Auditor-General's Report on the Annual Financial Report of the State of Victoria, 2009–10

Victorian Auditor-General's Report | October 2010 | 2010-11:16

VICTORIA

Victorian
Auditor-General

Auditor-General's Report on the Annual Financial Report of the State of Victoria, 2009–10

Ordered to be printed

VICTORIAN
GOVERNMENT PRINTER
October 2010

PP No 382, Session 2006–10

This report has been produced to ISO14001 environmental standards. It is printed on FSC cr
Print Silk paper. The print supplier, Blue Star PRINT has initiated an EMS promoting minimisation of envir
the deployment of efficient technology, rigorous quality management procedures and a philosophy of r

ISBN 978 1 921650 57 4

VAGO

Victorian Auditor-General's Office

Auditing in the Public Interest

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

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

Dear Presiding Officers

Under the provisions of section 16AB of the *Audit Act 1994*, I transmit the *Auditor-General's Report on the Annual Financial Report of the State of Victoria, 2009–10*.

Yours faithfully

D D R PEARSON
Auditor-General

7 October 2010

Contents

Audit summary

Background

This report informs Parliament about the results of the audit of the *Annual Financial Report of the State of Victoria, 2009–10* (AFR). Section 16A of the *Audit Act 1994* requires the Auditor-General to provide an audit opinion on the AFR, and to make a report to Parliament on each annual financial report.

Overall conclusion

The overall conclusion from this audit is that Parliament can have confidence in the AFR which was tabled in Parliament on 15 September 2010.

A clear audit opinion on the AFR was issued on 10 September 2010. A clear audit opinion indicates that the 2009–10 AFR was prepared in accordance with the requirements of the *Financial Management Act 1994* (FMA) and Australian accounting standards.

The 2009–10 net result for the state was a deficit of $5 677.7 million ($13 088.8 million deficit in 2008–09). This was largely due to an increase in the state's liability for unfunded superannuation of $1 435.8 million and a downwards revision of $4 000 million to the value of land under roads.

Findings

Results of audit

The AFR consolidates the financial results of 298 public sector entities, each of which is separately audited by the Auditor-General. Of these entities, 47 are deemed material entities because individually their financial operations are material to the consolidated finances of the state.

Our audit provides authoritative independent assurance that the Treasurer and the Minister for Finance, WorkCover and the Transport Accident Commission have prepared the AFR consistent with the provisions of the FMA and applicable accounting standards.

The accurate and timely production of the AFR is impacted by the quality and timing of information provided by public sector entities, and the production timetable and quality assurance processes adopted by the Department of Treasury and Finance (DTF).

To prepare the AFR, DTF sets key milestones and a timetable for material entities to provide draft financial statements to audit, and for financial reports to be finalised.

This timetable was not achieved with 74 per cent (83 per cent in 2008–09) of material entities not finalising their financial reports by the set milestone dates.

Financial performance of the state

The consolidated comprehensive operating statement in the AFR provides two key measures of financial performance and sustainability, the net result from transactions and the net result. The net result from transactions represents revenue less expenditure that can be directly attributed to government policy. The net result includes the net result from transactions and other economic flows such as changes in the value of assets and liabilities due to market re-measurements.

The statement also details the amount and type of state revenue and expenses.

A summary of the 2009–10 financial results for the state and the general government sector is set out below.

Figure A
2009–10 financial results for the state and the general government sector

	State of Victoria		General government sector	
	2009–10 ($mil)	2008–09 ($mil)	2009–10 ($mil)	2008–09 ($mil)
Net result from transactions	594.7	(123.8)	643.6	251.2
Net result	(5 677.7)	(13 088.8)	(5 413.1)	(8 372.8)

Source: Victorian Auditor-General's Office.

The 2009–10 surpluses arising from the net results from transactions in the general government sector and at the whole of state level were primarily due to increases in taxation and Commonwealth grant revenue totalling $4 861.4 million, offset by increases in employee costs, grants and other operating expenses totalling $3 972.6 million.

The net result from transactions for the general government sector exceeded the government's key financial objective of a surplus of at least $100 million.

The 2009–10 net result for the state largely reflected an increase in the state's liability for unfunded superannuation of $1 435.8 million and a downwards revision of $4 000 million to the value of land under roads.

The net result is the state's 'bottom line' and is an indicator of the state's financial sustainability and demonstrates the state's exposures to the financial markets and economic conditions.

Total expenditure of the state increased by 49.5 per cent from 2004–05 to 2009–10. This increase is greater than the increase in revenue for the same period of 45.0 per cent.

Financial position of the state

The consolidated balance sheet reports the value and composition of the state's assets and liabilities. A summary of the financial position of the state and the general government sector as at 30 June 2010 is set out below.

Figure B
Financial position of the state and the general government sector as at 30 June 2010

	State of Victoria		General government sector	
	30 June 2010 ($mil)	30 June 2009 ($mil)	30 June 2010 ($mil)	30 June 2009 ($mil)
Total assets	203 468.8	194 254.0	164 106.5	157 528.9
Total liabilities	84 078.2	76 250.4	46 551.0	40 855.1
Net worth	**119 390.6**	**118 003.6**	**117 555.5**	**116 673.8**

Source: Victorian Auditor-General's Office.

The state's asset base continued to grow in 2009–10. Land, buildings, infrastructure, plant and equipment account for 80 per cent of the state's assets. The increase in assets was driven by:
- a $10 769.3 million revaluation of rail, road and water infrastructure, and $4 510.6 million of spending on housing, water, road, rail and schools infrastructure
- offset by $3 392.5 million of depreciation charged during the year and a downwards revaluation in the carrying value of land under roads of $4 000 million.

State liabilities increased by 10.3 per cent ($7 827.8 million) from the prior year to $84 078.2 million at 30 June 2010. The major liabilities for the state are:
- borrowings, which increased by 18.5 per cent during 2009–10 to reach $28 580.3 million at 30 June 2010
- unfunded superannuation, which increased by 8.9 per cent during 2009–10 to total $22 597.7 million as at 30 June 2010
- provisions for insurance claims, which increased by 9.3 per cent during 2009–10 to total $18 172.1 million at 30 June 2010.

Significant developments

The status and financial implications of a post balance date event and the state's more significant projects and developments undertaken in 2009–10 follows.

Post balance date event

The AFR recognised that floods, which occurred on 4 and 5 September 2010, are expected to have financial implications for the state. The cost to the state could not be estimated at the time of finalising this report (refer Note 36 of the 2009–10 AFR).

Victorian Transport Plan

The Victorian Transport Plan (VTP) outlines $38 billion of transport projects which aim to improve all modes of transport. A financial analysis is provided of the new trains, M1 upgrade, and Peninsula Link projects in the VTP which are the larger projects currently underway. As at 30 June 2010:

- nine new X'trapolis trains have been delivered out of a total of 38 on order, one less than contracted
- the state will pay an estimated $1 340 million to upgrade the M1 and will receive 50 per cent of any extra profits of Citylink that are a consequence of those works. These extra profits will be calculated, after Transurban has recovered its own construction costs of $166 million
- the state's total financial commitment to Peninsula Link, including the Lathams Road overpass, is $2 752.0 million in nominal dollars over the 25-year term of the public private partnership.

Victoria's water plan: *Our Water Our Future*

The government's long-term strategic plans for water management were detailed in *Our Water Our Future,* released in 2004, and updated and extended in 2007. The plan includes the development of a desalination plant, modernising food bowl irrigation channels, a pipeline to transfer water into Melbourne's water supply, and the northern sewerage project.

To assist in funding the cost of projects under the *Our Water Our Future* plan, Melbourne Water has increased wholesale water charges to the three metropolitan water distribution companies. These increased charges, together with other cost increases, will result in metropolitan customer water prices nearly doubling over the 5-year period to 2012–13.

Desalination Plant

The desalination plant is being delivered using a public private partnership to produce up to 150 gigalitres per annum of drinking water. Water will be transferred to Melbourne by an 84 kilometre transfer pipeline, powered using an 87 kilometre underground power supply.

The total cost to the state of preparing for, financing, designing, constructing, operating and maintaining the desalination plant and associated infrastructure for the 27.75-year operating term, is expected to be $18 080 million in nominal dollar terms, or

$5 410 million in net present value terms. This represents the total estimated project cost to the state of having a desalination plant. The cost of any water purchased will be additional to this amount. If the state purchased the maximum 150 gigalitres per year for the entire operating term the total additional cost would be $5 834 million in nominal dollar terms, or $1 260 million in net present value terms.

The AFR, at Note 33, separately highlights the state's commitments to the consortium for the construction, operation and maintenance of the plant totalling $15 808 in nominal dollar terms, or $4 590 million in net present value terms. The balance of $2 272 million in nominal terms or $820 million in net present value terms includes capital, operating and maintenance commitments to the consortium associated with an underground power supply and plant refurbishment during the period of operation, and other related financial commitments of the Department of Sustainability and Environment.

With two reconciling items, this is consistent with the Partnerships Victoria project summary titled *Victorian Desalination Project*, dated November 2009. This project summary set out the cost of the plant as $5 720 million in net present value terms, based on estimated payments to the consortium over the total operating term. The reconciling items are:

- other related estimated costs of the state comprising project development and management costs, environmental assessments, land acquisition and compensation payments, totalling $308 million in net present value terms
- the impact of DSE using a different discount rate and time period over which the calculation is made for valuing the financial commitments to the consortium for financial reporting purposes under the Australian accounting standards, totalling $642 million in net present value terms.

This $5 720 million estimate includes the cost of purchasing the maximum volume of water, $1 260 million in net present value terms.

Food Bowl Modernisation

The $2 billion food bowl modernisation irrigation system aims to provide the Goulburn Murray Irrigation District with an irrigation delivery system that will reduce water losses and assist with the region's economic viability. The project is being delivered in two stages. Stage 1 is aiming to recover approximately 225 gigalitres of water per annum, and stage 2, 200 gigalitres of water per annum, as a long-term average. Water to be recovered relates to water that is currently lost to the system through leakage, seepage, unplanned spills or releases, evaporation and inaccurate metering.

Stage 1 of the project commenced in 2008 and is scheduled to be finished by 31 December 2012, at a cost of $1 004.5 million. As at 30 June 2010, $274.9 million had been spent on stage 1.

The metropolitan water distribution companies will have access to the water savings from the project which will be transferred to Melbourne via the 70 kilometre Sugarloaf Pipeline.

Sugarloaf Pipeline

The Sugarloaf Pipeline was commissioned in February 2010 at an estimated cost of $692.2 million. It is expected to transfer up to 75 000 megalitres per annum of water savings to Melbourne. As at 16 August 2010, 17 980 megalitres had been delivered by the pipeline.

The water savings are metered at the Goulburn River Pump Station, and are managed by Goulburn-Murray Rural Water Corporation and accessed by Melbourne Water for supply to the metropolitan water distribution companies. Water savings will be confirmed by an annual audit organised by the Department of Sustainability and Environment, pursuant to the Water Savings Supply and Transfer Agreement.

Northern Sewerage Project

The project commenced in August 2007 and is ahead of schedule. Works undertaken by Melbourne Water are now expected to be completed and commissioned by October 2011 and Yarra Valley Water Limited by February 2012. The original target date for the project was mid 2012.

Substantial project savings of $134 million (21 per cent) have been realised during the construction stage due to design reviews, construction risk management, and adverse ground conditions not being encountered.

Building the Education Revolution

The Commonwealth Government's *Building the Education Revolution* program will provide new facilities and refurbishments in Australian schools, including a funding allocation to Victoria of $3.8 billion over three years.

The Department of Education and Early Childhood Development's (DEECD) delivery of the program is behind schedule. All projects were originally to be completed by 30 June 2011 and the New Science and Language Centres for the 21st Century were to be fast tracked and completed by 30 June 2010. DEECD had spent $1 010 million at 30 June 2010, $412 million or 29 per cent less than budgeted, and none of the planned 70 science and language centres were complete. Consequently, DEECD advised the Commonwealth Department of Education, Employment and Workplace Relations of the delays, as it wanted to achieve best value for money through its procurement practices, and transfer of project funding into 2011–12 has been agreed.

Victorian Schools Plan

The Victorian Schools Plan is the government's 10-year, $1 934 million plan to transform schools by rebuilding, renovating or extending all government schools by 2016.

At 30 June 2010, DEECD had spent a total of $1 108 million on projects under the *Victorian Schools Plan*, compared to a total cumulative budget of $1 270 million.

Myki

Myki is the new ticketing system that will replace the Metcard and V/Line ticketing systems, and paper tickets on regional buses.

Control weaknesses in the new myki ticketing system meant that it was not possible to form an opinion on the completeness and accuracy of myki revenue for the year ending 30 June 2010. Accordingly, a qualified audit opinion was issued on the 2009–10 financial report of the Transport Ticketing Authority.

Public transport franchise contracts

On 31 August 2009 the state completed contracts with private sector providers to operate and maintain Melbourne's passenger train and tram networks.

During the myki start up period up to 30 June 2012 the state decided to accept the risk associated with the introduction of the new ticketing system and has guaranteed fare box revenue payments to the train and tram operators. The state will therefore fund any shortfall between the guaranteed fare box, which is based on projected fare box revenue, and the actual fare box revenue. The contract however does not provide for adjustments to the guaranteed revenue for variations not attributable to the new ticketing system.

In 2009–10, the state paid a total of $22.4 million above the actual amount of fare box revenue collected. This was an additional cost to the state borne by the Department of Transport primarily due to lower patronage growth on trains and buses, and a decline in tram patronage. Further additional costs may also arise in 2010–11 and 2011–12 if there is a shortfall between the fare box revenue collected and the guaranteed fare box payable to the operators in those years. Therefore, in addition to any adverse revenue implications associated with the new ticketing system, the state will also bear the cost of these impacts and any further adverse patronage movements.

Under the contract with the train operator, it is estimated that the state will pay $2.31 for each train passenger boarding in the 2010–11 financial year, the first full year of operation of the new contract. This is an 18 per cent increase when compared to the cost per boarding of $1.95 in 2008–09 and is due to higher maintenance payments by the state in the new contracts. The same analysis for trams shows a 21 per cent increase which will be offset by the state retaining 10 per cent more fare box revenue under the new contracts.

A performance bonus of $0.74 million was paid to the tram operator for the period 1 December 2009 to 30 June 2010, and performance penalties were levied on the train operator of $4.8 million for the same period. The capping of performance bonuses and penalties under the new franchise arrangements has reduced the financial bonuses that the state paid by $1.16 million and the financial penalties that it received by $10.6 million. The introduction of capping was designed to influence the bids from the franchisees who may have otherwise sought higher franchise payments.

Channel deepening

On 25 November 2009, the Port of Melbourne Corporation announced that the channel deepening project was complete, one month ahead of schedule. The estimated total cost of the project was $721 million, calculated on 31 May 2010 when most of the project expenditure had been paid. The project finished $248 million under budget assuming no payments are made on a $100 million guarantee issued by the Minister for Roads and Ports to remediate certain environmental related impacts of the project.

Victorian Bushfires Appeal Fund

Over 78 towns and communities across Victoria were devastated by the bushfires of February 2009. On 8 February 2009, the 2009 Victorian Bushfire Appeal Trust Fund was established.

Since the appeal fund's inception, $391.6 million has been received, including $8.5 million of interest revenue. The appeal fund has distributed $267.6 million to individuals and communities, leaving a balance in the fund of $124.0 million as at 31 August 2010. Of the $124 million remaining, 87 per cent has been committed for future disbursement.

Recommendation

Number	Recommendation	Page
1.	The Department of Treasury and Finance should develop strategies so that agreed AFR milestones are generally met by material entities.	11

Submissions and comments received

In addition to progressive engagement during the course of the audit, in accordance with section 16A and 16(3) of the *Audit Act 1994* a copy of this report, or relevant extracts from the report, was provided to the Treasurer and all relevant agencies with a request for submissions or comments.

The Treasurer's and agency views have been considered in reaching our audit conclusions and are represented to the extent relevant and warranted in preparing this report. Their full section 16(3) submissions and comments, however, are included in Appendix D.

Audit conduct

The audit of the AFR was conducted in accordance with Australian Auditing Standards.

The total cost of preparing and printing this report was $172 000.

1 Background

1.1 Introduction

The state election is scheduled for 27 November 2010 with Parliament rising in early October 2010. This shortens our time lines for reporting on the annual financial statement audits. Accordingly, we have produced interim reports on the annual financial statement audits of each sector and will produce a final acquittal report in February 2011.

This report is the fifth of seven reports to be presented to Parliament covering the results of the audits. Figure 1A shows the intended reports and time frames.

The purpose of this report is to:

- set out the results of the audit of the *Annual Financial Report of the State of Victoria, 2009–10* (AFR)
- comment on the financial performance and the financial position of the state and highlight risks to the state's finances
- provide observations on the status and financial implications of the more significant projects and developments.

Figure 1A
VAGO reports on the results of the 2009–10 financial audits

Report	Description
Portfolio Departments: Interim Results of the 2009–10 Audits (2010–11:1 tabled 28 July 2010	Reported on the interim results of audits of the 11 portfolio departments. It examined the effectiveness of internal controls for IT systems; for identifying, declaring and managing conflicts of interest; and for procurement. It also commented on financial reporting developments.
Local Government: Interim Results of the 2009–10 Audits (2010–11:3 tabled 11 August 2010)	Reported on the interim results of audits of 79 local councils, 13 agencies they control and 12 regional library corporations. It examined the effectiveness of internal controls supporting the preparation of the financial reports, controls over conflicts of interest and IT change management.
Water Entities: Interim Results of the 2009–10 Audits (2010–11:4 tabled 11 August 2010)	Reported on the interim results of audits of 19 water entities. It examined the effectiveness of internal control supporting the preparation of the financial reports and aspects of how they manage capital projects and creditors.
Public Hospitals: Interim Results of the 2009–10 Audits (2010–11:5 tabled 1 September 2010)	Reported on the interim results of audits of approximately 110 agencies in the sector. It examined the effectiveness of internal control supporting the preparation of the financial reports and aspects of how they manage leave and creditors.
Auditor-General's Report on the Annual Financial Report of the State of Victoria, 2009–10 (this report)	The report provides the result of the audit of the state's annual financial report. It examines the quality and timeliness of financial reporting, explains significant financial results for the state and makes observations on the status and financial implications of the more significant projects and developments.
Acquittal Report: Results of the 2009–10 Audits	The report will provide the results of the annual financial statement audits of approximately 420 agencies across the portfolio departments and associated entities, and all other sectors including local government, water entities and public hospitals. The report will include comment on the timeliness of their financial reporting and financial sustainability. *Proposed to be tabled in Parliament in February 2011.*
Tertiary Education and Other Entities: Results of the 2010 Audits	The report will provide the results of the annual financial audits of approximately 110 entities that end their financial year other than on 30 June 2010. It will examine timeliness of their financial and performance reporting, the effectiveness of their internal control, their financial sustainability and aspects of how they manage creditors, employee costs and student fee revenue. *Proposed to be tabled in Parliament in May 2011.*

Source: Victorian Auditor-General's Office.

1.2 Financial audit framework

Figure 1B shows the three phases of a financial audit and details how the 2009–10 audit of the AFR and the consolidated entities was conducted.

Figure 1A
Financial audit framework

Planning

Planning is not a discrete phase of a financial audit, rather it continues throughout the engagement. However, initial audit planning is conducted at two levels:

- At a high or entity level, planning involves obtaining an understanding of the entity and its environment, including its internal controls. The auditor identifies and assesses: the key risks facing the entity; the entity's risk mitigation strategies; any significant recent developments; and the entity's governance and management control framework.
- At a low or financial statements line item level, planning involves the identification, documentation and initial assessment of processes and controls over management, accounting and information technology systems.

The output from the initial audit planning process is a detailed audit plan and a client strategy document, which outlines the proposed approach to the audit. This strategy document is issued to the client after initial audit planning and includes an estimate of the audit fee.

Conduct

The conduct phase involves the performance of audit procedures aimed at testing whether or not financial statement balances and transactions are free of material error. There are two types of tests undertaken during this phase:

- Tests of controls, which determine whether controls identified during planning were effective throughout the period of the audit and can be relied upon to reduce the risk of material error.
- Substantive tests, which involve: detailed examination of balances and underlying transactions; assessment of the reasonableness of balances using analytical procedures; and a review of the presentation and disclosure in the financial statements, for compliance with the applicable reporting framework.

The output from this phase is a management letter which details significant findings along with value-adding recommendations on improving controls and processes.

