractual arrangements, and trends in the numbers of Australian and international film and television productions in Victoria.

In 1999-2000, Victoria had an active local film and television production industry. Estimated production spending in Victoria of \$128 million represented 22 per cent of total industry production spending in Australia. Almost all of this production spending was on Australian productions.

In 2004-05, estimated film and television production spending in Victoria was \$166 million (31 per cent of total estimated production spending in Australia<sup>31</sup>). This was a 44 per cent increase (from \$115 million) in production spending in Victoria during 2003-04. The significant increase in production spending in 2004-05 resulted from offshore productions (*Ghost Rider* and *Charlotte's Web*). This compares to most productions since 2000 having been for local productions<sup>32</sup>.

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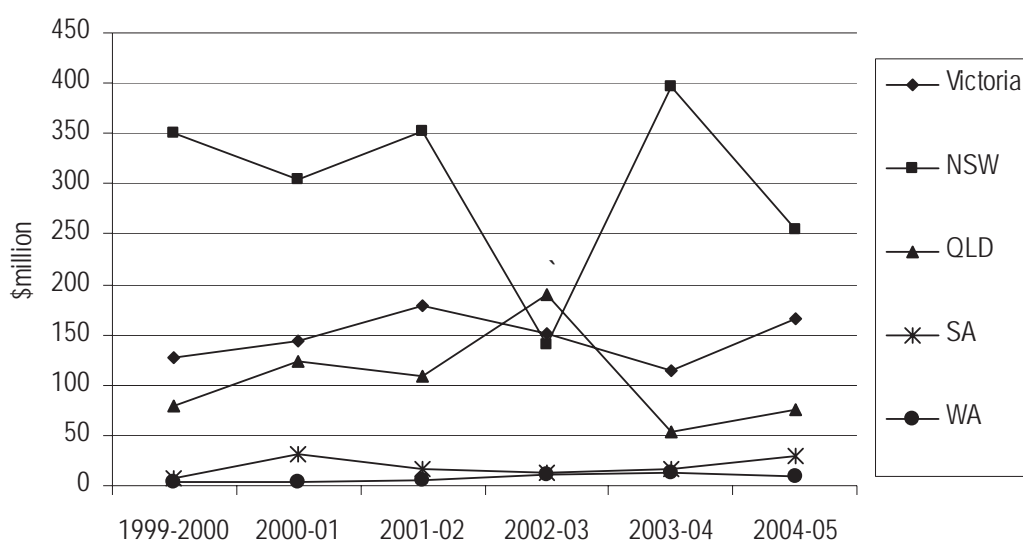
<sup>31</sup> Australian Film Commission, National Survey of Feature Film and Television Drama Production 2004-05.

<sup>32</sup> Ibid.

In 2004-05, the studios serviced an estimated \$54 million in film and television production spend in Victoria. However, they only captured a small fraction of that spending as revenue. The studios' total revenue in 2004-05 was substantially below its original 2002 projections.

Figure 4B shows that, while estimated film and television production spending in Victoria rose from 1999-2000 to 2001-02, and then fell from 2001-02 to 2002-03, production spending for feature and TV drama production in Victoria increased in 2004-05. Film Victoria advised us that the studios are one of several factors that have contributed to the increased in production spending in Victoria in 2004-05, compared to 2003-04.

**FIGURE 4B: LOCATION OF FILM AND TELEVISION PRODUCTION SPENDING IN AUSTRALIA, 1999-2000 TO 2004-05**



Source: Australian Film Commission, *National Survey of Feature Film and Television Drama Production* for 2004-05 and 1999-2000.

The \$166 million spent in Victoria on production in 2004-05 was spent on 19 productions. Of these, the studios serviced 2 productions with a production spend in Victoria of \$54 million.

## Conclusion

Our assessment of the developer's 2004-05 performance against the key performance indicators, being the first full year of operation of the studios, is that the studios have not serviced the required additional production spend in Victoria of at least \$100 million, or serviced Australian productions of at least \$25 million. Consequently, the studios have not achieved the targets set by the state for additional film and television production spend in Victoria. We acknowledge that 2004-05 was the first year of full operations, having only commenced in March 2004.

However, the studios were one of several factors that contributed to more production spending in Victoria in 2004-05, compared to 2003-04.

## Recommendation

### **4.4 That DIIRD develop and implement a methodology to quantify the contribution of the studios to annual increases in film and television production spending in Victoria.**

#### ***RESPONSE provided by the Secretary, DIIRD***

*DIIRD notes that the conclusion acknowledges the increase in film and television production spending in Victoria, along with the significant increase in spending from offshore productions and the role of the studios in achieving this. The government's objective of increasing the number of films made in Victoria was clearly achieved and the studios played a significant role in this.*

*The government's objectives for the project relate to industry development and the studios, after only 2 years of operation, are already contributing significantly to these industry development goals in a challenging operating environment.*

#### ***Response to recommendation 4.4***

*DIIRD will work with Film Victoria, the industry and the operator to develop appropriate methodology for qualifying the contribution of the studios to annual film and television spending in Victoria.*

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## 5. Westernport Region Water Authority - Investigation of aspects of the authority's management



## 5.1 Audit conclusions

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The Ombudsman of Victoria referred a number of allegations for investigation by my Office concerning various aspects of the management of the Westernport Region Water Authority.

The allegations included concerns about:

- taxation treatment of certain employment arrangements for some senior staff
- unauthorised changes to the authority's financial statements
- management of personnel
- use of credit cards
- certain accounting practices adopted by the authority
- the appropriateness of the authority's involvement in what was alleged to be "non-core" business, such as its involvement in natural gas reticulation in the area.

The allegations were made to the Ombudsman under the *Whistleblowers Protection Act 2001*.

We completed a detailed review of the allegations. Our review focused on the allegations and did not include a comprehensive review of all management practices employed by the authority.

While not specifically addressed during our review, we did identify that the overall performance of the authority has been sound and improving over the last 6 years, particularly relating to financial management and the strengthening of its overall financial position. During this period, improved financial management has resulted in consistently strong financial performance, improved risk management, documented policies and procedures, and the discontinuation of unacceptable work practices. Other areas where the authority's performance has improved includes:

- strategic planning, as evidenced by the authority's comprehensive corporate, business and water plans
- improved customer service as demonstrated in its strong customer survey results
- new processes to better manage staff, including the authority's employee performance management system and its Better Teams program.

The management of the authority also advised us that they believe the findings of this review should be considered in the context that they relate to a period of extensive change for the authority and its staff.

We found that some of the allegations made by the whistleblower were unproven. In other cases, we were unable to conclusively form an opinion on the validity of allegations due to the lack of documentary evidence to support either the whistleblower's claims or the views expressed by management.

We concluded that there were areas where the authority needed to improve its policies and management procedures in place during the period subject to review (2003 to 2005). Required improvements included:

- strengthening of monitoring and approval processes over the authority's annual financial statements
- continuing action to address staff-related issues (as evidenced by the results of staff surveys conducted by the authority and from issues raised by certain staff during discussions with us during our audit)
- strengthening control over the use of credit cards issued to senior staff and reimbursement of expenditure to ensure that all expenditure is appropriately approved and is adequately supported by documentation.

The authority advised us that it has actioned and continues to refine a range of measures to implement these improvements. In particular, it advised that it:

- has strengthened control over the processing of its annual financial statements, which has ensured that issues in relation to its 2003-04 statements will not recur
- is continuing actions to address staff management issues
- has implemented strengthened controls over the use of credit cards.

***RESPONSE provided by the Chief Executive Officer, Westernport Water***

*Westernport Water welcomes the opportunity to provide comment on the Auditor-General's proposed audit report of investigation into the allegations, detailed in its letter of 6 July 2006. Westernport Water believes that this report is, on the whole, factually correct and is a fair representation of the circumstances that existed in the period 2003 to 2005.*

*We note that of the 8 allegations investigated, 6 were found to be not proven and for the balance there was an inconclusive finding. The authority has always maintained that there was little of substance in these allegations and that its actions were consistent with good governance and general industry practice.*

***RESPONSE provided by the Chief Executive Officer, Westernport Water - continued***

*In respect to the treatment afforded to the authority, however, we do not believe that the issues of procedural fairness and natural justice, as required by the Whistleblowers legislation, have been adhered to at all times throughout this investigation. The authority has been particularly concerned with the timeliness of the resolution of the investigation and the formal advice of the allegations. While the actions of the Auditor-General's Office were not contrary to the requirements of the Whistleblowers Act, Westernport Water believes that the process undertaken prejudiced the authority's ability to defend itself against what have now been proven to be, on the whole, false and unjustified allegations.*