Reporting

The reporting phase involves the formal presentation and discussion of audit findings with the client management, and / or the audit committee. The key outputs from this process are:

- A signed audit opinion, which is presented in the client's annual report alongside the certified financial statements.
- A report to Parliament on significant issues arising from audits either for the individual entity or for the sector as a whole.

Source: Victorian Auditor-General's Office.

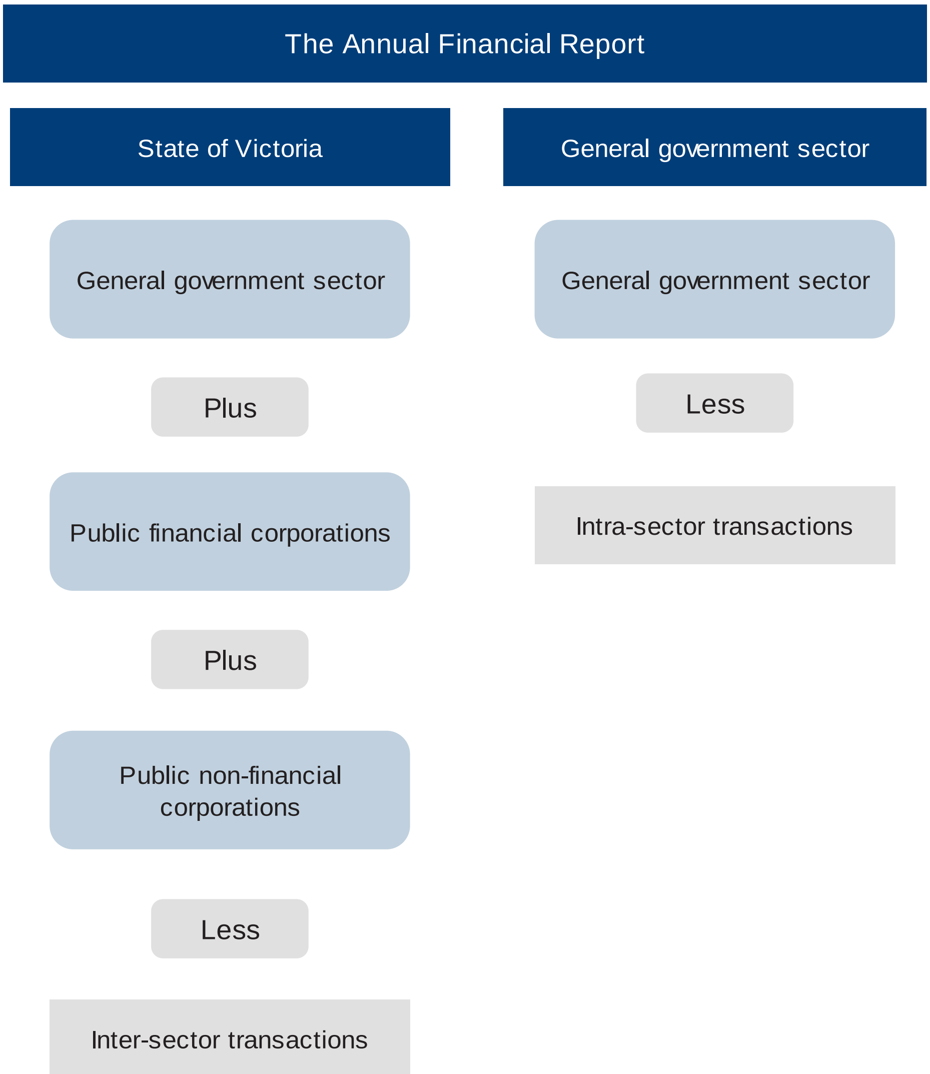
1.3 Scope

Section 9A of the *Audit Act 1994* requires the Auditor-General to provide an audit opinion on the AFR.

Section 16A of the *Audit Act 1994* requires the Auditor-General to make a report to the Parliament on each AFR.

Figure 1C outlines the financial report coverage included in the AFR.

Figure 1B
Structure of the Annual Financial Report



Source: Victorian Auditor-General's Office.

The AFR provides the combined financial results of all entities in each sector; except for inter and intra sector transactions between entities in those sectors which are netted out to avoid double counting where they are internal transactions, for example, payroll tax paid by a department is netted out in the results for the state.

In accordance with Australian accounting standards, only entities controlled by the state are included in the AFR. The state controls entities where it has the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. Controlled entities include the portfolio departments and state-owned enterprises.

Figure 1D details the entities that are not controlled by the state and the rationale for this, consistent with Australian accounting standards.

Figure 1C
Entities not controlled by the state

Entity	Rationale
Local government	Local government is a separate tier of government with councils elected by, and accountable to, their constituents.
Universities	Universities are primarily funded by the Commonwealth and the state directly appoints only a minority of University council members.
Denominational hospitals	Denominational hospitals are private providers of public health services and have their own governance arrangements.
Superannuation funds	The net assets of the funds are the property of the members. Any shortfall in the funds' net assets related to defined benefit scheme entitlements are an obligation of the state and reported as a liability in the AFR.

Source: Victorian Auditor-General's Office.

Those entities controlled by the state are classified into three sectors of government. Figure 1E describes each sector. A list of all entities consolidated is contained in Note 40 of the AFR.

Figure 1D
Sectors of government

Sector	Explanation
General government sector (GGS)	212 entities whose primary purpose is to provide public services. Examples include government departments, public hospitals and TAFE's.
Public financial corporations	Seven entities that borrow centrally, accept deposits and acquire financial assets. Examples include the Treasury Corporation of Victoria and the Rural Finance Corporation.
Public non-financial corporations	79 entities whose primary purpose is to provide goods and/or services in a competitive market and are non-regulatory and non-financial in nature. Entities include water authorities, alpine resort management boards and Victorian Rail Track Corporation.

Source: Victorian Auditor-General's Office.

1.4 Reporting framework

The *Financial Management Act 1994* (FMA) is the legislation that governs the administration of public finances in Victoria. The FMA requires the annual preparation of a consolidated financial report of the state, known as the AFR.

The AFR reports on the state in two ways:

- whole of the state: consolidates all three sectors of government
- GGS level: provides consolidated information on the entities that provide publicly funded services.

The AFR acquits the government's stewardship of the state's finances to Parliament. The AFR is incorporated into a narrative report, the *Financial Report for the State of Victoria 2009–10,* which analyses the government's costs, revenue, assets and liabilities.

The Treasurer and the Minister for Finance, WorkCover and the Transport Accident Commission are responsible for the AFR. The Department of Treasury and Finance prepares the AFR in accordance with section 24 of the FMA and applicable Australian accounting standards and interpretations. Australian Accounting Standard AASB 1049 *Whole of Government and General Government Sector Financial Reporting* is of particular relevance.

Section 24(m) of the FMA requires the AFR to be audited by the Auditor-General, and tabled in Parliament by 15 October each year. The tabling of the 2009–10 AFR was brought forward to 15 September 2010.

2 Results of audit

At a glance

Background

The *Annual Financial Report of the State of Victoria, 2009–10* (AFR) is audited by the Auditor-General and tabled in Parliament. The AFR is contained within the *Financial Report for the State of Victoria 2009–10* (the Financial Report), and acquits the government's stewardship of the state's finances for the year.

The Department of Treasury and Finance prepares the AFR. It consolidates the financial results of 298 public sector entities. In 2009–10, 47 of these entities were regarded as material entities (47 in 2008–09), as the magnitude of their individual financial operations are material to the consolidated finances of the state.

Findings

- A clear audit opinion on the 2009–10 AFR was issued on 10 September 2010 and included in Chapter 4 of the Financial Report. The Financial Report was tabled in Parliament on 15 September 2010.
- Seventy-four per cent of material entities did not finalise their 2009–10 financial reports by the agreed AFR milestone date.

Recommendation

The Department of Treasury and Finance should develop strategies so that agreed AFR milestones are generally met by material entities.

2.1 Introduction

The independent audit opinion adds credibility to the financial report by providing assurance that the information is reliable.

A clear audit opinion on the *Annual Financial Report of the State of Victoria, 2009–10* (AFR) was issued on 10 September 2010 and is included in Chapter 4 of *Financial Report for the State of Victoria 2009–10* (the Financial Report) that was tabled in Parliament on 15 September 2010. In the prior year, a clear audit opinion on the AFR was issued on 29 September 2009 and the Financial Report was tabled in Parliament on 14 October 2009.

A clear audit opinion indicates that the AFR has been prepared in accordance with the requirements of the *Financial Management Act 1994* (FMA) and Australian accounting standards.

2.2 Preparation of the Annual Financial Report

The Department of Treasury and Finance (DTF) consolidates the financial results of 298 public sector entities controlled by the state, in line with Australian accounting standards.

Of the controlled public sector entities, 47 were deemed material entities in 2009–10 (47 in 2008–09). A public sector entity is classified as a material entity when its individual financial operations are significant in the reporting of the consolidated finances of the state. Collectively material entities account for more than 90 per cent of the state's assets, liabilities, revenue and expenditure.

Material entities are listed in Appendix A of this report. All controlled public sector entities consolidated are listed in Note 40 of the AFR.

To prepare the AFR, public sector entities transmit their financial data into DTF's web based Business Management System (BMS). This process is known as data feeding.

Material entity data feeds are verified by audit and are based on:

- the audited public sector entities' financial reports, and
- separately audited data, where data required for the AFR is different to data reported in the financial reports of the public sector entities. For example, the use of fair values as opposed to historical cost for infrastructure assets.

2.2.1 Accuracy

The accuracy of the draft AFR financial statements is measured by the frequency and size of errors that required adjustment. Ideally there should be no errors identified or adjustments required.

When the auditor detects a material error in the draft AFR financial statements it is raised with DTF as the preparer of the AFR. Material errors need to be corrected before a clear audit opinion can be issued. DTF may also make changes to the draft AFR financial statements after submitting it to audit, if their quality assurance procedures identify that reported information is materially incorrect or incomplete.

The quality of the draft AFR depends on the accuracy of data feeds submitted to DTF by public sector entities. DTF undertake a review of these data feeds as part of their quality assurance process. The review includes analysing data, completing review checklists, conducting a variance analysis of prior year actual, current year actual and budget. Additional checks are made over contingencies and commitments, financial instruments and related party transactions.

Audit detected 21 material errors (49 in 2008–09) in the AFR drafts.

The majority of the errors were identified in the draft disclosure notes for commitments, which is consistent with the 2008–09 AFR, and include:

- double counting of commitments where two or more entities provided the same commitment information to DTF
- inter-government commitments not identified and eliminated.

Significant errors in the capital and operating commitments figures included overstatement errors totalling $989 million and understatement errors totalling $99.4 million.

All material errors were corrected in the AFR by DTF before issue of the clear audit opinion.

2.2.2 Timeliness of AFR preparation

The timely preparation and audit of the AFR depends on the consolidated entities meeting the AFR preparation timetable and the early identification and resolution of significant accounting and disclosure issues.

Due to the 2010 state election, the Premier required DTF to prepare and table the 2009–10 AFR in Parliament one month earlier than the 2008–09 AFR, which was tabled on 14 October 2009. The 2009–10 AFR was tabled on 15 September 2010, as targeted.

To facilitate the timely preparation of the AFR, DTF released tailored AFR timetables on 10 and 12 March 2010 (27 February in 2009) for public corporations and general government entities respectively. The AFR timetable includes two sets of key dates, those which impact on the AFR as a consolidated financial report and those which relate to the individual entities that transmit their financial information via the BMS. The AFR milestone dates for individual reporting entities are earlier than the legislative time frames.

The key milestone dates for the 2009–10 AFR are provided in Figure 2A.

Figure 2A
Key milestone dates for the AFR

Milestone	2009–10	2008–09
Certified datafeeds for general government (GG) entities	12 August	13 August
Certified datafeeds for public financial corporations (PFC) and public non-financial corporations (PNFC)	13 August	17 August
Draft AFR to audit	20 August	21 August
AFR finalised and an audit opinion issued	6 September	11 September

Source: Victorian Auditor-General's Office.

A complete AFR draft was provided to audit on 3 September 2010 (9 September in 2009). The draft AFR was received ten business days late, precluding audit achieving the intended 6 September 2010 audit opinion certification time frame.

The key milestone dates for material entities for 2009–10 are set out in Figure 2B.

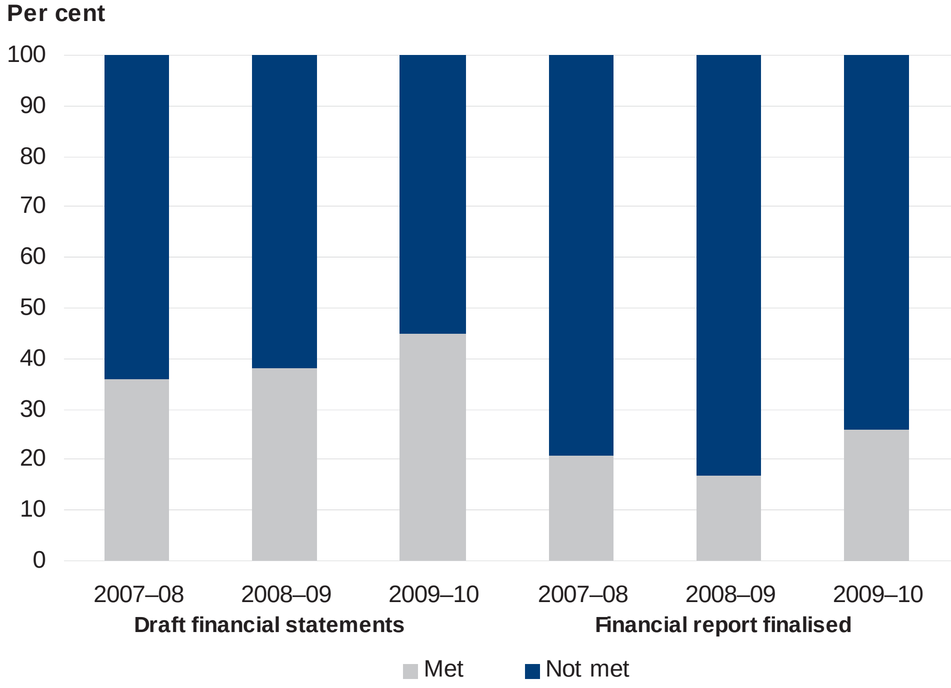
Figure 2B
Key milestone dates for material entities

Milestone	2009–10	2008–09
Complete draft financial reports to audit	26 July	24 July
Finalise financial reports including a certified audit opinion – GG	11 August	12 August
Finalise financial reports including a certified audit opinion – PNFCs and PFCs	11 August	14 August

Source: Victorian Auditor-General's Office.

The late provision of the draft AFR is a result of delays by DTF in the preparation of the AFR partly due to late reporting by material entities. Figure 2C shows the timeliness of material entities against the AFR timetable over a three-year period.

Figure 2C
Timeliness of material entities against the AFR milestones



Source: Victorian Auditor-General's Office.

Seventy-four per cent of material entities did not finalise their financial reports by the AFR milestone date.

Appendix C provides the individual results of each material entity against the AFR milestone dates for provision of draft financial statements and the finalisation of the financial report including certified audit opinion.

Recommendation

1. The Department of Treasury and Finance should develop strategies so that agreed AFR milestones are generally met by material entities.

2.3 Recognition and measurement of assets

2.3.1 Measurement of infrastructure assets

As at 30 June 2009, there was a $15.3 billion difference between the value of infrastructure assets in the AFR and in the financial reports of all water entities, VicTrack and the Port of Melbourne. All water entities, VicTrack and the Port of Melbourne measured their infrastructure assets at cost in their statutory financial statements as at 30 June 2009. However, the 2008–09 AFR measured these assets at fair value to comply with the requirements of AASB 1049 *Whole of Government and General Government Sector Financial Reporting*.

Financial Reporting Direction (FRD) 121 *Infrastructure Assets (Water/Rail)* allowed water, rail and port entities to record infrastructure assets at cost within their financial report in 2008–09. However, DTF required the entities to determine the fair value of their infrastructure assets as at 30 June 2009 with the revised valuations submitted to DTF to facilitate the preparation of the AFR.

For 2009–10, the four metropolitan water entities and the Port of Melbourne revised their accounting policies to measure infrastructure assets at fair value, which is consistent with the accounting policy adopted for the preparation of the state's annual financial report. Regional urban and rural water entities, and VicTrack will transition to fair value in 2010–11. The additional 12 months allow the entities to validate and update information within their asset systems and for qualified valuers to be engaged. This means that there remains a $12.5 billion difference between the value of infrastructure assets in the 2009–10 AFR and the financial reports of regional urban and rural water entities, and VicTrack.

Compared with the valuation policies and practices of other states and territories, Victoria is one of four Australian jurisdictions yet to require infrastructure assets to be measured at fair value in all entity financial reports. This is notwithstanding that the fair value requirement in AASB 1049, at the whole-of-government level, was first foreshadowed when the accounting standard was exposed as a draft in May 2007.

We continue to recommend that like transactions and events be treated consistently across the public sector so that financial reports are comparable. These differences, however, will remain until the 2010–11 year.

2.3.2 Recognition of land under declared roads

At 30 June 2009, all land under roads was recognised at a value of $18.7 billion at the whole-of-government level, to comply with the requirements of AASB 1049. This was inconsistent with the financial report for VicRoads, who manage the declared road network, which only recognised land under roads acquired after 1 July 2008.

In April 2010, FRD 118B *Land Under Declared Roads* was released pursuant to the FMA which required all land under roads controlled by VicRoads to be recognised as an asset and measured at fair value. Consequently, VicRoads recognised all land under roads in 2009–10, bringing the total value of land under roads in its balance sheet to $14.7 billion.

The carrying value of land under roads within the 2009–10 AFR was decreased to $14.7 billion to align with VicRoads. The $4.0 billion difference between the value of land under roads reported in the 2008–09 and 2009–10 AFR is due to a change in the valuation method adopted and has therefore been recognised as an ‘other economic flow’ in the comprehensive income statement (refer Note 15 of the 2009–10 AFR).

3 The state's financial result

At a glance

Background

The consolidated comprehensive operating statement in the *Annual Financial Report of the State of Victoria, 2009–10* contains two key measures of financial performance and sustainability, the net result from transactions and the net result.

The net result from transactions is revenue less expenditure that can be directly attributed to government policy. The net result includes the net result from transactions and other economic flows which represent changes in the value of assets and liabilities due to market re-measurements.

Findings

- The net result from transactions for the state was a surplus of $594.7 million in 2009–10 (deficit of $123.8 million in 2008–09) and for the general government was a surplus of $643.6 million in 2009–10 (surplus of $251.2 million in 2008–09). These surpluses were primarily due to increases in taxation and Commonwealth grant revenue totalling $4 861.4 million, offset by increases in employee costs, grants and other operating expenses totalling $3 972.6 million.
- The net result from transactions for the general government sector exceeded the government's key financial objective of a surplus of at least $100 million.
- In 2009–10 the net result for the state was a deficit of $5 677.7 million (deficit of $13 088.8 million in 2008–09) largely reflecting an increase in the state's liability for unfunded superannuation of $1 435.8 million and a downwards revision of $4 000 million to the value of land under roads.
- Total expenditure from transactions of the state increased by 49.5 per cent from 2004–05 to 2009–10. This increase is greater than the increase in revenue for the same period of 45.0 per cent.

3.1 Introduction

This chapter provides analysis of the significant results and balances of the state for the 2009–10 financial year.

To assist readers to make assessments about the state’s financial performance and position, we:

- overview the state’s financial results for the period 2004–05 to 2009–10
- review the general government sector (GGS) net result from transactions
- highlight financial risks to the financial performance and position of the state.

3.2 Financial performance of the state

The consolidated comprehensive operating statement in the *Annual Financial Report of the State of Victoria, 2009–10* (AFR) contains information about the amount and type of state revenue and expenses, and other economic flows. It also includes two key measures of financial performance and sustainability: the net result from transactions and the net result.

The net result from transactions is revenue less expenditure that can be directly attributed to government policy.