*In conclusion, Westernport Water welcomes the positive resolution of this investigation. The authority agrees with the findings that the vast majority of the allegations were not valid. The authority also accepts the view that, as with any organisation, it has had minor issues in respect of processes and controls. Westernport Water believes that the investigation has confirmed that the authority has been proactive in the identification and resolution of these issues through effective governance and its maintenance of a comprehensive internal audit function. The majority of the findings and recommendations of the Auditor-General had either been addressed prior to the investigation or have been implemented in the interim.*

*Westernport Water welcomes the finding that the "overall performance of the organisation has been sound and improving".*

## 5.2 Salary sacrifice arrangements

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**Allegation:** *The authority did not have the appropriate skills and expertise to administer salary sacrifice arrangements and it was, therefore, likely that its salary sacrifice arrangements may not be compliant with the taxation legislation.*

Salary sacrificing (also known as salary packaging) is a legal arrangement where, by agreement with their employer, part of an employee's salary is provided by way of a benefit other than payment of ordinary salary.

The authority has entered into a small number of salary sacrifice arrangements and is currently administering 4. We examined the authority's salary packaging policy and reviewed 2 arrangements in detail.

We found that the 2 arrangements complied with relevant taxation legislation. We, therefore, concluded that the allegation was not valid.

We identified that benefits were provided to employees in advance of salary being earned and salary deductions being made. While this practice is not contrary to taxation requirements and is consistent with professional advice obtained by the authority at the time of establishing these arrangements, it is inconsistent with good practices outlined in guidelines developed by the Department of Premier and Cabinet (DPC). While not binding on the authority, the guidelines outline good practice commonly applied by public sector agencies and should be considered by the authority.

## Recommendation

### **5.1 That for future salary sacrifice arrangements, the authority consider adopting DPC guidelines and discontinue its practice of providing benefits in advance of salary being earned.**

#### ***RESPONSE provided by the Chief Executive Officer, Westernport Water***

*Westernport Water agrees with and welcomes the finding that this allegation is not valid. The Department of Premier and Cabinet (DPC) guidelines referred to in the report had, until recently, never been forwarded to Westernport Water and then, as is stated in the body of the report, are not binding on the authority. The benefits referred to in the report were all reimbursements of expenses already incurred by the relevant employees and, in most cases, were offset against lump sum payments of performance bonuses with the balances being recovered within the financial year.*

*In establishing the salary sacrifice processes at Westernport Water, significant research as to industry practice, specific legal and other advice was gained, including private rulings from the Australian Taxation Office.*

*Westernport Water has since gained a copy of the DPC policy and guidelines, and has reviewed them for consistency with Westernport Water's policy and procedures and, contrary to the Auditor-General's findings, believe that the processes in place at Westernport Water are entirely consistent with those guidelines.*

*While not entirely agreeing with the interpretation of the Auditor-General in respect to providing benefits in advance of salary being earned, Westernport Water's processes have been amended to ensure consistency with the recommendation.*

## 5.3 Amendment to financial statements

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**Allegation:** *The finance manager at the time was wrongly accused of amending the authority's 2003-04 financial statements without appropriate consultation and approval.*

Following the release of the authority's 2003-04 financial statements, an article published in a local newspaper in June 2005 raised a number of concerns with the management of the authority. One of the issues raised in the article was a \$5 000 loan to a "responsible officer" which was disclosed in the notes to the 2003-04 financial statements.

The board and the former chief executive officer (CEO) were concerned that the authority's financial statements had been inappropriately amended to include this note. Accordingly, in June 2005, the authority's board engaged a chartered accounting firm to investigate how the note was included in the financial statements.

The firm's report indicated that the authority's finance manager at the time had:

- recalculated the former CEO's fringe benefits tax (FBT) liability relating to his salary sacrifice arrangements, showing him apparently owing the authority \$5 687
- amended the authority's published financial statements, without obtaining approval from the responsible officer or the board, to disclose this sum as a loan to a "responsible officer".

Subsequently, a broader inquiry undertaken by the authority, led to the dismissal of the then finance manager in October 2005.

Our examination revealed that:

- due to a different interpretation of fringe benefit tax payable than that used in initial calculations for a salary sacrifice arrangement, the finance manager at the time formed a view that the former CEO owed the authority \$ 5 687 at 30 June 2004
- while based on an interpretation of taxation legislation, the then finance manager's view was incorrect as it did not take into account an interpretive decision of the Australian Taxation Office (ATO Interpretive Decision 2003/159)
- the former finance manager incorporated the erroneous recalculations, a loan of \$5 687 to the former CEO, in an FBT return, authority financial records and the 2003-04 financial statements

- the authority's management believed that the former finance manager deliberately included the error in an FBT return and financial records. However, the former finance manager denies these allegations
- the inclusion of a note showing a loan in the financial statements without the knowledge of the former CEO was not detected before the publication of the financial statements.