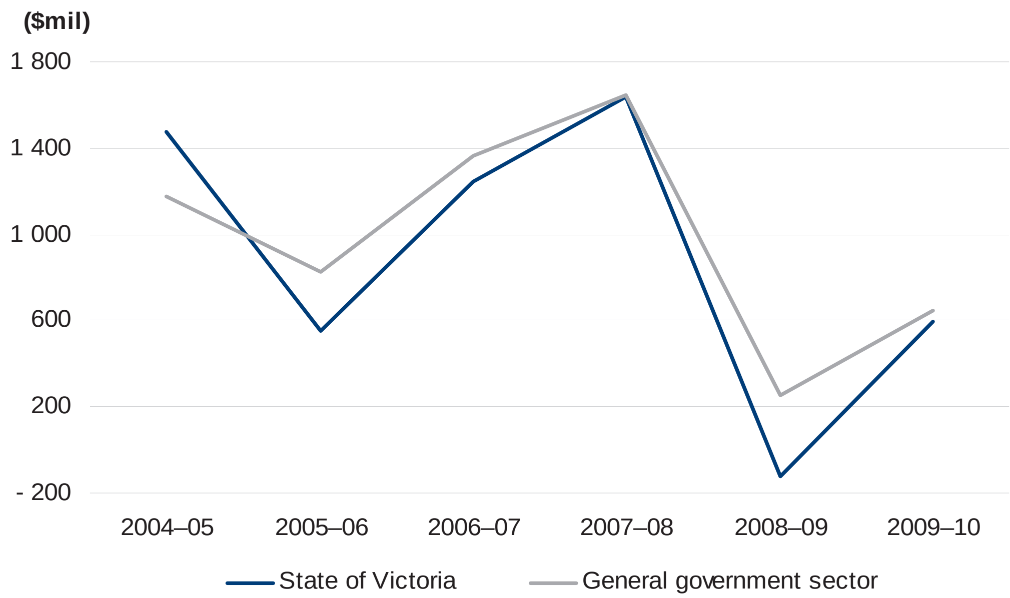
The net result, however, includes other economic flows which represent changes in the value of assets and liabilities due to market re-measurements. It includes actuarial gains and losses that primarily reflect the valuation movement in the state’s superannuation liability.

Commentary on the comprehensive result, which shows the total change in net worth, is included in our analysis of the financial position of the state.

3.2.1 Net result from transactions

Figure 3A shows the State of Victoria and GGS net result from transactions for the last six financial years.

Figure 3A
Net result from transactions—
State of Victoria and general government sector



Source: Victorian Auditor-General's Office.

The net result from transactions for the GGS is the government's key measure of short-term financial performance.

The comprehensive operating statement for 2009–10 shows the net result from transactions for the GGS was a surplus of $643.6 million ($251.2 million in 2008–09) which exceeded the government's key financial objective of a net result from transactions of at least $100 million. The achievement of this target was primarily due to:

- an increase of $3 747.8 million in Commonwealth Government grants received
- an increase of $1 113.6 million in taxes collected.

This was offset by:

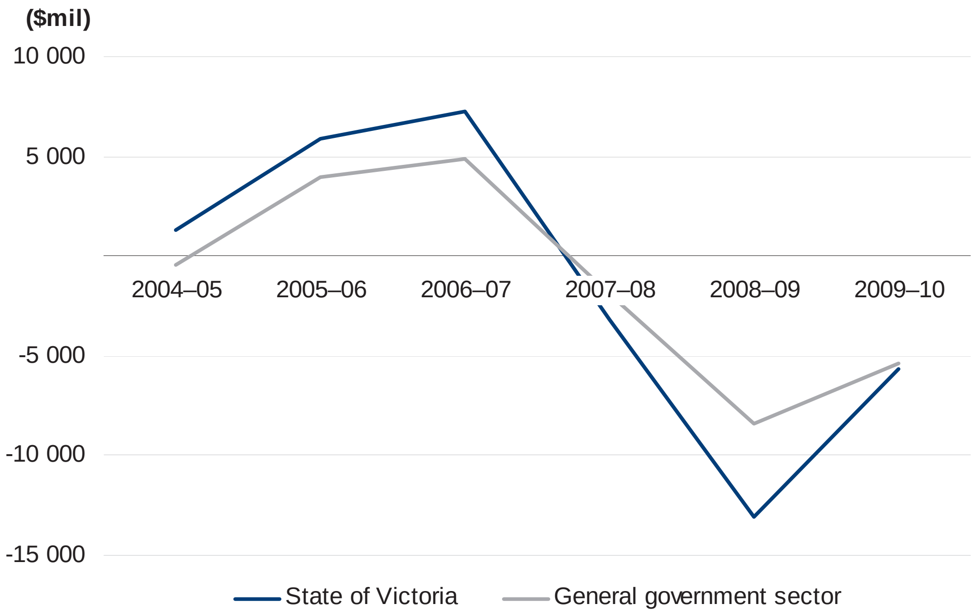
- an increase of $1 808.2 in grants and other transfers
- an increase of $1 107.9 million in employee benefits
- an increase of $1 056.5 million in other operating expenses.

The net result from transactions for the state was a surplus of $594.7 million (deficit of $123.8 million in 2008–09). A significant portion of the movement in the state's net result from transactions is attributed to the GGS. Further detailed explanations of significant movements follow.

3.2.2 Net result

Figure 3B shows the net result for the state and the GGS (including transactions and other economic flows) for the last six financial years.

Figure 3B
Net result—State of Victoria and general government sector



Source: Victorian Auditor-General's Office.

The 2009–10 net result of the GGS was a deficit of $5 413.1 million (deficit of $8 372.8 million in 2008–09). For the state it was a deficit of $5 677.7 million (deficit of $13 088.8 million in 2008–09).

The improvement in the deficit from 2008–09 to 2009–10 is primarily attributed to:

- $6 136.7 million reduction in the actuarial losses on the state's defined benefit superannuation plans. The loss made as a result of the movement in the unfunded superannuation plans was $1 435.8 million in 2009–10 compared to a loss of $7 572.5 million in 2008–09. Analysis of the unfunded superannuation obligations of the state is included at section 3.3.2
- $4 209.4 million improvement in the value of financial assets and liabilities. In 2008–09, a $4 022.2 million loss was recorded as a result of downward valuations on financial assets and liabilities reflecting global economic conditions at the time. In 2009–10, the revaluation on these assets and liabilities was a positive result of $187.2 million reflecting a stronger economy

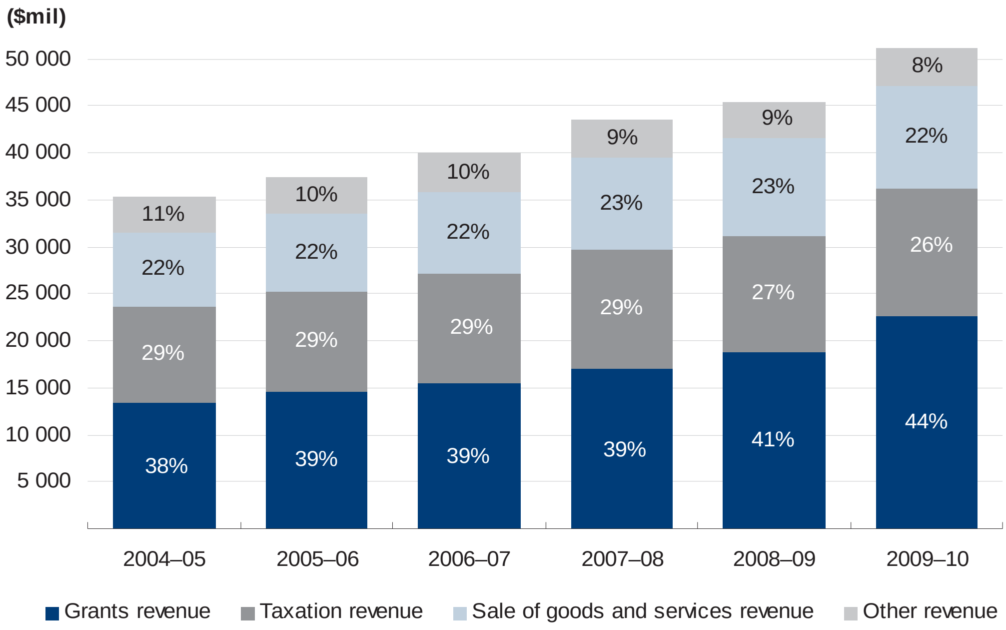
- $3 617.4 million increase in losses from other economic flows. The losses from other economic flows of $5 023.8 million in 2009–10 included a $4 000 million revaluation loss resulting from a change in the method of calculating the value of land under roads. This change was a result of an agreement reached during 2009–10 between all state Valuer-General's on the valuation method to be used for land under roads.

3.2.3 Revenue

Total revenue from transactions of the state rose from $35 296.0 million in 2004–05 to $51 162.4 million in 2009–10, an increase of 45.0 per cent over the six-year period. Over the same period, the consumer price index has increased by 14.9 per cent. Commonwealth grants, state taxation and the sale of goods and services are the primary sources of revenue for the state and an explanation of the major movements in these revenue sources is set out in the following paragraphs.

Figure 3C shows the major sources of revenue for the last six financial years.

Figure 3C
Total revenue from transactions—State of Victoria



Source: Victorian Auditor-General's Office.

Commonwealth grants

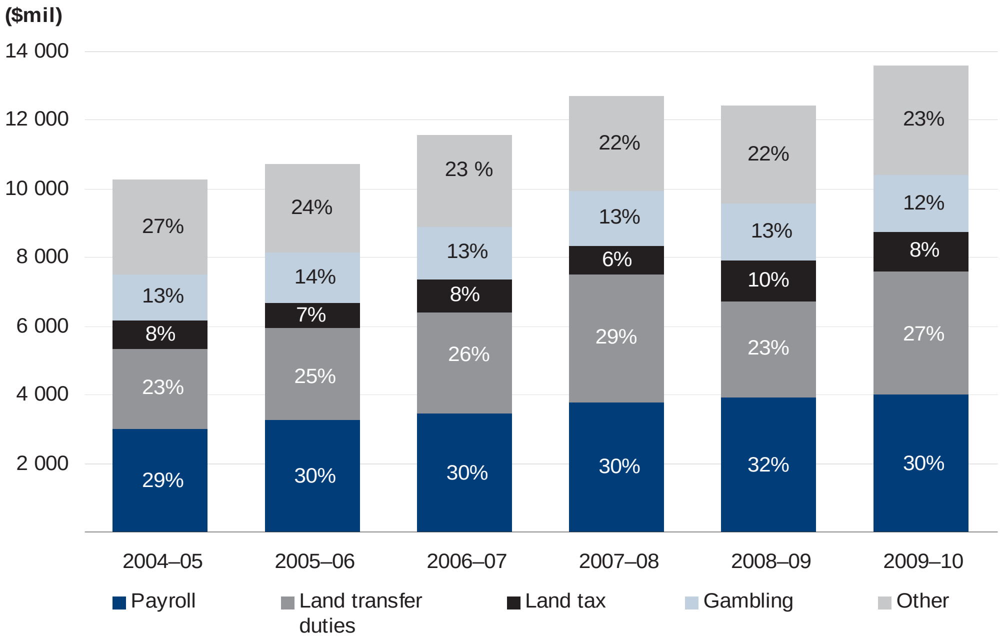
Commonwealth grants have increased by 68.8 per cent from $13 394.0 million in 2004–05 to $22 606.6 million in 2009–10. The percentage of state revenue received from the Commonwealth has grown to 44.2 per cent of the state's total revenue from transactions in 2009–10 (41.2 per cent 2008–09). The increase is due to the *Nation Building – Economic Stimulus Plan*, under which the state received $1 482.9 million for the Building the Education Revolution (BER) program, and an additional $934.5 million for construction and maintenance of public and social housing. An analysis of the BER program is provided in section 4.3.3 of this report.

Taxation revenue

Taxation revenue has increased by 31.6 per cent, from $10 282.3 million in 2004–05 to $13 534.6 million in 2009–10.

The major sources of taxation revenue are payroll tax, land transfer duty, gambling taxes, land tax and other taxes primarily comprising motor vehicle and insurance taxes. Figure 3D provides a breakdown of the components of taxation revenue for the last six financial years.

Figure 3D
Taxation revenue—State of Victoria



Source: Victorian Auditor-General's Office.

Figure 3D shows that although there has been an upward trend in taxation revenue over the past six years, the components of taxation revenue have remained constant.

In 2008–09, lower levels of taxation revenue reflected slower economic growth. During 2009–10, continued recovery from the impact of the global financial crisis resulted in an increase of 9 per cent in taxation revenue from $12 443.6 million in 2008–09 to $13 534.6 million in 2009–10. This is primarily attributed to an increase in land transfer duties as a result of an increase in the value and number of properties sold.

Taxation revenue as a share of nominal Gross State Product (GSP) was 4.66 per cent in 2009–10 (4.38 per cent in 2008–09). During the period from 2004–05 to 2009–10, taxation revenue has ranged between 4.08 per cent and 4.66 per cent of nominal GSP.

Sales of goods and services revenue

Revenue from the sale of goods and services increased by 39.9 per cent over six years, from $7 882.4 million in 2004–05 to $11 024.2 million in 2009–10. In 2009–10, sales of goods and services revenue represented 21.5 per cent of the state’s total revenue from transactions (22.7 per cent in 2008–09), increasing by $697.3 million from 2008–09.

In 2009–10, the growth in revenue from the sale of goods and services primarily reflects:

- $323.3 million increase in water charges and sewerage prices across all 19 water entities. In particular, the three metropolitan water distribution companies had significant increases of between 13.5 per cent and 18 per cent primarily to fund significant water sector projects including the Wonthaggi desalination plant, food bowl modernisation project and sugarloaf pipeline
- $265.0 million increase in Department of Transport (DOT) fare box revenue. Since the commencement of new train and tram operators in December 2009, DOT receives all fare box revenue and makes payments to the operators in accordance with guaranteed fare box amounts. This is a change from the prior year when the fare box revenue was paid directly from Metlink to the private operators
- $100.0 million increase in hospital patient fees in line with CPI
- $63.5 million increase in TAFE revenue as a result of an increase in course fees and a greater number of students
- $45.0 million increase in land title fees at the Department of Sustainability and Environment primarily as a result of price increases from 1 July 2009.

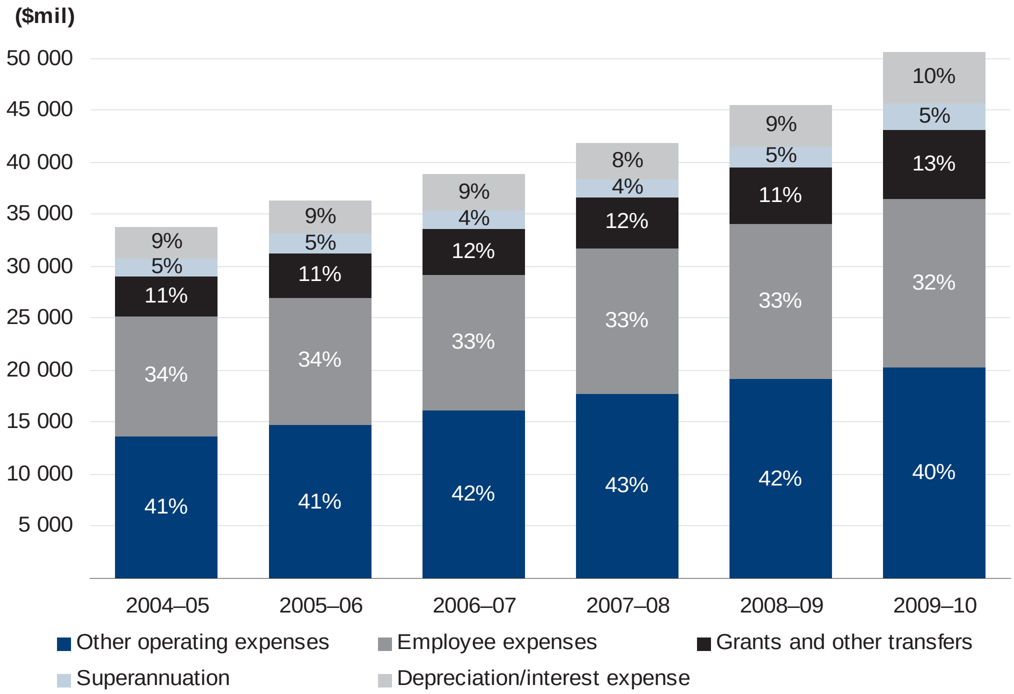
These increases have been offset by a $401 million decrease due to the Victorian Energy Networks Corporation winding up as of 1 July 2009 and its operations being transferred to the new Australian Energy Market Operator, a Commonwealth government organisation.

3.2.4 Expenditure

Total expenditure from transactions of the state rose from $33 817.3 million in 2004–05 to $50 567.6 million in 2009–10, an increase of 49.5 per cent over the six-year period. This increase is greater than the increase in revenue for the same period of 45.0 per cent, meaning expenditure has grown faster than revenue.

Figure 3E shows the major types of expenditure for the state for the last six financial years. Employee expenses, grants and other transfers are the primary costs incurred by the state, together making up 45 per cent of total expenditure in 2009–10.

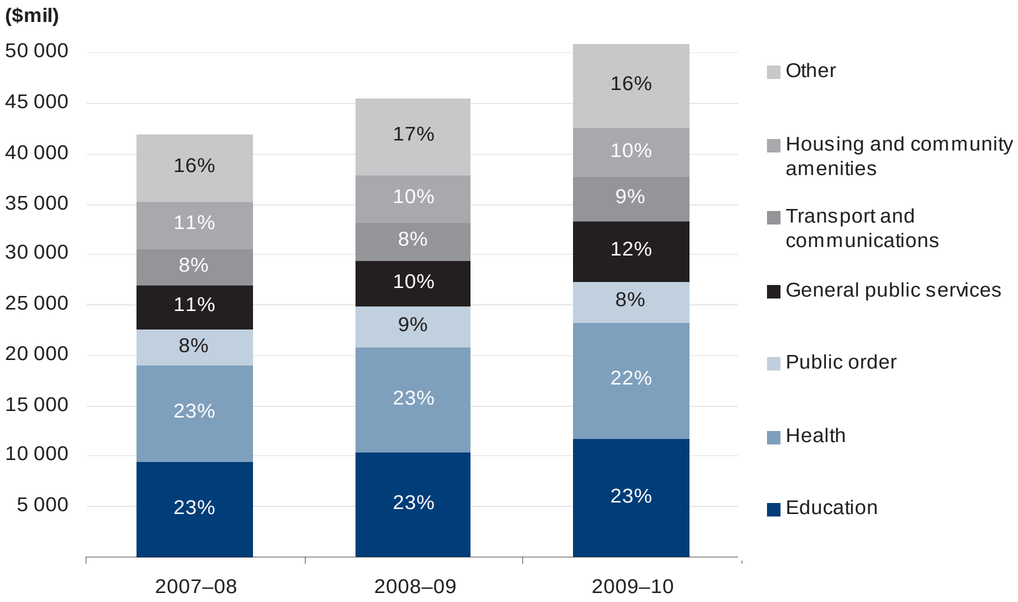
Figure 3E
Total expenses from transactions—State of Victoria



Source: Victorian Auditor-General's Office.

Figure 3E shows that while expenditure has increased, the proportion of money expended on each government purpose classification group remained consistent. Note 13 of the 2009–10 AFR report includes a breakdown of total expenditure from transactions by government purpose classification (GPC) for both the State of Victoria and the GGS. Figure 3F shows total expenses by GPC for the period 2007–08 to 2009–10 for the State of Victoria.

Figure 3F
Expenditure by government purpose classification —State of Victoria



Note: Comparative information has only been included for two years as the requirement to disclose expenditure by government purpose classification under AASB 1049 *Whole of Government and General Government Sector Financial Reporting* only became applicable for annual reporting periods beginning on or after 1 July 2008.

Source: Victorian Auditor-General's Office.

Although expenditure for the state increased by 20.6 per cent, from $41 924.9 million in 2007–08 to $50 567.6 in 2009–10, the proportion of money expended on each government purpose classification group remained consistent. Spending on education and health account for almost half of the state’s expenditure over the past three years.

Employee expenses

Employee expenses are the largest single expense of the state. Since 2004–05 the state’s total employee expenses (excluding superannuation expenses) have increased from $11 448.7 million to $16 218.3 million in 2009–10, an average annual increase of 7.2 per cent.