We were unable to conclude as to whether the former finance manager intentionally amended the financial statements to embarrass the former CEO. However, given the nature of the amendment, we would have expected the former finance manager to have specifically highlighted this amendment for attention by the former CEO and other senior management.

The circumstances surrounding this matter indicate the need for improvements to procedures surrounding the processing of financial transactions, and the review and approval of the financial statements. Specifically, procedures should ensure that:

- controls be in place to ensure that the authority's CFO is aware of, and approves, all amendments to draft financial statements
- the authority's CEO, chief finance officer, audit committee and auditors ensure that all oversight functions are fully performed before the approval of the financial statements.

The error that resulted in the inclusion of a note was corrected in the authority's 2004-05 financial statements. The authority advised us that, as a result of the newspaper article, it had an independent audit firm review the existing procedures. It further advised that, prior to our review, it had implemented the audit firm's recommendations to improve procedures for processing annual financial statements so that similar issues did not arise in 2004-05 and subsequent years.

***RESPONSE provided by the Chief Executive Officer, Westernport Water***

*Westernport Water agrees with the findings of this report and, as detailed in the report, has implemented revised processes from June 2005 that are consistent with the Auditor-General's recommendations. Westernport Water believes that it is clear that the former finance manager was in breach of her duty to disclose changes to the accounts and the associated notes to senior managers in that the change to note 20 was not explicitly made known to any member of the authority's management team or its board.*

***RESPONSE provided by the Chief Executive Officer, Westernport Water - continued***

*Westernport Water also believes that the Auditor-General's agents who audited the 2003-04 accounts did not fully discharge their respective duties to inform the senior management or the board once they became aware of the existence of the changed note, particularly as it related to the supposed existence of a loan to a responsible officer. Westernport Water is firmly of the view that this allegation was not valid.*

## 5.4 Salary overpayment

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**Allegation:** *The authority's management of a \$35 000 salary overpayment was inappropriately handled.*

An employee on a fixed-term contract was approved for higher duties and associated higher salary payments from September 2003 to November 2004. The authority subsequently identified an overpayment of \$35 000 to this employee due the incorrect calculation of the employee's higher duty entitlement and related salary sacrifice arrangements.

During our discussions with the employee concerned, he alleged that other authority staff made inappropriate threats during negotiations to agree terms for repayment of the debt arising from the overpayment. Authority staff deny this. In March 2005, the employee went on stress leave and submitted a WorkCover claim.

In late 2005, the authority settled the salary overpayment and the WorkCover claim with the employee.

Our review of the overpayment revealed that the overpayment was not identified until September 2004. The employee concerned advised that this occurred even though he had queried his pay arrangements on a number of occasions but had been reassured that they were accurate. However, authority management deny that they were ever advised by the employee that he was being overpaid.

We concluded that:

- the overpayment, and significant delays in identifying it, occurred due to inadequate review and approval of payroll adjustments and of fortnightly payroll reports

- the authority's proposals for repayment of the debt may not have been consistent with the principle, outlined in the *Financial Management Act 1994*, that salary deductions for recovery of overpayments should not exceed one-tenth of salary
- while the authority acted on legal advice, resolution of the recovery of the overpayment could have been managed more effectively.

The authority advised that since this overpayment, its internal audit has completed a detailed review of payroll, and that improvements to payroll management recommended by internal audit were implemented in December 2004 and January 2005. These improvements included processes to ensure that salary amendment calculations are independently reviewed and approved, and that fortnightly payroll is independently reviewed and any discrepancies followed-up.

## Recommendation

### **5.2 That the authority enhance its policy and procedure for managing the recovery of overpayments.**

#### ***RESPONSE provided by the Chief Executive Officer, Westernport Water***

*Westernport Water is in partial agreement with the recommendation in relation to this matter. In respect of where it does not agree with the recommendation, it remains our position that the issue of recovery of overpayments is not one that can be dealt with by policy and procedure alone. It is a matter subject to legal precedent requiring agreement to be reached prior to any recovery action being undertaken as governed by the law of mistake and, therefore, relies on the ability to negotiate settlement with a usually unwilling party.*

*This was a complex issue requiring many months of substantiation and negotiation. Westernport Water did not undertake any collection action against this employee in the 4-month period from November 2004 to February 2005. Westernport Water also provided, at no cost to the employee, independent financial advice and extended employee assistance program support. The employee was not threatened, however, the matter of legal action was discussed in the context of its being an option open to the authority in the event that a compromise could not be reached.*

***RESPONSE provided by the Chief Executive Officer, Westernport Water - continued***

*Westernport Water's management handled the matter of the recovery of the overpayment in a manner in line with its board's direction and its legal and departmental advice. The authority gained legal advice as to utilising the section of the Financial Management Act referred to in the report. The advice was straightforward in that the relevant section of the Act was not applicable to the authority and could not be enforced. It was not an available option for the authority.*

*The recovery action undertaken by the authority from February 2005 was in respect to an interrelated matter of attempting to balance the employee's salary sacrifice arrangements. These arrangements were the subject of a written salary sacrifice agreement signed by both parties that dealt specifically with the circumstances of under recovery. The authority's actions were always consistent with the agreement and were designed to protect the authority from further loss. This action was, therefore, not within the scope of section the Financial Management Act referred to in the report and was entirely consistent with good financial practice as required by the Financial Management Act.*

*The report details conclusions that had been previously reached and addressed through an internal audit report tabled in December 2004 and acted on immediately by the authority.*

*As with any process, there is always room for improvement and learning, and the authority has learned from this experience. This learning has been incorporated into an improved policy and procedure, which is in line with the report's recommendation.*

## 5.5 Staff management

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<b>Allegation:</b> <i>Staff management and organisational leadership were poor.</i>
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The authority employs around 42 people. To assess the quality of the authority's management of staff, we reviewed a sample of organisational health indicators and had discussions with past and present staff of the authority.

Certain indicators were generally in line with those experienced by similar organisations, for example, the level of sick leave taken by staff. However, a number of other factors indicate that there have been leadership and staff management issues. This is evidenced by:

- poor overall results of 2 detailed employee opinion surveys in December 2003 and April 2005
- a number of formal complaints made to the board and external bodies regarding management
- the number of WorkCover claims, particularly stress-related claims, given the size of the organisation
- concern expressed to us by many employees about the quality of management and, in several cases, allegations about bullying and harassment by the CEO and members of the senior management team.

The authority has implemented strategies to address the issues identified in the employee opinion surveys, including new processes to better manage staff such as the authority's employee performance management system and its Better Teams program. We commend management for the action taken to date.

## Recommendation

### **5.3 That the board and senior management continue to closely monitor the climate and health of the authority to ensure that staff and management issues are appropriately resolved.**

#### ***RESPONSE provided by the Chief Executive Officer, Westernport Water***

*Westernport Water accepts the recommendation of the report in relation to this allegation and thanks the Auditor-General for the commendation.*

*Westernport Water has undergone significant cultural and organisational change in the period since 2000 which was required to establish the basis for a commercially viable and customer focused organisation. This change was required to address issues of entrenched and, in some cases, unacceptable work practices. Traditionally, it is a difficult exercise to maintain and improve staff morale throughout such processes.*

*In developing the change management plan, support processes were established in order to attempt to engage in, and assist staff through, this process. These included a staff consultative committee, an employee assistance program, a dispute resolution process, training and development in communication for all staff, including management, and a comprehensive employee opinion survey to monitor progress.*

***RESPONSE provided by the Chief Executive Officer, Westernport Water - continued***

*It is now a matter of record that this has lead to a small number of employees becoming disenfranchised with management and the direction of the organisation. This, in turn, carried on to develop into a series of jurisdictional shopping exercises with a small group making similar complaints to various authorities and some media outlets. The latter is in direct contravention of the organisation's code of conduct and the Victorian State Constitution. To date, over each of the subsequent separate investigations, none of the allegations made in respect of poor leadership or inappropriate management action have been borne out. Westernport Water remains, as is outlined in the conclusions of this report, a soundly managed organisation.*

## 5.6 Use of authority credit cards and reimbursement of staff expenditure

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**Allegation:** *Staff were inappropriately using authority credit cards for private expenditure.*

In April 2003, the board approved the use of corporate credit cards. At the date of audit, 6 corporate credit cards had been issued. Expenditure incurred using these credit cards amounted to \$47 085 in 2003-04 and \$38 890 in 2004-05.