In 2009–10, employee expenses increased by 7.9 per cent, from $15 037.0 million in 2008–09 to $16 218.3 million. The increase is primarily attributed to higher wage rates under enterprise bargaining agreements (EBA) and employee numbers—both of which support increased service delivery. Specifically, $865 million can be attributed to increases of:

- $458 million at hospitals as a result of a 3.25 percent EBA increase and an additional 3 565 full time equivalent (FTE) staff
- $211 million at the Department of Education and Early Childhood Development as a result of a 2.71 per cent EBA increase effective 1 January 2010 and an additional 790 FTE staff at schools

- $82 million at TAFE entities as a result of a 3.25 per cent EBA increase effective 1 October 2009 and an additional 311 FTE teaching staff
- $63 million at Victoria Police as a result of an additional 351 police officers, and two EBA increases, 2 per cent effective 6 July 2009 and a further 2 per cent effective 6 February 2010
- $51 million at the Department of Justice as a result of a 3.25 per cent EBA increase.

Ninety-five per cent of the state's employee costs are public sector employees in the GGS. In 2009–10, the GGS employee costs increased by 7.7 per cent, from $14 296.9 million in 2008–09 to $15 404.8 million. This increase was greater than the Victorian public sector wage growth index of 5.5 per cent for 2009–10. Employee costs for the GGS are predicted in the state Budget to reach $18 560.3 million (38.0 per cent of total expenditure) by 2013–14.

3.3 Financial position of the state

The consolidated balance sheet in the AFR reports the value and composition of the state's assets and liabilities. The notes to the AFR contain further information about financial commitments, and contingent assets and liabilities that are not reflected in the consolidated balance sheet.

The state's net worth increased by 1.2 per cent in 2009–10 to $119 390.6 million ($118 003.6 million in 2008–09).

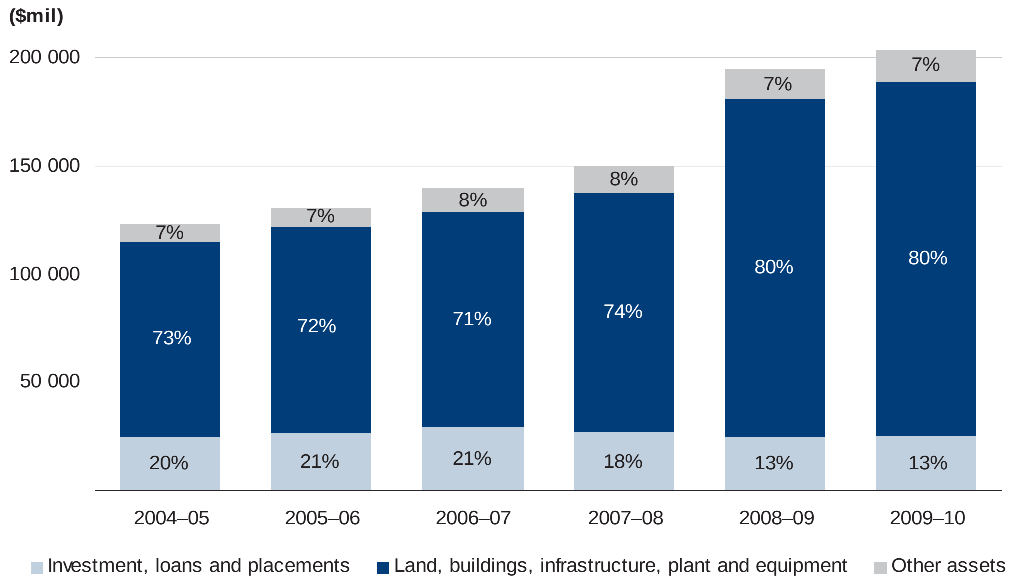
3.3.1 Assets

Total state assets increased from $123 092.6 million in 2004–05 to $203 468.8 million in 2009–10, an increase of 65.3 per cent over the six-year period.

Land, buildings, infrastructure, plant and equipment are the major non-financial assets of the state. Investments and loans are the major financial assets of the state.

Figure 3G shows the major assets for the state for the last six financial years.

Figure 3G
Total assets—State of Victoria



Source: Victorian Auditor-General's Office.

In 2009–10, total assets increased by 4.7 per cent, from $194 254.0 million in 2008–09 to $203 468.8 million. The increase is accounted for by an increase in land, buildings, infrastructure, plant and equipment as a result of:

- $10 769.3 million revaluation of the state’s rail assets and road networks, and water infrastructure at the metropolitan water entities
- $1 000 million spent on social housing under the *Nation Building – Economic Stimulus Plan*
- $973.9 million spent on water infrastructure by Melbourne Water
- $818 million spent on school buildings under the Commonwealth BER program
- $540 million spent on road infrastructure under the *Nation Building (Auslink II)* program
- $452 million spent on schools under the *Victorian Schools Plan*
- $337.7 million spent to upgrade the West Gate – Monash Freeways
- $241 million spent on new trains.

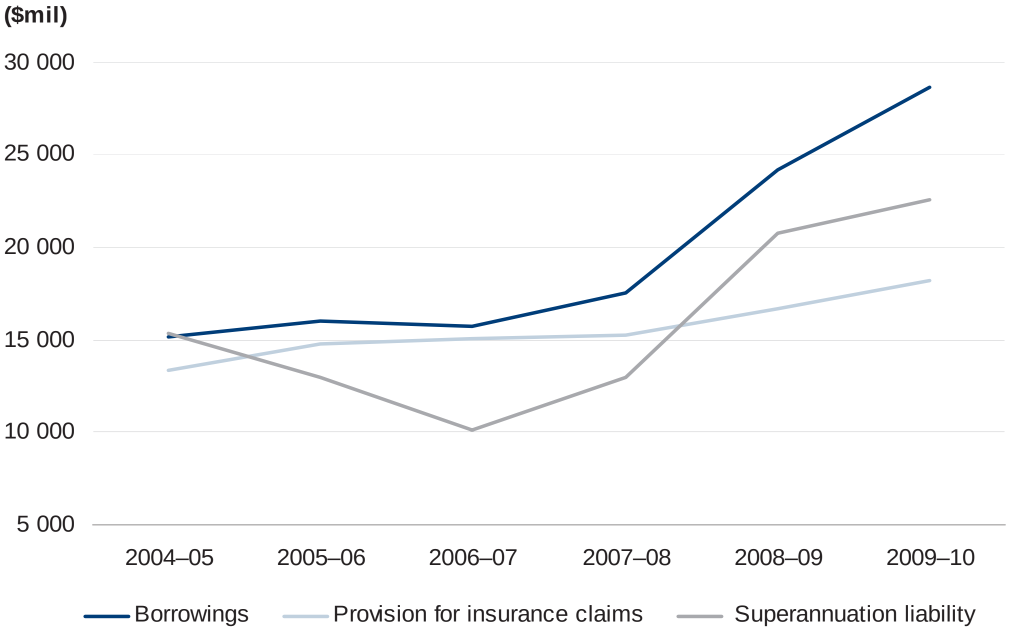
These increases have been offset by $3 392.5 million of depreciation charged during the year and a downwards revaluation in the carrying value of land under roads of $4 000 million.

3.3.2 Liabilities

Borrowings, provisions for insurance claims, and unfunded superannuation liabilities are the major obligations of the state. Total state liabilities increased from $53 614.0 million in 2004–05 to $84 078.2 million in 2009–10, an increase of 56.8 per cent over the six-year period.

Figure 3H shows the major liabilities for the state for the last six financial years, with borrowings increasing at a faster rate than unfunded superannuation liabilities and provisions in 2009–10.

Figure 3H
Borrowings, provision for insurance claims and unfunded superannuation liabilities—State of Victoria



Source: Victorian Auditor-General's Office.

Borrowings

Since 2004–05 the state's total borrowings have increased from $15 143.2 million to $28 580.3 million in 2009–10, an increase of 88.7 per cent. This excludes the state's unfunded superannuation liabilities.

In 2009–10, the state's borrowings increased by 18.5 per cent to reach $28 580.3 million at 30 June 2010. They include public sector borrowings of $23 842.8 million, derivative financial instruments of $2 059.9 million and finance leases of $2 677.6 million entered into by public sector entities. Public sector borrowings are predominately raised through the Treasury Corporation of Victoria.

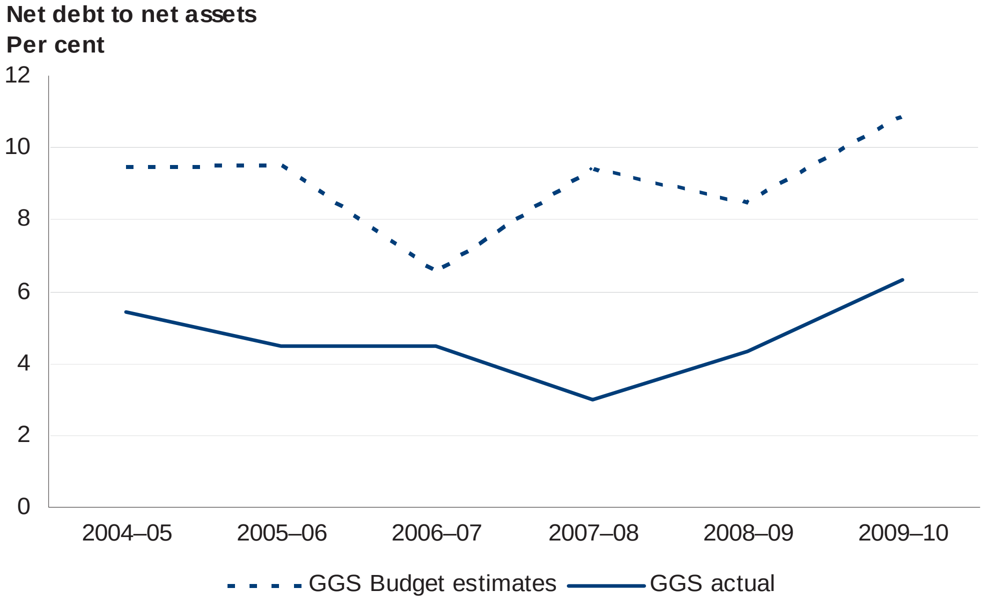
The money from the $4 454.3 million increase in borrowings in 2009–10 is being used to fund infrastructure programs in schools, transport and water.

Gearing is a key measure of the extent of the state's reliance on borrowings to fund asset acquisition and growth. The ratio is calculated by dividing net debt (borrowings, advances received and deposits held, less cash and deposits, advances paid and investments, loans and placements) by net worth. This ratio excludes unfunded superannuation liabilities. A lower ratio indicates less reliance on debt to fund assets, and lower exposure to rising finance costs associated with increased interest rates.

At 30 June 2010, the state had a net cash position of $1 479.5 million ($4 376.4 million at 30 June 2009) compared to the GGS which had net debt of $7 963.6 million (net debt of $ 5 219.6 million at 30 June 2009). The gearing ratio for the GGS increased from 4.34:1 in 2008–09 to 6.34:1, indicating that debt levels have increased during 2009–10 relative to the GGS asset base. This is consistent with the current infrastructure investment programs.

Figure 3I shows the GGS gearing ratio for the last six financial years.

Figure 3I
Gearing—general government sector



Source: Victorian Auditor-General's Office.

While the state projects surpluses for the GGS for the period 2010–11 to 2013–14, it also projects increased net debt. Net debt for the GGS is projected in the state Budget to almost double over the coming four years and reach $15 795.2 million by 30 June 2014.

Unfunded superannuation liability

The AFR includes unfunded superannuation liabilities of the state which are managed in the Emergency Services and State Super, Constitutionally Protected Schemes, Parliamentary Contributory Superannuation Fund and Health Super Fund.

The Emergency Services Superannuation Scheme (ESSS), which incorporates the former State Superannuation Fund, represents 97.1 per cent of the state's superannuation liability. The scheme consists of three main sections; the ESSS Defined Benefit Fund (open scheme), the State Super Funds (closed schemes), and accumulation accounts.

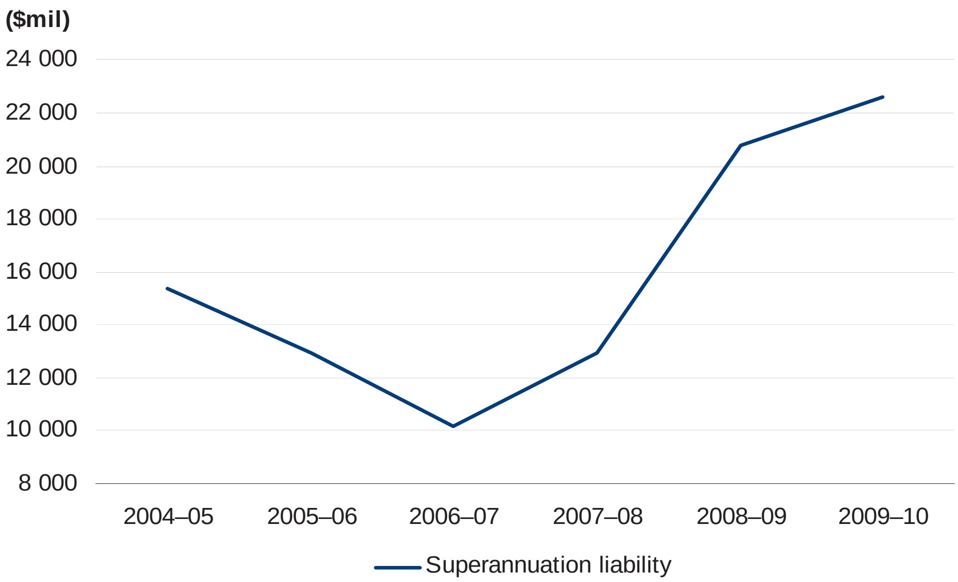
The ESSS Defined Benefit Fund pays benefits as a lump sum based on salary, period of membership, age and contribution rates during membership. Benefits are payable on retirement, resignation, retrenchment, death or disability.

The unfunded superannuation liability represents the difference between the value of superannuation benefits accrued to date and the value of superannuation plan assets. The liability exists due to the plans assets being insufficient to cover the accrued benefits payable to members.

The superannuation schemes themselves are not consolidated by the state as they belong to the members, however the state has a legislated obligation to pay the unfunded superannuation liabilities of the funds.

Figure 3J shows the balance of the state's unfunded superannuation liability over the last six financial years.

Figure 3J
Unfunded superannuation liability–State of Victoria



Source: Victorian Auditor-General's Office.

Since 2004–05 the state’s total unfunded superannuation liability has continued to grow reaching $22 597.7 million in 2009–10, an increase of 47.3 per cent over six years.

When calculating the liability, accounting standards require that the value of superannuation benefits accrued at balance date be discounted to present value using a long-term bond rate. Specifically, the fixed interest Commonwealth Government bond rate is used.

In 2009–10, the state’s unfunded superannuation liability increased by 8.9 per cent, from $20 755.1 million as at 30 June 2009 to $22 597.7 million as at 30 June 2010. Of this increase, $1 435.8 million is recognised in the net result of the state as a ‘net actuarial loss of superannuation defined benefits plans’ and is a result of the Commonwealth Government bond rate used to discount the liability, reducing from 5.7 per cent to 5.3 per cent.

The ESSS defined benefit fund is open to operational employees of the Victorian Police, Metropolitan Fire & Emergency Services Board, Ambulance Victoria, Country Fire Authority and certain other positions in the Department of Sustainability and Environment and the Department of Primary Industries. The remaining $406.8 million increase in the liability is predominantly the result of additional members joining the fund at 30 June 2010 compared to the prior year, actual salary increases, and changes in inflation assumptions.

The ESSS fund’s expected long-term investment return on the assets invested is 8 per cent. In 2009–10, the return was 10.3 per cent (negative 15.1 per cent in 2008–09) compared to the six-year average of 4.6 per cent.

Provision for insurance claims

The AFR includes a provision for insurance claims relating primarily to the Victorian WorkCover Authority (VWA), the Transport Accident Commission (TAC) and the Victorian Managed Insurance Authority. The provisions for insurance claims are independently assessed by actuaries and is the estimated amounts payable at 30 June in respect of claims reported but not paid, claims incurred but not reported, and the anticipated direct and indirect costs of settling those claims.

In 2009–10, the state’s provision for insurance claims increased by 9.3 per cent, from $16 625.6 million to $18 172.1 at 30 June 2010. This increase was predominately at TAC and VWA.

A $934.2 million increase at TAC is attributed to:

- a 3 percentage point increase in the ‘risk margin’ factored into calculations to allow for the inherent uncertainty in the outstanding claims estimate
- an increase in the assumed short-term inflation rate and a reduction in the short-term discount rate.

A $660.1 million increase at VWA is attributed to:

- an increase in the assumed short-term inflation rate and a reduction in the short- and medium-term discount rates
- the impact of the *Accident Compensation Amendment Act 2010* passed in Parliament on 11 March 2010.

Onerous contract provision

The State Electricity Commission of Victoria (SECV) recognises an onerous contract provision at the end of each financial year in accordance with AASB 137 *Provisions, Contingent Liabilities and Contingent Assets*. This provision represents obligations under the low flexible tariff electricity arrangements entered into by the state in 1984 to attract investment in the Point Henry and Portland aluminium smelters. The tariff arrangements require the state, through SECV, to subsidise the lower electricity prices charged to the smelters. The SECV is responsible for the future liabilities arising from the tariff arrangements until the smelter contracts expire in 2014 (Point Henry) and 2016 (Portland).

In 2004, the Treasurer executed an agreement and Deed of Indemnity with SECV. Under the Deed of Indemnity, the state is obliged to fund the shortfall relating to SECV's obligations under these electricity supply agreements.

The value of SECV's contractual obligations are assessed at the end of each financial year, taking into account changes in forecast assumptions including aluminium prices, foreign exchange rates, discount rates and electricity prices.

In 2009–10, the state’s onerous contract provision decreased by 26.1 per cent, from $1 209.5 million as at 30 June 2009 to $893.6 million as at 30 June 2010.

The decrease in the onerous contract provision of $315.9 million is a result of:

- one year closer to contract maturity
- increase in forecast aluminium prices from between US$1 681 and US$2 378 per tonne in 2008–09 to between US$2 058 and US$2 468 in 2009–10.

3.4 Key financial indicators

3.4.1 Infrastructure renewal

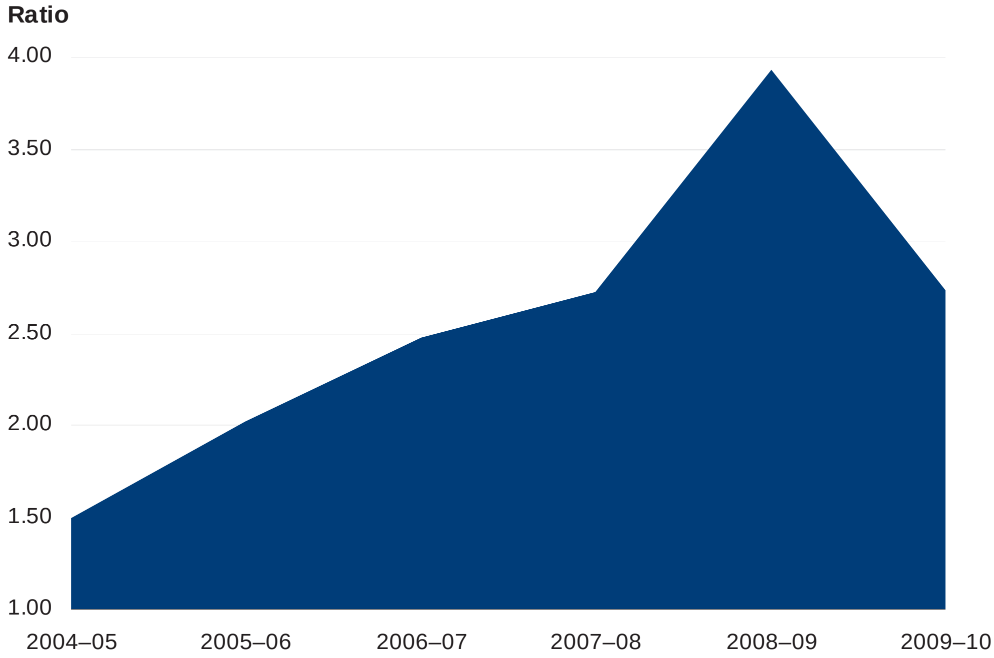
The state’s infrastructure assets are primarily roads, transport networks, ports and water infrastructure assets. In 2009–10, the value of the state’s infrastructure assets increased by 12.2 per cent, from $55 984.1 million as at 30 June 2009 to $62 788.8 million as at 30 June 2010.

A significant challenge for the state is to maintain existing infrastructure and to provide for new infrastructure required to achieve the state’s social, economic and environmental objectives.