The authority's Corporate Credit Card and Expenses Reimbursement policy governs the use of credit cards and reimbursement (non-credit card) of the authority's employees and board members.

We found that this policy is consistent with credit card rules and reimbursement policies operating throughout the public sector.

Our review of credit card expenditure and other expenditure related to authority staff revealed:

- instances where expenditure was not supported by adequate documentation such as a tax invoice
- a lack of clear documentation of reasons for incurring expenditure (the authority has advised that it has since reviewed each expenditure item and ensured that each item was justified within the authority's policies)

- expenditure that, although approved by the board, we consider may not be in line with community or government expectations for public expenditure such as:
  - costs incurred by staff members on behalf of their partners and family members when attending an industry awards ceremony
  - functions for staff and board members
- examples where expenditure claims of the former CEO had not been approved by the board's chairperson or chair of the board's audit committee, as required by the authority's policy
- inadequate policies regarding expenditure for conference attendance, entertainment and hospitality
- an overpayment of \$110 in the reimbursement of car hire to a board member, which has since been recovered.

While we did not find any evidence of fraud in relation to the use of credit cards or the reimbursement of staff, we concluded that the authority needed to enhance its policy and strengthen internal control in operation over the use of credit cards and the reimbursement of employees. The authority advised that it had implemented such improvements prior to this review following an internal audit on credit card use in 2005.

## Recommendation

### 5.4 That the authority should:

- **reinforce the need for all expenditure claims to be adequately supported and approved**
- **review its practices to ensure that board members and staff are only reimbursed for expenses incurred for business purposes.**

### *RESPONSE provided by the Chief Executive Officer, Westernport Water*

*Westernport Water welcomes the finding that there was no fraud detected in the review of expenditure. The authority agrees with and accepts the recommendations, but has issues with the contents of this section of the report.*

*The authority maintains that:*

- *All expenditure was incurred for, and on behalf of, the business and was done within the established authority policies at the time. There is no evidence that there was any private expenditure or inappropriate use of corporate credit cards.*

***RESPONSE provided by the Chief Executive Officer, Westernport Water - continued***

- *In the small number of instances where tax invoice documentation was not available, other documentary evidence of the expenditure has been supplied to substantiate the expenditure in line with Australian Taxation Office and other policy guidelines.*
- *The documentation of the reasons for expenditure at the time of this review was achieved by cross-reference to personal diaries to substantiate travel and accommodation expenses or attendance at conferences, i.e. parking for meetings held in Melbourne. All of this expenditure has since been reviewed and the approvals and documentation established.*
- *The authority disagrees that costs incurred for staff, board or corporate functions are not in line with community and or government expectations. The provision of an annual Christmas function for staff and partners is an accepted practice and well in line with community norms, as are meals for board members when they attend meetings that require overnight accommodation. This is seen as part of normal recognition for staff and practice for the overnight accommodation. These events are annual or infrequent.*
- *In regard to the incorrect authorisation of expenditure, these petty cash items were minor in nature and total cost. All expenditure was appropriately supported by tax invoice documentation and has been established as being legitimate business expenditure. The reason for the incorrect authorisation was a misunderstanding over delegations of authority, which has since been rectified.*
- *The board adopted a work/life balance focused policy in respect of expenditure for conference attendance, entertainment and hospitality in 2003. This policy was seen as both appropriate and providing satisfactory controls, and was benchmarked against other industry and state government standards prior to its adoption.*

*Westernport Water has reorganised and strengthened its financial management function since late 2004 with the appointment of a dedicated chief finance officer and 2 qualified accountants. The issues raised and related recommendations made by the Auditor-General had been addressed prior to the review in October 2005 and credit card expenditure has since been reviewed by internal audit in June 2006. No subsequent issues arose from this review.*

## 5.7 Financial performance

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**Allegation:** *Inappropriate actions were taken by management to improve the reported operating performance of the authority.*

The whistleblower alleged inappropriate action was taken by the authority to bolster the reported financial performance. We conducted a detailed examination of all specific matters raised by the whistleblower.

We identified a number of issues that had some impact on the reported operating performance of the authority for 2003-04 including:

- an understatement of operating expenditure by \$12 600 because goods and services purchased and received by the authority before balance date were not recognised in the financial statements
- delays in transferring amounts from work in progress to fixed asset accounts which resulted in a minor understatement of depreciation expenditure.

We found no evidence to suggest that these issues resulted from inappropriate manipulation of the reported operating result. Instead, we concluded that they were indicative of a need for improved procedures and monitoring by senior management and the board.

In addition, we identified instances where expenditure was initially incorrectly capitalised in the financial records of the authority. However, these errors were corrected prior to the finalisation of the 2003-04 financial statements and, therefore, had no impact on the reported operating performance of the authority for the year.

A further allegation was made that the authority had reduced expenditure in 2005 to contain any budget overrun by:

- changing its raw water quality testing program within the authority's reservoir
- not purchasing and using chemicals to control odours from the sewerage pumping stations.

We found that

- the change to the raw water quality testing regime was unlikely to have had an impact on the quality of treated water supplied
- although the authority received 6 sewerage odour complaints over a 2-month period from April to May 2005, the complaints did not relate to areas from which the use of chemicals had been withdrawn.

## Recommendation

### 5.5 That the authority:

- enhance procedures to ensure that all transactions are reported in the correct accounting period
- improve its monitoring of capital works in progress to ensure timely transfer of the costs of completed projects to its fixed assets register
- strengthen its asset capitalisation policy.

#### *RESPONSE provided by the Chief Executive Officer, Westernport Water*

Westernport Water agrees with the findings of the Auditor-General that there is no foundation to the allegation that its management manipulated the reported operating performance of the organisation in 2003-04. The actions recommend by the Auditor-General are similar to those identified in the 2003-04 management letter from the Auditor-General's agent as a result of the external audit of the annual accounts. Those recommendations were put in place in 2004-05, following a reorganisation of the authority's finance department and have been subject to external audit by the Auditor-General's agent in August 2005.

The authority has since implemented electronic purchasing, committal accounting and monthly monitoring of the works in progress account, along with an improved timeliness of operational financial reporting and monitoring.

## 5.8 Management of capital projects

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**Allegation:** Management were neglecting the authority's core business, through its involvement in a number of new projects, namely:

- natural gas project
- water treatment initiatives
- connection to the Melbourne Water supply network.

In respect of the natural gas project, it was also alleged that the full costs had not been allocated to the project and that it had achieved very little since its inception.

We acknowledge that some may consider the natural gas project referred to in the allegation to be outside the authority's core business. However, other projects mentioned in the allegation, namely, water treatment initiatives and connection to the Melbourne Water supply network, are clearly connected to the normal business of a regional water authority.

We identified that for all 3 projects referred to above, the authority has:

- obtained legal advice on whether these projects are consistent with the legislative powers of the authority
- appropriately investigated and planned the projects which ensured consistency with both government policy and the authority's own development and environmental objectives
- obtained, or is pursuing, the necessary approvals required for projects of this type.

We recognise that the authority has devoted significant time and resources to these projects. However, we found no evidence to suggest that this had led to the authority neglecting core business.

The natural gas project is a 3-stage project. The authority expected the first stage to involve capital expenditure of \$711 000 over 2 years. We found that:

- all relevant costs appear to have been allocated to the project although it is difficult for us to determine whether all internal staff costs incurred have been correctly allocated
- to date, the authority has spent \$145 000 on capital assets<sup>1</sup> and expects to spend a total of \$236 000 on capital and \$60 000 on operating expenditure.

While the project had not progressed as quickly as expected, we do not consider progress to be unacceptable given the project's significance and the time necessary to obtain necessary approvals. The authority is continuing work to progress the project.

***RESPONSE provided by the Chief Executive Officer, Westernport Water***

*Westernport Water agrees with the finding that this allegation is not valid.*

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<sup>1</sup> Expenditure incurred in 2004-05.

## 5.9 Construction of the authority's administration building

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**Allegation:** *The construction of the authority's administration building was poorly handled.*

The authority planned that its new administration complex would be completed by December 2002 at a cost of a little over \$3.7 million. Ultimately, the complex was completed in March 2004 at a cost of \$4.03 million.

We identified that the delay in completion and the additional costs were mainly due to the default and liquidation of the company appointed to construct the complex.

We concluded that the decision by the authority's board to appoint the company was reasonable, based on the recommendation of consultants that undertook a tender evaluation process on the authority's behalf.

We consider that before providing this recommendation, the consultants could have undertaken more detailed evaluation of the financial viability of the construction company and of its ability to fulfil its contractual obligations.

We did not identify any other matters that would lead us to conclude that the construction project was poorly handled.