One indicator of the state's financial performance in relation to infrastructure maintenance is the difference between the rate at which existing infrastructure is being used up and the rate at which it is being replaced. This can be measured by comparing the amount spent investing in assets with the annual depreciation charge on these assets. A renewal ratio higher than 1:1 indicates that infrastructure expenditure exceeds depreciation.

Figure 3K shows the results calculated for infrastructure replacement for the financial periods 2004–05 to 2009–10.

Figure 3K
Plant, equipment, vehicles and infrastructure systems



Source: Victorian Auditor-General's Office.

Based on reported balances, the infrastructure replacement ratio for the state increased from 1.5:1 in 2004–05 to 2.7:1 in 2009–10, indicating that the state's spending on infrastructure has increased steadily over the period.

The state currently has new infrastructure programs in place for schools, transport and water infrastructure. These programs will progressively increase the state's asset base, increasing the future maintenance requirements of the state. Spending on maintenance will need to increase in line with the increase in infrastructure to avoid a maintenance backlog and consequential shortening of asset life, and greater overall life cycle costs.

Caution is required when interpreting these results, as annual expenditure on infrastructure includes both upgrade of existing assets and acquisition of new assets. At this point it is not possible to conclude to what extent asset upgrades alone are keeping pace with consumption (depreciation expense) of those assets.

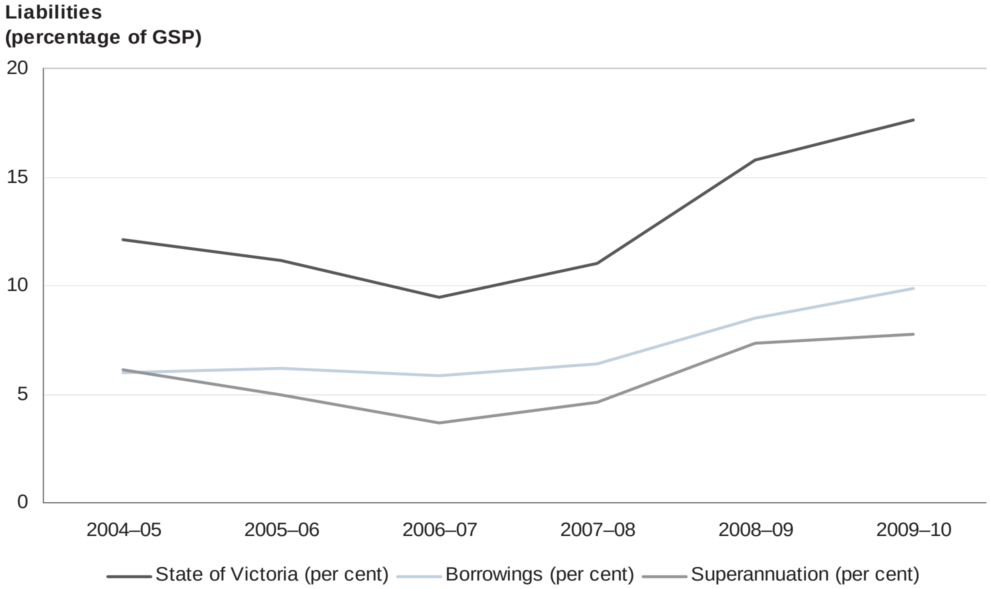
3.4.2 Debt sustainability

Sustainable debt is the level of debt that can be paid back, principal and interest, given economic growth, interest rates and the future surplus generating capacity of the state. The measurement of debt sustainability is difficult as debt is generally repaid over a significant period where these factors are not able to be reliably forecast.

An indicator of debt sustainability is the ratio of borrowings and the unfunded superannuation liability to gross state product. A lower ratio indicates that the state is better able to service its debt obligations.

Figure 3L shows the state’s debt sustainability for the last six financial years.

Figure 3L
Debt sustainability—State of Victoria



Source: Victorian Auditor-General's Office.

Reduced levels of gross state debt resulted in a reduction of this ratio over the financial periods 2004–05 to 2006–07.

Increased debt levels between 2006–07 and 2009–10 reflects the commitment to growing the state’s infrastructure, represented through an increased capital program.

3.5 Risks to financial performance and condition

There are a number of external factors that need to be continually monitored by the state in managing its short- and long-term fiscal sustainability.

External factors relevant to the state’s future financial performance and condition include:

- the performance of the national economy influences the spending and investment decisions of the Commonwealth Government
- volatility in the performance of the Australian and international financial and equity markets, significantly influencing the investment revenues, interest on debt and superannuation expenses of the state
- demographic trends expected to impact on the level and nature of services provided by the government
- the public sector workforce wage and salary growth, and the need to maintain sustainable workforce numbers whilst meeting increased demands on service delivery.

4 Significant developments

At a glance

Background

There were a range of significant projects and developments, and a post balance date event, which occurred during 2009–10, the status and financial implications of which are set out in this chapter.

Findings

- The Victorian Transport Plan outlines $38 billion of transport projects to improve all modes of transport. Under the plan:
  - nine new trains have been delivered in 2009–10, one less than contracted
  - the state will pay an estimated $1 340 million to upgrade the M1 and will receive 50 per cent of any extra profits of Citylink that are a consequence of those works. These extra profits will be calculated after Transurban has recovered its own construction costs of $166 million.
- To assist in funding the cost of projects under the *Our Water Our Future* plan, Melbourne Water has increased wholesale water charges to the three metropolitan water distribution companies. These increased charges, together with other cost increases, will result in metropolitan customer water prices nearly doubling over the five-year period to 2012–13.
- The total cost to the state of preparing for, financing, designing, constructing, operating and maintaining the desalination plant and associated infrastructure for the 27.75-year operating term from commercial acceptance, is expected to be $18 080 million in nominal dollar terms or $5 410 million in net present value terms. This represents the total estimated project cost to the state of having a desalination plant. The cost of any water purchased will be additional to this amount. If the state purchased the maximum 150 gigalitres per year for the entire operating term the total additional cost would be $5 834 million in nominal dollar terms, or $1 260 million in net present value terms.
- Victoria's delivery of the Commonwealth Building the Education Revolution program is behind schedule. At 30 June 2010, the Department of Education and Early Childhood Development has spent $1 010 million, $412 million or 29 per cent less than budgeted, and none of the planned 70 Science and Language Centres were complete.

At a glance - *continued*

Findings – *continued*

- Control weaknesses in the new myki ticketing system meant that it was not possible to form an opinion on the completeness and accuracy of myki revenue for the year ending 30 June 2010. Accordingly, a qualified audit opinion was issued on the 2009–10 financial report of the Transport Ticketing Authority.
- During the myki start up period up to 30 June 2012 the state decided to accept the risk associated with the introduction of the new ticketing system and has guaranteed fare box revenue payments to the train and tram operators. The state will therefore fund any shortfall between the guaranteed fare box revenue and the actual fare box revenue. In 2009–10, the state paid a total of $22.4 million above the actual amount of fare box revenue collected. This was an additional cost to the state borne by the Department of Transport primarily due to lower patronage growth on trains and buses, and a decline in tram patronage. Further additional costs may also arise in 2010–11 and 2011–12 if there is a shortfall in fare box revenue collected compared with the guaranteed revenue. Therefore, in addition to any adverse revenue implications associated with the new ticketing system, the state will also bear the cost of these impacts and any further patronage movements.
- On 31 August 2009 the state completed contracts with private sector providers to operate and maintain Melbourne's passenger train and tram networks. The current contracts include the following significant changes from the previous franchise arrangements:
    - it is estimated that the state will pay $2.31 for each train passenger boarding in the 2010–11 financial year. This is an 18 per cent increase when compared to the cost per boarding of $1.95 in 2008–09, and is due to higher maintenance payments by the state in the new contracts. The same analysis for trams shows a 21 per cent increase which will be offset by the state retaining 10 per cent more fare box revenue under the new contracts
    - a performance bonus of $0.74 million was paid to the tram operator for the period 1 December 2009 to 30 June 2010, and performance penalties of $4.8 million were levied on the train operator for the same period. The capping of performance bonuses and penalties under the new franchise arrangements has reduced the financial bonuses that the state paid by $1.16 million and the financial penalties that it received by $10.6 million. The introduction of capping was designed to influence the bids from the franchisees who may have otherwise sought higher franchise payments.

4.1 Introduction

The status and financial implications of the post balance date event, and the more significant projects and developments undertaken in 2009–10, are set out in this part. The projects and developments have been selected where there is a reasonable expectation that Parliament or the public would require timely, independent disclosure of the related financial implications.

4.2 Post balance date event

On 4 and 5 September 2010, significant rain caused flooding across parts of Victoria. The floods are expected to have financial implications for the state as follows:

- the Premier announced on 5 September 2010 that the state would provide emergency relief grants to people affected by the floods
- significant damage to public assets
- insurance claims could be made against the state's insurer, the Victorian Managed Insurance Authority.

The cost to the state could not be estimated at the time of finalising this report. Note 36 of the *Annual Financial Report of the State of Victoria, 2009–10* (AFR) provides disclosure of this post balance date event.

4.3 Significant projects

4.3.1 Victorian Transport Plan

The Victorian Transport Plan (VTP) was released on 8 December 2008 for the period to 2020 and beyond. The plan encompasses all modes of transport and sets out the government's direction and key projects for road, rail, buses, freight and cycling.

The VTP outlines major initiatives with short-, medium- and longer-term goals. At the completion of each year of the plan, the Department of Transport releases a report card. The 2010 report card was released on 12 July 2010. The report card outlines what has been delivered against the plan. However it does not provide an analysis of spending against the $38 billion expected cost of projects detailed in the VTP. Below we provide a financial analysis of the new trains, M1 upgrade and Peninsula Link projects in the VTP, which are the larger projects currently underway.

New trains

The VTP predicts an increase in patronage on public transport coinciding with a predicted population increase to seven million people in Victoria by 2036. In recognition of the expected patronage growth and current overcrowding, the VTP commits the government to purchase 70 new trains as follows:

- 18 new X'trapolis trains already on order when the VTP was published at a cost of $260 million
- 20 additional X'trapolis trains at a cost of $342 million
- 32 new generation trains at a cost of $1 969 million.

Figure 4A details budget, actual cost and future commitments for the new X'trapolis trains as at 30 June 2010.

Figure 4A
Budget, actual cost and commitments for new X'trapolis trains as at 30 June 2010

Number of new trains	Original budget ($mil)	Actual cost ($mil)	Committed cost ($mil)
38 – Xtrapolis	602	389	213

Source: Victorian Auditor-General's Office.

The delivery of new X'trapolis trains commenced in December 2009. At 30 June 2010, the state had paid $389 million towards the purchase of 38 trains representing:

- full payment of $130 million against nine trains received
- advance payments on order placement and interim payments totalling $259 million.

As at 30 June 2010, nine new X'trapolis trains had been delivered which is one less than the 10 trains contracted to be delivered. The delay in receiving trains was due to the need to install CCTV systems prior to use. Five further trains have been delivered as at 31 August 2010. It was contracted that 12 new trains would be delivered in 2010–11 and 16 new trains in 2011–12. This has been rephrased to 13 in 2010–11 with 16 still to be delivered in 2011–12.

As at 31 August 2010, none of the 32 new generation trains had been ordered.

The X'trapolis trains are purchased from a French company who make the body of the trains in France. The first nine trains were assembled in Italy and later shipped to Australia for electronic fit out. The remaining nine trains are to be assembled in Ballarat. The cost to purchase X'trapolis trains can therefore be impacted by changes in exchange rates between the Euro and the Australian dollar. For the 18 X'trapolis trains ordered before the VTP was announced, the cost per train was $14.4 million. For the 20 X'trapolis trains committed to in the VTP the cost has increased to $17.1 million per train, an increase of 19 per cent. This was principally because the Australian dollar became weaker against the Euro between the time of the original order and the exercising of the option to purchase the additional 20 trains.

The $1 969 million expected cost for the 32 new generation trains includes operating costs for 2015–16 to 2020–21, capital works costs and the cost of the new trains. The new generation trains will have 30 per cent greater passenger capacity than existing trains, more hand holds and more doors for quicker boarding.

M1 Upgrade

The M1 Upgrade is a road infrastructure project upgrading the Monash Freeway, City Link and West Gate Freeway, including strengthening of the West Gate Bridge.

On 25 July 2006, VicRoads and Transurban signed a M1 corridor redevelopment deed under which the state upgrades the Monash and West Gate Freeways, and Transurban upgrades the Southern Link section of Citylink. In 2007, the West Gate Bridge strengthening works were added to the project.

VicRoads is managing the works on the Monash Freeway, West Gate Bridge and West Gate Freeway with an expected cost of $1 340 million over the period to July 2011. Transurban's upgrade of the Southern Link section of CityLink has an expected cost of $166 million, to be borne by Transurban.

An analysis of budget, actual cost and commitments for the project components being delivered by the state, as at 30 June 2010, is provided in Figure 4B below.

Figure 4B
M1 Upgrade works and cost analysis as at 30 June 2010

Project component	Original 2006 budget ($mil)	Revised 2007 budget ($mil)	Actual cost ($mil)	Commitments ($mil)	Expected final cost ($mil)	Expected completion date
Monash-West Gate Freeway upgrades	737	1 100	910	101	1 011	31 December 2010
West Gate Bridge strengthening	240	240	200	129	329	31 July 2011
Total	**977**	**1 340**	**1 110**	**230**	**1 340**	

Source: Victorian Auditor-General's Office.

The cost of both the Monash-West Gate Freeway upgrade works, and the West Gate Bridge strengthening works has increased. The original total 2006 budget of $977 million was increased to $1 340 million in 2007 to cover an underestimation of costs, to remediate contaminated land, manage traffic during road works to minimise congestion, and in order to minimise revenue losses to Transurban.

As at 30 June 2010, $1 110 million had been spent and $230 million committed bringing the total cost of both projects to $1 340 million, in nominal dollar terms.

The Monash-West Gate Freeway upgrades are scheduled to be completed by 31 December 2010, and the West Gate Bridge strengthening works are scheduled to be completed by 31 July 2011. Current indications are that both projects will be completed in these time lines.

The M1 corridor redevelopment deed provides for the state to receive 50 per cent of any extra Citylink revenue after Transurban has recovered its construction and operating costs for the Southern Link upgrade works. The amount to be paid to the state will be 50 per cent of the difference between actual net revenue and an agreed revenue trend, and will be calculated three financial years after the upgrades are complete. A contingent asset has been disclosed in Note 34 of the AFR, however, the amount to be received by the state was not able to be quantified.

Peninsula Link

Peninsula Link will be a 27 kilometre road link between EastLink in Carrum Downs and the Mornington Peninsula Freeway in Mount Martha. Peninsula Link is intended to improve travel times between the EastLink-Frankston Freeway and the Mornington Freeway, with a full trip on Peninsula Link taking around 17 minutes.

The Southern and Eastern Integrated Transport Authority, trading as Linking Melbourne Authority (LMA), is the state authority responsible for delivery of Peninsula Link.

With the exception of the Lathams Road overpass, the main project will be delivered through a public private partnership where:

- the private sector will finance, design and build the road, then maintain and operate it for 25 years
- the state will make quarterly service payments which are subject to the performance of the private sector.

Ownership of Peninsula Link will transfer to the state at the end of the 25-year contract.

In January 2010, a consortium was awarded the contract to finance, design, build, maintain and operate Peninsula Link for a 25-year term. The construction cost has been quoted to be $759 million in nominal dollars.

Work on the construction of the $9.4 million Lathams Road overpass is expected to be completed on schedule in early 2011. Further, the main construction works are planned to be finished and operational in early 2013.

The state will make quarterly service payments to the consortium from the date the road is complete. The quarterly service payments are based on the road being available, and the consortium meeting or exceeding set key performance indicators.

The key performance indicators cover four broad areas—operational performance, maintenance, reporting and environmental management. Examples of key performance indicators in the contract include:

- emails from the public responded to in seven business days
- emergency calls made from roadside help phones answered by a person within 60 seconds, 24-hours a day, seven days of the week
- 30 minutes to respond to an incident during peak times
- periodic maintenance to be completed within 60 days of the scheduled time
- monthly water quality measurement targets met.

The quarterly service payments can be reduced if the key performance indicators are not achieved.

The state's total financial commitment to Peninsula Link including the Lathams Road overpass, is $2 752.0 million nominal dollars. The 2009–10 financial statements of LMA report this commitment as:

- $2 295.3 million nominal dollars or $844.8 million net present value (year 2013 dollars) commitment for the design and construction of the Peninsula Link over the project term
- $368.0 million operating commitments in nominal dollars, to operate and maintain the road over the 25-year period
- $79.3 million of capital commitments in nominal dollars for related works performed by the state
- $9.4 million work in progress for the Lathams Road overpass.

A finance lease liability and an asset totalling $844.8 million will be recognised by LMA when the road has been completed and the quarterly service payments commence, which is expected to occur in 2013 in accordance with the contract.

The state's interest is protected by a bond required in the third year prior to the expiry of the operations and maintenance term. The bond provides security to the state that the required maintenance and repair work will occur prior to the handover of Peninsula Link at the end of the 25-year period. The value of the bond will be agreed between LMA and the consortium based on six-monthly inspections to determine required maintenance. These inspections will commence three years prior to the handover.

4.3.2 Victoria's water plan: *Our Water Our Future*

The government's long-term strategic plans for water management are detailed in *Our Water Our Future,* released in 2004. This water plan has 110 actions that aim to secure Victoria's water and sustain growth over a 50-year period.

In 2007 the plan was updated and extended, including new projects such as the development of a desalination plant, modernising irrigation channels, and a pipeline to transfer water into Melbourne's water supply. Two progress reports against the 2007 plan were released in June 2008 and December 2009 providing an update on the work done and expected timing for each of the key projects.

To assist in funding the cost of the desalination plant, expansion of Victoria's water grid and the Sugarloaf Pipeline project, Melbourne Water has increased wholesale water charges levied until 2012–13 against the three metropolitan water distribution companies, City West Water Limited, South East Water Limited and Yarra Valley Water Limited. These increased charges, together with the retailers' contributions to the food bowl modernisation project, plus other local cost increases, will result in customer water prices nearly doubling in nominal terms over the 5-year period to 2012–13.

Desalination plant

The Department of Sustainability and Environment (DSE) is responsible for the delivery of the desalination plant. The plant is being delivered as a public private partnership.

On 30 July 2009, the successful consortium made up of three companies that are designing, financing, constructing, operating and maintaining the desalination plant and associated infrastructure was announced. Financial close for the project was achieved on 2 September 2009. The consortium will operate and maintain the plant for a 27.75-year term from commercial acceptance.

The desalination plant will produce up to 150 gigalitres per annum of drinking water and have long marine inlet and outlet tunnels to assist in the protection of coast and marine areas. Water will be transferred to Melbourne and regional areas by an 84 kilometre transfer pipeline, powered using an 87 kilometre underground power supply. The contract between the state and consortium requires that renewable energy will fully offset the electricity used by the plant and transfer pipeline.

Construction of the desalination plant commenced in September 2009 and, subject to commercial acceptance being achieved, the state anticipates the plant will be capable of supplying water from December 2011.

Figure 4C details the state's total financial commitments to the consortium and other costs it expects to incur on the project.

Figure 4C
Estimated cost of the construction and operation of the desalination plant and associated infrastructure – 30 June 2010

	Nominal value ($mil)	Net present value ($mil)
Financial commitments to the consortium:		
• plant construction costs, including capitalised finance costs and other fees, which will lead to the recognition of a leased asset and liability of the state	13 549	4 112
• plant operating and maintenance commitments over the 27.75-year period of operation (inclusive of GST)	2 259	478
Sub total (a)	**15 808**	**4 590**
• capital commitments, and estimated operating and maintenance costs associated with an underground power supply for the project pipeline and plant refurbishment during the period of operation (inclusive of GST)	2 373	611
• less GST recoverable from the Australian Taxation Office	(421)	(99)
Total (b)	**17 760**	**5 102**
Other estimated costs of the state:		
• estimated project development and management costs, environmental assessments, land acquisition and compensation payments (c)	320	308
Total estimated cost (d)	**18 080**	**5 410**

Note: (a) Note 33 to the 2009–10 AFR report separately highlights the state's commitments for the design, financing, construction, operation and maintenance costs of the plant as shown in this table. Note 19 to the 2009–10 DSE financial report states that the leased asset and liability will be recognised upon commercial acceptance, which is expected to occur at the end of 2011.
(b) These payments are subject to satisfactory performance and an abatement regime.
(c) These costs will be incurred by DSE.
(d) The net present value represents the estimated present value of the cost to the state of the plant, including construction costs, fixed operating and maintenance costs over the 27.75-year period, the capital costs of an underground power supply and the cost of plant refurbishment during the period of operation, and the estimated cost of operating and maintaining the underground powerlines. It excludes costs associated with any water purchased during the contractual period.