**RESPONSE** *provided by the Chief Executive Officer, Westernport Water*

*Westernport Water agrees with the finding and welcomes the conclusion that the allegation is not valid.*

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## 6. Accountability for public funds provided to a non-government organisation



## 6.1 Background

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In response to an external inquiry, we reviewed the actions taken by the Department of Human Services (DHS) to recover publicly-funded assets from South Gippsland Community Support Service Inc., a non-government not-for-profit entity, following termination by DHS in April 2003 of the funding and service agreement with the service.

DHS provides funding to a large number of non-government agencies through funding and service agreements under different legislation, including the *Mental Health Act 1986*, *Health Services Act 1988* and the *Disability Services Act 1991*. The community support service had been funded for several years by DHS under the *Mental Health Act 1986* to provide community support services, particularly housing options for young people with psychiatric disabilities. Annual funding in the order of \$160 000 to \$190 000 was provided.

## 6.2 Audit findings

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In the course of our review, we identified that in late 2002 and early 2003 there were concerns about the ability of the community support service to perform its activities and the adequacy of accountability for the expenditure of public funds. In mid-March 2003, prior to termination of the funding and service agreement, DHS undertook a review of the governance and financial management of the community support service, in response to concerns about whether the community support service was able to fulfil its service delivery obligations. DHS's review was undertaken in accordance with the provisions of the *Mental Health Act 1986* under which grant funds were provided and, as it was a departmental review, the findings were not made available to members of the community support service.

Our review identified that some of the public funds received by the community support service had not been accounted for fully and that certain assets sourced from public funds, including 4 motor vehicles, were not returned to DHS by the community support service in accordance with the requirements of the funding and service agreement.

Once the service agreement had been terminated, it appears that DHS was not able to adequately protect or recover the assets acquired through public funding provided by DHS. Only after DHS commenced legal action against the community support service did it obtain from the service financial statements and some other relevant information, including information about the disposal of inappropriately retained assets. Nevertheless, the information provided by the community support service to DHS was not complete as it did not include financial statements for 2003-04. Further, documents associated with an agreement that was reached during the legal proceedings were not made available to members of the community support service.

In the course of our review, we noted that the community support service did not comply with the *Associations Incorporation Act 1981* in that it did not table audited financial statements at annual general meetings for 2002-03 and 2003-04. As a result, there was no accountability to the members of the service, and hence the wider community, for the funds that had been provided, in this case, for psychiatric community support services.

It should be noted that the incorporation of South Gippsland Community Support Service was cancelled by notice published in the *Victorian Government Gazette* on 9 March 2006.

## 6.3 Conclusion

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Based upon DHS's difficulty in obtaining information, and protecting and recovering assets from the community support service, it is our view that the funding and service agreements between DHS and non-government organisations need to be enhanced to facilitate ongoing access by DHS following termination of such agreements with agencies. In particular, DHS needs to be able to obtain access to undertake its own review of the operations of a non-government organisation following the termination of a funding and service agreement.

***RESPONSE provided by the Secretary, DHS***

*The findings of the audit indicate that the organisation in question – South Gippsland Community Support Service (SGCSS) – failed to comply with the terms and conditions of its service agreement with DHS, and failed to comply with the provisions of the Associations Incorporation Act 1981. I concur with these findings. The conclusion however is that my department should strengthen the terms of the service agreement. The problem in this case was the actions of SGCSS rather than the terms of the service agreement and there was no evidence presented in the report that changing the terms and conditions of the agreement would guard against future instances of this sort.*

*The terms of the service agreement were quite sufficient for my department to pursue the return of the assets in question from SGCSS through legal action. In this situation, legal action was ultimately discontinued not because of any inadequacy in the service agreement, but because there were insufficient funds remaining in the organisation to make it financially sound to pursue the action.*

*DHS has however added a time limit of one month for funded organisations to provide up to date financial statements on termination of the service agreement for any reason if requested by DHS.*

*DHS has also, over the past year, introduced a new monitoring framework for funded non-government organisations, using a risk-based approach to detect early warning signs of emerging issues. The monitoring framework is designed to operate within the government's overarching policy of operating in partnership with funded organisations, and is focussed on working collaboratively to identify problems and resolve issues.*

***FURTHER COMMENT by the Auditor-General***

*We have considered the comments from DHS and remain of the view that our conclusion is appropriate.*

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2006

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Access to specialist medical outpatient care (2006:2)	June 2006
Results of financial statement audits for agencies with other than 30 June 2005 balance dates, and other audits (2006:3)	June 2006
Protecting our environment and community from failing septic tanks (2006:4)	June 2006
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