Source: Victorian Auditor-General's Office.

Note 33 to the 2009–10 AFR report separately highlights the state's commitments to the consortium for the construction, operation and maintenance of the plant totalling $15 808 in nominal dollar terms, or $4 590 million in net present value terms, which form part of the total estimated project cost. Other state costs of the plant, as set out in Figure 4C, include capital, operating and maintenance commitments to the consortium associated with an underground power supply for the project pipeline and plant refurbishment during the period of operation, and other financial commitments of DSE.

The total estimated project cost to the state of the desalination plant for the 27.75-year operating term is therefore expected to be $18 080 million in nominal dollars or $5 410 million in net present value terms. The state will pay this amount to make the desalination plant available. The cost of any water purchased will be additional to this amount. If the state purchased the maximum 150 gigalitres per year for the entire operating term the total additional cost would be $5 834 million in nominal dollar terms, or $1 260 million in net present value terms. The actual amount of water to be purchased will be determined based on dam storage levels reaching a target of 65 per cent.

With two reconciling items, this is consistent with the Partnerships Victoria project summary titled *Victorian Desalination Project*, dated November 2009. This project summary set out the cost of the plant as $5 720 million in net present value terms, based on estimated payments to the consortium over the total operating term. The reconciling items are:

- other related estimated costs of the state comprising project development and management costs, environmental assessments, land acquisition and compensation payments, totalling $308 million in net present value terms
- the impact of DSE using a different discount rate and time period over which the calculation is made for valuing the financial commitments to the consortium for financial reporting purposes under the Australian accounting standards, totalling $642 million in net present value terms.

This $5 720 million estimate includes the cost of purchasing the maximum volume of water, $1 260 million in net present value terms.

Food Bowl Modernisation

The State Owned Enterprise for Irrigation Modernisation in Northern Victoria trading as NVIRP, was established in December 2007 to deliver the $2 billion Food Bowl Modernisation irrigation system.

The program aims to provide the Goulburn Murray Irrigation District (GMID) with an irrigation delivery system that will reduce water losses and assist with the region's economic viability. The project is being delivered in two stages. Stage 1 is aiming to recover approximately 225 gigalitres of water per annum, and stage 2, 200 gigalitres of water per annum, as a long-term average. Water to be recovered relates to water that is currently lost to the system through leakage, seepage, unplanned spills or releases, evaporation and inaccurate metering.

The irrigation modernisation program is expected to reduce water losses through the installation and construction of automated gates, computer metering, channel lining and embankment improvement. Any water savings achieved from stage 1 will be shared equally by irrigators in the GMID, the environment and metropolitan Melbourne customers pursuant to the Water Savings Supply and Transfer Agreement.

Stage 1 of the project commenced in 2008 with the initial construction works managed by the Goulburn-Murray Rural Water Corporation (G-MW) under an alliance arrangement. NVIRP is now managing the remainder of the stage 1 construction works using a managing contractor. Stage 1 is scheduled to be finished by 31 December 2012 at a cost of $1 004.5 million. This cost includes construction works of $680.1 million, payments for farm connections of $274 million and NVIRP operating costs of $50.4 million.

A Water Savings Supply and Transfer Agreement between G-MW, Melbourne Water and the metropolitan water distribution companies was executed in June 2010. The metropolitan water distribution companies will have access to the water savings from GMID. Water savings will be transferred to Melbourne via the 70 kilometre Sugarloaf Pipeline.

The stage 1 cost of $1 004.5 million will be funded by contributions totalling $100 million each from the three metropolitan water distribution companies, a further $100 million from G-MW and $604.5 million from DSE. The three metropolitan water distribution companies had each contributed $56.7 million as at 30 June 2010 and G-MW is due to pay $50 million in 2011–12 and $50 million in 2012–13. The contributions are held by DSE and distributed to NVIRP in accordance with milestone achievements outlined in the funding agreement.

Ownership and responsibility for the operation of the new irrigation infrastructure will transfer from NVIRP to G-MW as discrete parts of the capital works are completed.

As at 30 June 2010, $274.9 million had been spent on construction works for stage 1, including:

- $113.0 million of initial works including automated gates, computer meters, channel lining and embankment improvements undertaken by G-MW before the program was transferred to NVIRP
- $87.7 million of completed capital works transferred from NVIRP to G-MW in 2009–10
- $74.2 million of construction works in progress as at 30 June 2010.

Stage 2 provides for the upgrade of the remaining farm connections not included in stage 1. This stage is expected to deliver a further 200 gigalitres of water savings at an expected cost of $1 000 million. The state has sought funding for stage 2 of the project from the Commonwealth Government following the submission and approval of a business case. Preliminary costs amounting to $3 million have been incurred to date, mainly for the development of the business case.

Sugarloaf Pipeline

The Sugarloaf Pipeline connects Melbourne's water supply system with the Goulburn River system via a 70 kilometre pipeline. Completed in February 2010, the pipeline is expected to transfer up to 75 000 megalitres per annum of water savings to Melbourne achieved under the Food Bowl Modernisation program. As at 16 August 2010, Melbourne Water had advised that 17 980 megalitres had been delivered by the pipeline. These water savings are metered at the Goulburn River Pump Station, and are managed by G-MW and accessed by Melbourne Water for supply to the metropolitan water distribution companies. Water savings will be confirmed by an annual audit organised by DSE, pursuant to the Water Savings Supply and Transfer Agreement.

The construction of the Sugarloaf Pipeline was managed by Melbourne Water under an alliance arrangement entered into in April 2008 with an original budget cost of $750 million. This budgeted cost comprised:

- $625 million for construction of a 70km pipeline connecting the Goulburn River to the Sugarloaf Reservoir
- $125 million for improvements to the Sugarloaf Reservoir and upgrades to Melbourne's water treatment and distribution network to accept this new source of water.

The budgeted cost of $750 million was revised down to $692.2 million. This $57.8 million reduction was principally due to the decision to construct a pump station at Preston and associated works at a cost of $20 million, rather than the original $70 million cost for a pipeline and works to upgrade downstream transfer.

The Sugarloaf Pipeline was commissioned ahead of schedule in February 2010. Final completion will occur after reinstatement works, environmental compliance, easement acquisition and defect rectification have been finalised.

Details of the original budget, revised forecast, actual costs and future commitments for the Sugarloaf Pipeline are provided in Figure 4D. This shows that the pipeline is expected to be delivered for the revised budget cost of $692.2 million.

Figure 4D
Sugarloaf Pipeline financial data as at 30 June 2010

	Original budget ($mil)	Revised budget ($mil)	Actual cost ($mil)	Future committed cost ($mil)	Commission date
Sugarloaf Pipeline	625.0	608.8	591.6	17.2	February 2010
Upgrade to water treatment and distribution network	125.0	83.4	67.4	16.0	October 2010
Total	**750.0**	**692.2**	**659.0**	**33.2**	

Source: Victorian Auditor-General's Office.

Northern Sewerage Project

Announced in 2004 under the Victorian State Government's Yarra River Action Plan, the Northern Sewerage Project (NSP) involves the construction of 12.5 km of new sewer from Reservoir to Essendon.

The NSP is a joint project being undertaken by the Melbourne Water Corporation and Yarra Valley Water Limited. Total project costs were originally estimated at $650.1 million but have been revised down to $516.1 million. This substantial project saving of $134 million has been realised during the construction stage due to design reviews, construction risk management, and adverse ground conditions not being encountered.

The project commenced in August 2007 and is ahead of schedule. Works undertaken by Melbourne Water are now expected to be completed and commissioned by October 2011 and Yarra Valley Water Limited by February 2012. The original target date for the project was mid 2012.

Figure 4E provides details of the original budget, revised budget, actual costs and future commitments for the NSP as at 30 June 2010.

Figure 4E
Northern Sewerage Project financial data as at 30 June 2010

	Original budget ($mil)	Revised budget ($mil)	Actual cost to 30 June 2010 ($mil)	Future committed cost ($mil)
Melbourne Water Corporation	422.1	336.1	273.3	62.8
Yarra Valley Water Limited	228.0	180.0	124.5	55.5
Total	**650.1**	**516.1**	**397.8**	**118.3**

Source: Victorian Auditor-General's Office.

Figure 4E shows that the overall project cost is expected to be $516.1 million, in accordance with the revised budget.

4.3.3 Building the Education Revolution

The Commonwealth Government has committed funding of $16.2 billion over 3 years to provide new facilities and refurbishments in Australian schools. The program is called Building the Education Revolution (BER) and is intended to provide school facilities that meet the needs of 21st century students and teachers.

The three programs within the BER are:

- **Primary Schools for the 21st Century**—$14 100 million for all Australian primary schools, K-12 schools (primary school component) and special schools to build new facilities, such as libraries, multipurpose halls or classrooms, or to upgrade existing facilities

- **Science and Language Centres for 21st Century Secondary Schools**—$821.8 million for all schools in Australia, for the construction of new science laboratories or language learning centres
- **National School Pride program**—$1 288 million for all schools in Australia, government and non-government, for funding minor capital works and maintenance projects.

The objectives of the BER are to:

- provide economic stimulus through the rapid construction and refurbishment of school infrastructure
- build learning environments to help children, families and communities participate in activities that will support achievement, develop learning potential and bring communities together.

In Victoria, the Department of Education, Employment and Childhood Development (DEECD) is responsible for achieving the outcomes and outputs of the state's component of the BER program.

Building the Education Revolution program funding

The Commonwealth Government has allocated approximately $3.8 billion of BER project funding to Victorian schools over three years, and the projects are to be completed by 30 June 2011.

DEECD facilitates the payments to the Catholic and Independent school sectors but is not responsible for delivering the BER program outcomes. DEECD is only responsible for the government school sector and its associated BER program outcomes.

Figure 4F shows the allocation of Victoria's BER project funding by program and type of education provider.

Figure 4F
Building the Education Revolution project funding by program and education provider

BER funding program	Government ($mil)	Catholic ($mil)	Independent ($mil)	Total ($mil)
Primary Schools for the 21st Century	2 203	750	321	3 274
Science and Language Centres for the 21st Century	137	30	29	196
National School Pride	205	67	30	302
Total BER funding	**2 545**	**847**	**380**	**3 772**

Source: Victorian Auditor-General's Office.

Current status of the Building the Education Revolution program

Figure 4G shows the amount of BER project funding received and BER expenditure to 30 June 2010 for government schools.

Figure 4G
Building the Education Revolution project funding and expenditure for the three-year program to 30 June 2010

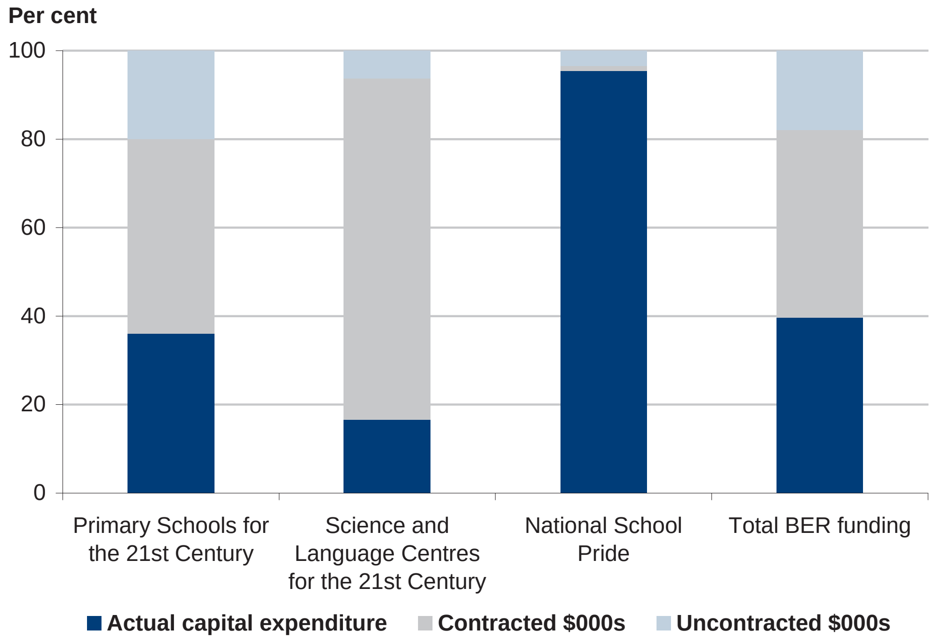
BER funding program	Total funding ($mil)	Funding received ($mil)	Budgeted expenditure ($mil)	Actual expenditure ($mil)	Actual to budget (per cent)
Primary Schools for the 21st Century	2 203	1 277	1 097	792	72%
Science and Language Centres for the 21st Century	137	137	120	23	19%
National School Pride	205	205	205	195	95%
Totals	**2 545**	**1 619**	**1 422**	**1 010**	**71%**

Source: Victorian Auditor-General's Office.

At 30 June 2010, DEECD has spent $1 010 million, $412 million or 29 per cent less than budgeted. Spending has been delayed as DEECD wanted to achieve best value for money through its procurement practices in a relatively buoyant market.

Figure 4H shows the government's actual, contracted and un-contracted project expenditure by BER program as at 30 June 2010.

Figure 4H
Actual, contracted and uncontracted project expenditure as at 30 June 2010



Source: Victorian Auditor-General's Office.

When the BER was announced, projects were to commence by June 2009 and be completed by 30 June 2011. The building of new science and language centres was to be fast tracked and completed by 30 June 2010. An analysis of completed BER projects by program is contained in Figure 4I.

Figure 4I
BER project status as at 30 June 2010

BER funding program	Planned projects	Not started	Design and construction phase	Completed projects	Completed projects (per cent)
Primary Schools for the 21st Century	1 253	1	1 160	92	7%
Science and Language Centres for the 21st Century	70	0	70	0	0%
National School Pride	1 581	0	216	1 365	86%
Total	**2 904**	**1**	**1 446**	**1 457**	**50%**

Source: Victorian Auditor-General's Office.

The National School Pride program is almost complete, with 86 per cent of projects completed at 30 June 2010. The Primary Schools for the 21st Century (P21) program has 7 per cent of projects complete, and none of the Science and Language Centres for the 21st Century (SLC) projects are complete. DEECD forecasts the SLC projects will be completed by December 2010, six months after the original deadline and the Commonwealth Department of Education, Employment and Workplace Relations (DEEWR) has agreed to the extended completion date. As at 30 June 2010, 21 of the 70 SLC projects had not commenced construction.

The P21 program is expected to be completed by September 2011, three months after the original deadline. However, as at 30 June 2010, only 62 per cent of projects had commenced construction. DEECD have advised DEEWR of the delays and transfer of project funding into 2011–12 has been agreed.

As at 31 August 2010, DEECD have completed more projects with 15 per cent of the P21 projects complete, 5 per cent of the SLC projects complete and 89 per cent of the National School Pride projects complete.

Administration costs

The cost to administer the BER funding was expected to be 1.5 per cent of project costs. DEECD has been allocated $38 million to administer the program, which represents 1.5 per cent of total BER project funding.

A breakdown of the allocated administration costs per program and actual administration costs incurred to 30 June 2010 are provided in Figure 4J.

Figure 4J
Building the Education Revolution program administration fee allocation and actual spending to 30 June 2010

BER funding program	Funding allocated to administration fees ($mil)	Actual administration fee expenditure ($mil)	Funding spent (per cent)
Primary Schools for the 21st Century	33.0	11.9	36%
Science and Language Centres for the 21st Century	2.1	0.3	14%
National School Pride	3.1	2.9	94%
BER funding program	**38.2**	**15.1**	**40%**

Source: Victorian Auditor-General's Office.

At 30 June 2010, DEECD has spent $15.1 million or 40 per cent of its $38.2 million administration funding. This spending on administration across the three programs is consistent with the level of spending on the BER as a whole as outlined in Figure 4G.

4.3.4 *Victorian Schools Plan*

The *Victorian Schools Plan* (VSP) is the government’s 10-year plan to transform Victorian schools by rebuilding, renovating or extending all government schools by 2016.

The VSP has committed $1 934 million of state investment towards school infrastructure, recognising that high quality infrastructure is critical in delivering educational outcomes.

A critical condition of the Commonwealth BER funding is that existing capital investment plans, such as the VSP, are to continue. This means that BER investment must be in addition to the state’s existing capital investment.

Current status of the *Victorian Schools Plan*

The first instalment of $239 million under the VSP was allocated for the 2007–08 financial year in the state Budget. Subsequently, each state Budget has made further allocations under the plan. Figure 4K shows the amount of Budget funding allocated over the past four years and the planned Budget allocations to 2012–13.

Figure 4K
Victorian Schools Plan—Budget allocations to 30 June 2010

Financial Year	Annual budget allocation ($mil)	Cumulative budget allocation ($mil)
2007–08	239	239
2008–09	506	745
2009–10	525	1 270
2010–11	474	1 744
2011–12	187	1 931
2012–13	3	1 934
Total	**1 934**	

Source: State Budget papers for 2007–08, 2008–09, 2009–10, 2010–11.

To 30 June 2010, DEECD has spent a total of $1 108 million on projects under the VSP, compared to a total cumulative budget of $1 270 million.

4.3.5 Myki

Myki is the new ticketing system that will replace the Metcard and V/Line ticketing systems and paper tickets on regional buses, providing one integrated ticketing solution for all modes of transport within the state. Myki smartcards allow commuters to credit the card’s balance on the internet either as required or automatically via a credit/debit authority, via the phone or on the transport system itself.

A time line summary of the introduction of the myki system is in Figure 4L.

Figure 4L
Time line summary of the myki system

Year	Event	Capital ($mil)	Operating ($mil)	Total ($mil)
2003	**Original budget**	283.3	715.6	998.9
	The Transport Ticketing Authority (TTA) was established to oversee the current public transport ticketing system and to procure and manage the new myki ticketing system.			
2008	**Revised budget**	460.4	891.3	1 351.7
	An additional $352.8 million was allocated to the project to operate the existing Metcard system and for additional system functionality.			
2009	Myki operated in parallel with Metcard on town buses in Ballarat, Bendigo, Geelong, Seymour, Warragul and the Latrobe Valley			
30 June 2010	**Actual expenditure**	328.8	308.4	637.2
	Commitments	88.5	286.9	375.4
	Uncommitted	43.1	296.0	339.1

Source: Victorian Auditor-General's Office.

It has been announced that Metcard will continue to operate at least until Easter 2011. The contract for the Metcard system expires in March 2012 however the state can terminate the contract with no financial penalty with six months notice.

Cost analysis

Capital expenditure from 17 June 2003 to 30 June 2010 totalled $328.8 million, acquiring the following significant assets for the new ticketing system:

- **hardware**—$143.9 million
- **software**—$108.8 million
- **devices**—$76.1 million.

The operating expenditure from 17 June 2003 to 30 June 2010 totalled $308.4 million and includes:

- **Metcard system operating costs**—$137.8 million
- **service charges; Kamco**—$63.1 million
- **employee benefits**—$32.0 million
- **depreciation**—$12.4 million
- **decommissioning existing system**—$4.5 million
- **other operating costs to 30 June 2010**—$58.6 million.

Control weaknesses

In November 2009, the TTA Board engaged an accounting firm to conduct a systems audit of myki. The scope of the review was to 'form a conclusion on whether the system and controls were adequately designed and operating effectively to ensure accuracy, completeness, integrity and reliability of the system'.

Total fare revenue collected by TTA in 2009–2010 was $648.3 million, of which $10.7 million was collected through myki. TTA collects this revenue for distribution to the transport operators and the Director of Public Transport.

The systems audit found significant weaknesses in the myki system controls and concluded that the myki system did not demonstrate the key attributes of accuracy, completeness, integrity and reliability for the period 1 July 2009 to 30 April 2010. Subsequent reviews were performed by the same auditor for the period 1 May 2010 to 30 June 2010 which found that although steps had been taken to strengthen controls, these did not change the conclusion reached regarding the period to 30 April 2010.

The failure of TTA to implement appropriate controls over the myki system meant that it had not complied with section 45 of the *Financial Management Act 1994* which requires public bodies to implement and maintain an effective control framework over:

- revenue transaction processing and management to ensure that revenue is completely and accurately identified, recorded and collected
- cash handling and banking so that cash from all sources is completely and accurately identified, banked and recorded in the financial records
- reconciliations to ensure they are completed and reviewed in a timely manner to ensure the accuracy of the financial records.

Accordingly, it was not possible to form an opinion on the completeness and accuracy of myki revenue collections for the 2009–10 financial year. TTA's failure to implement appropriate controls over the processing of revenue transactions limited the scope of our audit, and the effect was qualitatively material to the financial statements. As a result, a qualified audit opinion was issued on the financial report of the TTA for the 2009–10 financial year. Disclosure of these control weaknesses was made by TTA in its 30 June 2010 financial statements.

4.3.6 Channel Deepening Project

The Port of Melbourne Corporation (the corporation) promotes sustainable trade growth by providing port services and managing sea channels for vessels to access these services.

In February 2008 the corporation commenced a channel deepening project to allow larger ships with a draught of up to 14 metres to use the port at all tides. The project had an approved total cost of $969 million. An alliance contract was entered into for the dredging of the channels and protection of underwater utilities.

On 25 November 2009 the corporation announced that the project was complete and one month ahead of the scheduled completion date of 31 December 2009. The estimated total cost of the project was $721 million, calculated on 31 May 2010 when most of the project expenditure had been paid. The project therefore finished $248 million under budget assuming no payments are made on a $100 million guarantee issued by the Minister for Roads and Ports. Figure 4M provides a summary of the project budget against estimated actual costs.

Figure 4M
Budget to actual analysis for the Channel Deepening Project

	Original budget ($mil)	Actual expenditure to 31 May 2010 ($mil)	Forecast remaining expenditure ($mil)	Total estimated cost ($mil)	Variance ($mil)
Development and approval	132	127	0	127	(5)
Construction costs	700	583	11	594	(106)
Contingency and risk provision	137	0	0	0	(137)
Totals	**969**	**710**	**11**	**721**	**(248)**

Source: Victorian Auditor-General's Office.

Figure 4M shows a $248 million underspend against the original budget. The corporation advised that the $137 million contingency and risk provision was not required. Further, the $111 million savings in construction costs were due to favourable weather conditions, improved dredging productivity, and the use of an additional dredging vessel.

The forecast remaining expenditure of $11 million shown in Figure 4M is for continued environmental monitoring and reporting.

A contingent liability still exists for the project. As a condition of project approval, the Minister for Environment and Climate Change required the Minister for Roads and Ports to provide a $100 million performance bond for any remedial actions resulting from:

- a breach of the Environmental Management Plan or terms of approval for the Channel Deepening Project
- impacts not anticipated in the Environmental Management Plan and/or the Supplementary Environment Effects Statement.

The contingent liability will continue until:

- the Minister for Environment and Climate Change deems it not required
- the $100 million has been paid in full; or
- 5 December 2012.

4.4 Significant developments

4.4.1 Public transport franchise contracts

On 31 August 2009 the state completed contracts with private sector providers to operate and maintain Melbourne's passenger train and tram networks.

The contracts to run the train and tram franchise are for a maximum of fifteen years, split into an initial eight-year period and a seven-year extension. The right to negotiate the extension will be based on the operator's performance through the first six years. Otherwise after eight years there is a fixed price option to extend the franchise by up to three years. The agreements continue to include performance standards that will be closely monitored and publicly reported.

Under the terms of these agreements the state subsidises public transport services and maintenance of the train and tram networks. The state's arrangement with the providers includes the following significant changes from the previous franchise arrangements:

- increased franchise payments per passenger boarding
- guaranteed fare box payments during the myki start-up period
- capping of performance bonuses and penalties.

Payments to train and tram operators

The state is contracted to make franchise payments to the train provider of $4 861.8 million and to the tram provider of $1 436.8 million over the eight-year operating period. For the period 1 December 2009 to 30 June 2010, the train provider was paid $494.2 million and the tram provider $209.0 million in franchise payments. These franchise payments include a monthly subsidy, rolling stock payments, guaranteed fare box revenue payments until 2012, capital grants, and maintenance funding.

Responsibility for the conduct of maintenance of the networks resides with the operators. The state has committed to contribute $1 825 million for maintenance of the train network and $421.8 million for maintenance of the tram network, over eight years.

A breakdown of the total franchise payments over the eight-year contract period for the train network is set out in Figure 4N and for the tram network is set out in Figure 4O.

Figure 4N
Payments to the train operator over the eight-year contract

Financial period	Total monthly subsidies ($mil)	Capital grants ($mil)	Rolling stock payments ($mil)	Other[(a)] ($mil)	Total franchise payment ($mil)	Fare box revenue ($mil)	Net franchise payments ($mil)
1 December 2009 to 30 June 2010[(b)]	246.9	13.2	49.8	184.3	494.2	131.7	362.5
2010–11	354.4	35.8	83.6	327.9	801.7	278.6	523.1
2011–12	358.8	17.8	91.0	349.0	816.6	298.6	518.0
2012–13	359.9	18.4	84.2	51.5	514.0	–	514.0
2013–14	366.1	16.2	80.2	54.9	517.4	–	517.4
2014–15	338.0	16.7	90.3	56.9	501.9	–	501.9
2015–16	324.7	2.5	82.1	59.0	468.3	–	468.3
2016–17	329.2	2.7	77.4	61.3	470.6	–	470.6
1 July 2017 to 30 November 2017	124.8	10.9	77.7	63.7	277.1	–	277.1
Total	**2 802.8**	**134.2**	**716.3**	**1 208.5**	**4 861.8[(c)]**	**708.9**	**4 152.9**

Note: (a) Other includes guarantee fare box revenue of $149.2 million in 2009–10, $278.6 million in 2010–11 and $298.6 million in 2011–12.
(b) Actual figures for the period 1 December 2009 to 30 June 2010.
(c) Total franchise payments of $4 861.8 million includes $1 825 million maintenance allowance.
Source: Victorian Auditor-General's Office.

Figure 4O
Payments to the tram operator over the eight-year contract

Financial period	Total monthly subsidies ($mil)	Capital grants ($mil)	Rolling stock payments ($mil)	Other[(a)] ($mil)	Total franchise payment ($mil)	Fare box revenue ($mil)	Net franchise payments ($mil)
1 December 2009 to 30 June 2010[(b)]	62.0	4.2	20.5	122.3	209.0	98.7	110.3
2010–11	94.3	17.7	35.1	213.1	360.2	194.6	165.6
2011–12	77.4	3.4	35.1	237.0	352.9	216.2	136.7
2012–13	55.3	3.5	35.1	18.1	112.0	–	112.0
2013–14	43.9	3.3	35.1	20.5	102.8	–	102.8
2014–15	39.2	0	35.1	21.8	96.1	–	96.1
2015–16	26.6	0	35.1	23.0	84.7	–	84.7
2016–17	14.7	0	31.5	24.4	70.6	–	70.6
1 July 2017 to 30 November 2017	1.7	0	21.5	25.3	48.5	–	48.5
Total	**415.1**	**32.1**	**284.1**	**705.5**	**1 436.8[(c)]**	**509.5**	**927.3**

Note: (a) Other includes guarantee fare box revenue of $103.6 million in 2009–10, $194.6 million in 2010–11 and $216.2 million in 2011–12.
(b) Actual figures for the period 1 December 2009 to 30 June 2010.
*(c)*Total franchise payments of $1 436.8 million includes $421.8 million maintenance allowance.
Source: Victorian Auditor-General's Office.

In addition to the franchise payments outlined in Figure 4N and 4O, between 2018–2032 the train and tram providers will receive $99.5 million and $13.8 million respectively, to fund rolling stock financing commitments that arise after the eight-year term of the current contracts.

Higher franchise payments are estimated for 2010–11 and 2011–12 recognising the myki start-up period during which the state has guaranteed fare box revenue to the operators. The guaranteed fare box amounts are included in the ‘other’ columns of Figures 4N and 4O. The state will retain all related fare box revenue actually collected during the guarantee period. Actual fare box revenue collected by the state was $230.4 million up to 30 June 2010 and the guaranteed fare box payment by the state was $252.8 million. This $22.4 million difference was primarily due to actual patronage growth across the transport network being lower than the projected 4.0 per cent per annum. Actual patronage growth in 2009–10 was 2.7 per cent on trains and 2.0 per cent on buses, with a decline of 1.2 per cent on trams.

Figure 4N shows that capital grants for improvements to the train network will be higher in the first five years of the eight-year train contract. Similarly, Figure 4O shows capital grants for the tram network to be higher in the first four years of the eight-year tram contract.

It is estimated that the state will pay $2.31 for each train boarding in the 2010–11 financial year. This is an 18 per cent increase when compared to the cost per boarding of $1.95 in 2008–09 under the previous contract. This primarily reflects the state’s requirement that the new train operator increase maintenance spending so that service delivery is maintained, and asset condition is in line with a long-term asset management strategy. The maintenance paid to the franchisee in 2008–09 was $107 million compared to maintenance of $221 million contracted to be paid in 2010–11.

Figure 4P
Cost per boarding analysis for trains and trams

	2008–09			2010–11		
	Patronage (million)	Franchise payments ($mil)	Cost per boarding ($)	Patronage (million)	Franchise payments ($mil)	Cost per boarding ($)
Trains	213.9	416.9	1.95	226.9	523.1	2.31
Trams	178.1	129.0	0.72	189.5	165.6	0.87

Note: The franchise payments for 2010–11 exclude guarantee fare box payments. The years 2008–09 and 2010–11 have been used as these represent full years under both the old and new contracts. While common cost elements have been adopted between 2008–09 and 2010–11, the scope of operation and maintenance requirements in the franchise contracts differ.

Source: Victorian Auditor-General's Office and patronage data from the Department of Transport.

The same analysis for trams shows a 21 per cent increase. However, changes to the distribution of fare box revenue means that the new tram operator will receive 30 per cent of total fare box revenue, a decrease from 40 per cent in 2008–09, As a result, the tram franchise payments are likely to be higher under the new contract but this increase is offset by the state receiving the extra 10 per cent of fare box revenue.

Guaranteed fare box revenue payments

During the myki start-up period, which ends 12 months after the Metcard system is decommissioned, the state has guaranteed fare box revenue payments to the train and tram operators. The state determined, prior to calling for tenders for the public transport franchising arrangements, that it would bear all risks associated with the implementation of myki on fare box revenue. The state will therefore fund any shortfall between the expected fare box revenue which is based on projected fare box revenue, and the actual fare box revenue collected from Metlink and myki from the start of the contracts on 1 December 2009 to 30 June 2012. The contract however does not provide for adjustments to the guaranteed revenue for variations not attributable to the new ticketing system

These payments are included in the 'other' column of franchise payments detailed in Figures 4N and 4O.

The state will pay a total of $988 million in guaranteed fare box payments during the 2010–11 and 2011–12 financial years. This amount was based on the franchisee's forecast of fare box revenue for those years. Offsetting this payment, the state will receive all the fare box revenue actually collected.

For the period 1 December 2009 to 30 June 2010, there was a shortfall of 9 per cent between the fare box revenue collected and the guaranteed fare box payable to the operators. As a result, the state paid a total of $22.4 million above the actual amount collected. This was an additional cost to the state borne by the Department of Transport primarily due to lower patronage growth on trains and buses, and a decline in tram patronage. Further additional costs may also arise in 2010–11 and 2011–12 if there is a shortfall between the fare box revenue collected and the guaranteed fare box payable to the operators in those years. Therefore, in addition to any adverse revenue implications associated with the new ticketing system, the state will also bear the cost of these impacts and any further adverse patronage movements.

After the myki start-up period, the train and tram operators will take a share of the fare box revenue generated from the transport network. A revenue sharing agreement divides the fare box revenue as follows:

- 40 per cent for the train network
- 30 per cent for the tram network
- 30 per cent to Department of Transport, comprising 20 per cent for the bus network and the remainder for other public transport costs.

Performance penalties and bonuses

The previous and current contracts with train and tram operators contained performance penalties and bonuses. In the new contracts between the operators and the Director of Public Transport, however, the performance penalties and bonuses are capped. The performance penalty and bonus caps have been introduced:

- due to patronage growth
- as operational performance will be adversely impacted by increased maintenance works over the short-term to medium-term
- to assist with the ongoing viability of the operators
- to provide an incentive to operators to focus on performance.

The train operator is liable to pay penalties to the state up to a maximum of $1 million per month where a performance breach occurs, based on reliability and punctuality benchmarks in the contract. The reliability benchmarks are measured in minutes and consider the impacts of planned and unplanned cancellations, delays, early arrivals and bypass.

Performance penalties levied for the period 1 December 2009 to 30 June 2010 on the train operator were $4.8 million. If penalties had not been capped, the performance penalties would have been $15.4 million for that period. The capping of penalties has reduced the financial compensation received by the state for poor performance.

The tram operator is liable to pay penalties to the state up to a maximum of $500 000 per month where a performance breach occurs, based on reliability and punctuality benchmarks.

The tram operator received $0.74 million in operating bonus payments for the period 1 December 2009 to 30 June 2010 as their net performance result was positive. Without capping, this performance bonus would have been $1.9 million.

The introduction of capping on performance bonuses and penalties was designed to influence the bids provided by the franchisees such that they may have otherwise sought higher franchise payments. Consequently, it is not possible to accurately quantify the overall net impact on the cost of the franchising arrangements to the state due to the introduction of caps on performance bonuses and penalties.

4.4.2 Victorian Bushfire Appeal Fund

Over 78 towns and communities across Victoria were devastated by the bushfires of February 2009. This presented the state with exceptional challenges to provide emergency assistance to affected communities, families and individuals. On 8 February 2009, the Victorian Government, as part of its partnership with the Commonwealth Government and the Australian Red Cross Society, approved the establishment of the 2009 Victorian Bushfire Appeal Fund under section 19(1) of the *Financial Management Act 1994*.

The purpose of the trust fund was to receive donations and other contributions, and disburse these funds to individuals and communities affected by the bushfires.

Monies from the fund have been distributed by the Department of Human Services (DHS) at the direction of an advisory panel. The advisory panel guides, accounts and reports on the disbursement of monies from the trust fund.

In line with the relevant accounting framework, the appeal fund is reported as money held in trust for the beneficiaries, being the individuals and communities affected by the bushfires. The appeal money is not controlled for the benefit of the Victorian Government. Accordingly, the appeal funds are not presented as assets or income of the state or DHS. The 2008–09 and 2009–10 annual reports of DHS have appropriately disclosed the appeal funds as third party funds under management. Disclosure of the fund is also included in Note 35, Funds under management, in the AFR.

Probity over the appeal fund

DHS has established an appropriate framework to provide assurance that the appeal funds are distributed in accordance with the aims of the fund. Critical to that assurance is the operation of an effective internal control regime and the appointment of an independent probity auditor whose role is to review the continued operation of the fund.

For 2009–10, the probity auditor concluded that the operation of the appeal fund was regular in all material respects and the department's control framework over the disbursement of appeal funds is reliable. Our audit coverage supports this conclusion.

Operation of the fund

In February 2010, the Victorian Bushfire Appeal Fund released a 12-month progress report. The report outlined how the appeal funds have been distributed to bushfire affected individuals and communities, and how it intends to provide financial support into the future. A further summarised report will be released by DHS in September 2010 showing the 18 month progress of the Victorian Bushfire Appeal Fund.

Figure 4Q shows that since the appeal fund's inception, $391.6 million has been received, including $8.5 million of interest revenue. The appeal fund has distributed $267.6 million to individuals and communities, leaving a balance in the fund of $124.0 million as at 31 August 2010. Of the $124.0 million remaining 87 per cent has been allocated for future disbursement.

Figure 4Q
Victorian bushfire appeal trust account receipts and payments to 31 August 2010

Item	30 June 2009 ($mil)	30 June 2010 ($mil)	31 August 2010 ($mil) (unaudited)	Total receipts and payments
Opening balance	0	238.2	130.2	
Donations and other contributions	375.1	8.0	0.0	383.1
Interest earned	2.2	5.8	0.5	8.5
Total receipts	**377.3**	**13.8**	**0.5**	**391.6**
Less payments to individuals and communities	*139.1*	*121.8*	*6.7*	*267.6*
Balance of fund	**238.2**	**130.2**	**124.0**	

Source: Victorian Auditor-General's Office.

Appendix A. Material entities

Material entities for the 2009–10 year

General government sector

Entity
Austin Health
Alfred Health
Barwon Health
Country Fire Authority
Department of Education and Early Childhood Development
Department of Health
Department of Human Services
Department of Innovation, Industry and Regional Development
Department of Justice
Department of Planning and Community Development
Department of Premier and Cabinet
Department of Primary Industries
Department of Sustainability and Environment
Department of Transport
Department of Treasury and Finance
Eastern Health
Melbourne Health
Metropolitan Fire and Emergency Services Board
National Gallery of Victoria
Office of the Chief Commissioner of Police (Victoria Police)
Parks Victoria
Roads Corporation (VicRoads)
Royal Children's Hospital
Southern Health
Victorian Commission for Gambling Regulation
Victorian Skills Commission
Western Health

Public non-financial corporations

Entity
Barwon Region Water Corporation
City West Water Limited
Goulburn-Murray Rural Water Corporation
Melbourne Water Corporation
Port of Melbourne Corporation
South East Water Limited
State Electricity Commission of Victoria
V/Line Passenger Corporation
Victorian Rail Track (VicTrack)
Victorian Urban Development Authority (VicUrban)
Yarra Valley Water Limited

Public financial corporations

Entity
Rural Finance Corporation
Transport Accident Commission
Treasury Corporation of Victoria
Victorian Managed Insurance Authority
Victorian WorkCover Authority

Other entities

Entity	Certification required for:
Emergency Services Superannuation Scheme	Unfunded superannuation liability
Residential Tenancies Bond Authority	Monies held in trust
Senior Master of the Supreme Court	Monies held in trust
State Trustees Limited	Monies held in trust

Appendix B. Acronyms and glossary

Acronyms

AASB	Australian Accounting Standards Board
ABS	Australian Bureau of Statistics
ABS GFS	Australian Bureau of Statistics Government Finance Statistics
AFR	*Annual Financial Report of the State of Victoria*
BER	Building the Education Revolution
BMS	Business Management System
DEECD	Department of Education and Early Childhood Development
DHS	Department of Human Services
DSE	Department of Sustainability and Environment
DTF	Department of Treasury and Finance
EBA	Enterprise Bargaining Agreement
ESSS	Emergency Services Superannuation Scheme
FMA	*Financial Management Act 1994*
FRD	Financial Reporting Direction
FTE	Full-time equivalent
GDP	Gross Domestic Product
GGS	General Government Sector
GMID	Goulburn Murray Irrigation District
G-MW	Goulburn Murray Water Corporation
GSP	Gross State Product
LMA	Linking Melbourne Authority

NSP	Northern Sewerage Project
NVIRP	Northern Victoria Irrigation Renewal Project
PFC	Public Financial Corporation
PNFC	Public Non-Financial Corporation
P21	Primary Schools for the 21st Century
SECV	State Electricity Commission of Victoria
SLC	Science and Language Centres for the 21St Century
TTA	Transport Ticketing Authority
VAGO	Victorian Auditor-General's Office
VTP	Victorian Transport Plan.

Glossary

Actuarial gain/loss

Unrealised gain or loss experienced due to fair value movements of a superannuation liability between specific periods of time.

Acquisition

Acquisition, in relation to assets, means establishing control over the asset, undertaking the risks, and receiving the rights to future benefits, as would be conferred with ownership, in exchange for a cost of acquisition.

Asset

A resource controlled by an entity as a result of past events, and from which future economic benefits are expected to flow to the entity.

Asset’s useful life

An asset’s useful life is the period over which it is expected to provide the entity with service. Depending on the nature of the asset, useful life can be expressed in terms of time or output.

Auditor’s opinion

Positive written expression within a specified framework indicating the auditor’s overall conclusion on the financial report based on audit evidence obtained. A clear opinion indicates that the financial report has been prepared in accordance with the requirements of relevant legislation and Australian accounting standards.

Audit Act 1994

The *Audit Act 1994* establishes the operating powers and responsibilities of the Auditor-General. This includes the operations of his office – the Victorian Auditor-General's Office as well as the nature and scope of audits conducted by VAGO. The Act also addresses the relationship of the Auditor-General with the Public Accounts and Estimates Committee as the representative body of Parliament and the Auditor-General's accountability to Parliament for discharge of the position's responsibilities.

Capital expenditure

Amount capitalised to the balance sheet for contributions by a public sector entity to major assets owned by the entity, including expenditure on:

- capital renewal of existing assets that returns the service potential or the life of the asset to that which it had originally
- capital expansion which extends an existing asset at the same standard to a new group of users.

Commitments

Commitments include those operating, capital and other outsourcing commitments arising from non cancellable contractual or statutory sources.

Comprehensive result

The net result of all items of income and expense recognised for the period. It is the aggregate of operating result and other movements in equity.

Consolidation

The process of adjusting and combining financial information from the individual entities in each government sector to prepare the consolidated financial statements and present financial information for the state as a whole.

Contingent asset

A possible asset that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one, or more uncertain future events, not wholly within the control of the entity.

Contingent liability

- A possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or
- a present obligation that arises from past events but is not recognised because it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or (ii) the amount of the obligation cannot be measured with sufficient reliability.

Debt securities

Securities representing money borrowed by an issuer that must be paid back at a specific date. The security pays interest or is purchased at a discount to face value.

Debt sustainability

Debt sustainability is the ratio of borrowings and the superannuation liability to GSP and is a key measure of the state's ability to support and finance its debt. A lower ratio indicates that the state is better able to service its debt obligations.

Deficit

Total expenditure exceeds total revenue resulting in a loss.

Depreciation

The systematic apportionment of an asset's capital value as an expense over its estimated useful life to take account of normal usage, obsolescence, or the passage of time.

Derivative financial instrument

A financial contract that derives its value from changes in underlying assets or indices.

Entity

Is a body whether corporated or unincorporated that has a public function to exercise on behalf of the state or is wholly owned by the state, including: departments, statutory authorities, statutory corporations and government business enterprises.

Fair value

The amount for which an asset (financial or non financial) could be exchanged between knowledgeable, willing parties in an arm's length transaction.

Financial assets

A financial asset is any asset that is:

- cash
- an equity instrument of another entity
- a contractual right
  - to receive cash or another financial asset from another entity, or to exchange financial assets or;
  - financial liabilities with another entity under conditions that are potentially favourable to the entity

- a contract that will or may be settled in the entity's own equity instruments and is:
  - a non derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments or;
  - a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments.

Financial instruments

A contract that represents a financial asset of one party and a financial liability or equity instrument of another party.

Financial Management Act 1994

The *Financial Management Act 1994* deals with financial administration and accountability and provides for annual reporting to Parliament by all Victorian public sector agencies.

Financial Reporting Direction

The Department of Treasury and Finance issues Financial Reporting Directions (FRDs) to facilitate consistent application of accounting treatments across the Victorian public sector.

Financial sustainability

An entity's ability to manage financial resources so it can meet spending commitments, both at present and into the future.

Financial year

The period of 12 months from which a financial report is prepared ending on 30 June each year.

Fiscal stimulus funding

Government funding provided through grants in an attempt to stimulate the economy.

General government sector

The general government (GG) sector comprises all government departments, offices and other bodies engaged in providing services free of charge or at prices significantly below their cost of production. General government services include those which are mainly non market in nature, those which are largely for collective consumption by the community, and those which involve the transfer or redistribution of income. These services are financed mainly through taxes, other compulsory levies and user charges.

Government finance statistics

Government Finance Statistics (GFS) enables policy makers and analysts to study developments in the financial operations, financial position and liquidity situation of the Government. More details about the GFS can be found in the Australian Bureau of Statistics (ABS) GFS Manual *Australian System of Government Finance Statistics: Concepts, Sources and Methods 2005.*

Grants and other transfers

Transactions in which one unit provides goods, services, assets (or extinguishes a liability) or labour to another unit without receiving approximately equal value in return. Grants can either be of a current or capital nature.

Gross state product (GSP)

The measurement of economic output for the state. It is the sum of all value added by industries within the state and serves as a counterpart to the gross domestic product (GDP) for a nation.

Infrastructure

Fixed capital assets, such as schools and hospitals, which support the provision for services. Infrastructure can also refer to a network of reticulated services such as roads, energy services, rail, airports etc.

Internal control

A process affected by an entity's structure, work and authority flows, people and management information systems, designed to assist the entity accomplish specific goals and objectives. Internal control is a means by which an entity's resources are directed, monitored and measured. It plays an important role in preventing and detecting fraud and protecting the entity's resources.

Inter-sector transactions

Transactions that occur between Victorian public sector entities within one sector, which are eliminated upon consolidation.

Joint venture

A contractual agreement joining two or more parties, for the purpose of executing a particular business undertaking. All parties agree to share in the profits and losses of the enterprise.

Liability

A present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

Managed investments

A unit trust which allows investors to pool their money with that of other investors so that the fund can buy a wide range of investments. These investments are primarily managed in Government by the Victorian Funds Management Corporation who makes the investment decisions.

Materiality

Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial report. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which information must have if it is to be useful.

Material entity

Material entities represent those entities which are collectively deemed to have a significant effect on the transactions and balances reported in the state's annual report. The selection of these entities follows a detailed analysis of the financial operations of all controlled entities and takes into account any major risk factors that are attached to specific entities or portfolios.

Net debt

Net debt equals sum of deposits held, advances received, government securities, loans and other borrowings less the sum of cash and deposits, advances paid and investments, loans and placements, and investment in GG sector entities using the equity method.

Net present value

The total present value of a time series of cash flows. It is a standard method for using the time value of money to appraise long-term projects.

Net result

Net result is a measure of financial performance of the operations for the period. It is the net result of items of revenue, gains and expenses (including losses) recognised for the period, excluding those that are classified as 'other non owner movements in equity'.

Net result from transactions

Net result from transactions is a key fiscal aggregate and is revenue from transactions minus expenses from transactions. It is a summary measure of the ongoing sustainability of operations. It excludes gains and losses resulting from changes in price levels and other changes in the volume of assets. It is the component of the change in net worth that is due to transactions and can be attributed directly to government policies.

Net worth

Assets less liabilities, is an economic measure of wealth and reflects the contribution of jurisdictions to the wealth of Australia.

Nominal value

The total value of a commitment.

Non financial assets

Non financial assets are all assets that are not financial assets. It includes inventories, land, buildings, infrastructure, road networks, land under roads, plant and equipment, cultural and heritage assets, intangibles and biological assets such as commercial forest.

Onerous contract

A type of contract where the costs involved with fulfilling the terms and conditions of the contract are higher than the amount of economic benefit received.

Other economic flows

Other economic flows are changes in the value or value of an asset or liability that do not result from transactions. It includes gains and losses from disposals, revaluations and impairments of non current physical and intangible assets; actuarial gains and losses arising from defined benefit superannuation plans; fair value changes in financial instruments and agricultural assets; and depletion of natural assets (non produced) from their use or removal. In simple terms, other economic flows are changes arising from market re-measurements.

Public financial corporations sector (PFC)

PFC's are bodies primarily engaged in the provision of financial intermediation services or auxiliary financial services. They are able to incur financial liabilities on their own account (e.g. taking deposits, issuing securities or providing insurance services). A listing of all material entities comprising the PFC sector is included in Appendix A.

Public non-financial corporations sector (PNFC)

The PNFC sector comprises bodies mainly engaged in the production of goods and services (of a non financial nature) for sale in the market place at prices that aim to recover most of the costs involved (e.g. water and port authorities). In general, PNFCs are legally distinguishable from the governments which own them; a listing of all material entities comprising the PNFC sector is included in Appendix A.

Return on superannuation plan assets

Interest, dividends and other revenue derived from superannuation plan assets, together with realised and unrealised gains or losses on the assets, less any costs of administering the superannuation plan and less any tax payable by the superannuation plan itself.

Revaluation

The act of recognising a reassessment of values for non-current assets at a particular point in time.

Risk

The chance of a negative impact on the objectives, outputs or outcomes of the entity.

Sale of goods and services

Refers to revenue from the direct provision of goods and services and includes fees and charges for services rendered, sale of goods and services, fees from regulatory services, work done as an agent for private enterprises. It is also rental income under operating leases and on produced assets such as buildings and entertainment, but excludes rent income from the use of non produced assets such as land. User charges includes sale of goods and services revenue.

Surplus

Total revenue exceeds total expenditure resulting in a profit.

Appendix C.
Key milestone dates

Material entity results against Department of Treasury and Finance milestone dates

	Draft financial reports		Finalisation of the financial report including audit opinion	
Material entity	**Met**	**Not met**	**Met**	**Not met**
General Government Sector	**26 July 2010**		**11 August 2010**	
Austin Health		●		●
Alfred Health		●	●	
Barwon Health		●	●	
Country Fire Authority	●		●	
Department of Education and Early Childhood Development		●		●
Department of Health		●		●
Department of Human Services		●		●
Department of Innovation, Industry and Regional Development		●		●
Department of Justice	●			●
Department of Planning and Community Development	●			●
Department of Premier and Cabinet		●		●
Department of Primary Industries	●			●
Department of Sustainability and Environment	●			●
Department of Transport		●		●
Department of Treasury and Finance		●		●
Eastern Health	●		●	
Melbourne Health	●		●	
Metropolitan Fire and Emergency Services Board	●			●
National Gallery of Victoria	●			●
Office of the Chief Commissioner of Police (Victoria Police)		●		●
Parks Victoria		●		●
Roads Corporation (Vic Roads)		●		●
Royal Children's Hospital	●			●
Southern Health	●		●	

Material entity	Draft financial reports		Finalisation of the financial report including audit opinion	
	Met	Not met	Met	Not met
General Government Sector – *continued*	**26 July 2010**		**11 August 2010**	
Victorian Commission for Gambling Regulation	●			●
Victorian Skills Commission	●			●
Western Health		●		●
Public Non Financial and Public Financial Corporations	**26 July 2010**		**11 August 2010**	
Barwon Region Water Corporation		●	●	
City West Water Limited	●			●
Goulburn-Murray Rural Water Corporation		●	●	
Melbourne Water Corporation	●			●
Port of Melbourne Corporation		●	●	
Rural Finance Corporation	●		●	
South East Water Limited	●			●
State Electricity Commission of Victoria		●		●
Transport Accident Commission		●		●
Treasury Corporation of Victoria	●		●	
V/Line Passenger Corporation		●		●
Victorian Managed Insurance Authority		●		●
Victorian Rail Track		●		●
Victorian Urban Development Authority	●			●
Victorian WorkCover Authority		●		●
Yarra Valley Water Limited	●			●
Other	**26 July 2010**		**11 August 2010**	
Emergency Services Superannuation Scheme		●		●
Residential Tenancies Bond Authority		●		●
Senior Master of the Supreme Court	●		●	
State Trustees Limited		●		●
2009–10	21	26	12	35
Per cent	**45**	**55**	**26**	**74**
2008–09	18	29	8	39
Per cent	38	62	17	83

Source: Victorian Auditor-General's Office.

Appendix D.

Audit Act 1994 section 16—submissions and comments

Introduction

In accordance with section 16A and 16(3) of the *Audit Act 1994* a copy of this report, or relevant extracts from the report, was provided to the Treasurer and all relevant agencies with a request for submissions or comments.

Responses were received as follows:

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

Submissions and comments received

RESPONSE provided by the Treasurer

Department of Treasury and Finance

1 Treasury Place
GPO Box 4379
Melbourne Victoria 3001
Telephone: (03) 9651 5111
Facsimile: (03) 9651 2062
DX 210759

Mr Des Pearson
Auditor-General
Victorian Auditor-General's Office
Level 24, 35 Collins Street
MELBOURNE VIC 3000

Dear ~~Mr Pearson~~ Des

RESPONSE TO AUDIT REPORT ON THE ANNUAL FINANCIAL REPORT OF THE STATE OF VICTORIA, 2009-10

Thank you for providing the opportunity to submit formal comments on the proposed Auditor-General's Report on the Annual Financial Report (AFR) of the State of Victoria, 2009-10 prior to its finalisation and transmission to Parliament.

I wish to provide the following formal response for inclusion at the end of the Audit Summary.

I welcome the Auditor-General's report on the government's Annual Financial Report for the 2009-10 financial year.

The Auditor-General's report complements the Annual Report by reaffirming the strong financial results achieved by the government during 2009-10, notwithstanding challenging economic conditions and additional funding demands associated with fire recovery and preparedness following the devastating 2009 bushfires. These results have been instrumental to ensuring achievement of the government's financial targets, and the longer-term sustainability of State finances.

The auditor's report also acknowledges the challenges in completing the Annual Report within a record timeframe. This was successfully achieved 2 weeks ahead of the previous year, and reflects considerable effort across the Victorian public sector, and by the Department of Treasury and Finance (DTF) in ensuring the timely communication of information requirements to entities and an ongoing dialogue with departments, CFOs and Audit Committee chairs to maintain focus on this issue.

The achievement of a timely Annual Report also reflects the efforts of the Victorian Auditor-General's Office (VAGO) in working collaboratively and constructively with entities and DTF to address any emerging issues arising during the reporting period.

Victoria
The Place To Be

RESPONSE provided by the Treasurer – continued

DTF will continue work collaboratively with Departments, other public sector entities and VAGO over future years to facilitate ongoing improvements in the timeliness and quality of pubic sector reporting. In this regard, the proposed Public Finance and Accountability Legislation, currently before Parliament, will assist by improving clarity on the related responsibilities of Departments and public sector entities.

If you require further information or wish to discuss the contents of this letter, please contact Director, Budget and Financial Management Division on

Please accept my appreciation for the professionalism shown by your Office in working closely with my Department during the conduct of the audit of the AFR and in the completion of this report.

Yours sincerely

JOHN LENDERS MP
Treasurer

RESPONSE provided by the Secretary, Department of Sustainability and Environment

Department of Sustainability and Environment

8 Nicholson Street
PO Box 500 East Melbourne
Victoria 8002 Australia
Telephone: (03) 9637 8000
Facsimile: (03) 9637 8100
ABN 90 719 052 204
DX 210098

Ref: SEC007129
File:

Mr D D R Pearson
Auditor-General
Auditor General Victoria
Level 24
35 Collins Street
MELBOURNE VIC 3000

Dear Mr Pearson

PROPOSED AUDIT REPORT – AUDITOR-GENERAL'S REPORT ON THE ANNUAL FINANCIAL REPORT OF THE STATE OF VICTORIA 2009-10

I refer to your letter of 16 September 2010 on your proposed audit report *Auditor-General's Report on the Annual Financial Report of the State of Victoria 2009-10.*

Overall the department confirms the factual accuracy of the report.

In relation to the information presented, the department considers it necessary to provide a formal response to the information on the desalination plant. The response, being additional comments sought to be included in the report, is attached to this letter.

If you have any further queries, please do not hesitate to contact Chief Finance Officer on

Yours sincerely

Greg Wilson
Secretary

Privacy Statement
Any personal information about you or a third party in your correspondence will be protected under the provisions of the ***Information Privacy Act 2000****. It will only be used or disclosed to appropriate Ministerial, Statutory Authority, or departmental staff in regard to the purpose for which it was provided, unless required or authorised by law. Enquiries about access to information about you held by the Department should be directed to the Manager Privacy, Department of Sustainability & Environment, PO Box 500, East Melbourne, 3002.*

Victoria
The Place To Be

RESPONSE provided by the Secretary, Department of Sustainability and Environment – continued

RESPONSE

The Victorian Desalination Project is essential for Victoria's long term water security of a growing economy and population. It will provide a rainfall independent source of water, to supplement other water supplies.

The capital cost (design and construction) of the project remains at $3.5 billion. The maximum cost over the 27.75 year Public Private Partnership (PPP) contract with AquaSure is $5,720 million Net Present Cost as released in the Partnerships Victoria Project Summary in November 2009 based on the government approved discount rate. This includes design, construction, financing, maintenance and operating costs, and based on ordering 150 billion litres of water every year for the 27.75 years operating period. The costs will be less if less water is ordered.

The DSE Annual Report has presented a range of financial data in accordance with the requirements of prevailing accounting policies and standards. Such accounting policies and standards require the Victorian Desalination Project to be considered as a finance lease using a fair value assessment process. This results in what is termed a 'net present value', being based on plant construction costs, capitalised finance costs during construction and other costs using other assumptions. This needs to be differentiated from the actual Net Present Costs of the future payments under the contract between the State and AquaSure, which are only made once the whole project is commissioned. This remains at $5,720 million which represents the maximum contract cost in June 2009 dollars. There is no payment to AquaSure during construction and AquaSure bears the risk of any capital cost increases.

The development costs of $320 million (nominal) associated with the Victorian Desalination Project are in line with the Government's commitment to deliver Australia's largest and most advanced desalination plant, while minimising the impact on the environment and delivering benefits to the local community.

A dedicated project team has been assembled within the DSE to manage the development and delivery of the project. The development costs include:

- the cost of undertaking a comprehensive suite of environmental investigations to ensure the protection of the environment, including an Environment Effects Statement, Environment Protection Authority Works Approval, Cultural Heritage Management plans and Commonwealth EPBC approvals;
- extensive ground and marine condition investigations, technical and engineering costs associated with development of the Reference Design, development of bidding documents and the management of the tender process including evaluating bids and recommending the preferred bidder;
- the cost of land acquisition and compensation; and
- the past and future costs of management of the project to the end of its 30 year term to ensure its successful delivery.

RESPONSE provided by the Acting Secretary, Department of Transport

Department of Transport

PO Box 2797
Melbourne, Victoria 3001
Telephone: (03) 9655 6666
Facsimile: (03) 9095 4096
www.transport.vic.gov.au
DX 210410

Our Ref:

Mr D D R Pearson
Auditor General
Victorian Auditor General's Office
Level 24, 35 Collins St
Melbourne VIC 3000

Dear Mr Pearson,

Auditor Generals Report on the Annual Financial Report of the State of Victoria 2009-10

I refer to your letter of 16 September 2010 requesting the Department's comments on the above report. Please see below for comments in respect of the sections relating to the Department of Transport for inclusion in your report.

New Trains

The report refers to the delivery of nine new trains as at 30 June 2010 against the contracted delivery of ten new trains. While this was behind schedule the tenth train was accepted on the 5th of August. The Department was monitoring the delivery schedule closely and was satisfied that Alstom had recovered from its earlier timeline slippages; a conclusion validated by the subsequent delivery of trains 11 and 12 in August and September respectively. Delivery is now in line with contracted requirements.

The report identifies that the expected cost of $1 969 million for the 32 new generation trains includes operating costs for 2015 – 16 to 2020-21, capital works and the cost of the new trains. It should be noted that the capital costs will include the provision of a new maintenance depot, new stabling facilities and traction power upgrades and will represent a significant component of the allocated cost for the delivery of the new trains.

Payments to Train and Tram Operators

The direct comparison between the two franchises in the manner presented by the Auditor General's report does not accurately reflect the differences between the two arrangements due to the complex changes in contractual obligations

The report estimates the State will pay $2.31 for each metropolitan train passenger boarding in 2010-11 (compared to $1.95 in 2008-09), and $0.87 for each tram passenger boarding in 2010-11 (compared to $0.72 in 2008-09). While the report recognises the increase is to support significant changes in network maintenance it also provides for additional customer service personnel, and the impact of general inflation.

Victoria
The Place To Be

RESPONSE provided by the Acting Secretary, Department of Transport – continued

The estimates in the Auditor-General's report have not been adjusted for changes to the tram franchisee's share of fare box revenue from 40 to 30 per cent, if the additional 10 per cent of fare box revenue were recognised, the cost per boarding would be lower than in 2008-09. The revenue increase to the department as a result of the changes to the fare box allocation will exceed the additional payments to the Tram Operator.

Guarantee payments

The new franchise (MR3) arrangements were constructed to shelter franchisees from farebox volatility in an effort to better balance risk in the MR3 proposition and attract a reduced margin. The report indicates that the State paid $22.4 million in guarantee payments to the operators during the myki start up period. As stated in the report this is entirely attributable to the difference in revenue projection in the franchisees bids and actual revenue and this difference is mostly likely due to lower than projected patronage growth, which is in no way related to myki. In any event, the State would have received the benefit of the reduced margin and if farebox revenue had exceeded projections the State would also have fully retained revenue collected. This retention of possible farebox benefits will remain the case until the end of the guarantee period.

Public Transport Operator Penalties

The previous and current franchise agreements contained incentives and penalties. The report correctly identifies that the capping of incentives and penalties under the new arrangements was designed to influence the bids by the franchisees that would have otherwise sought higher franchise payments to cover additional risk.

Whilst the report identifies that the State would have received $15.4 million in penalties if capping were not in place, this must be weighed against the impact of benefits of lower bids throughout the life of the contract. The capping only has an impact in the years during which the cap is triggered . The impact on the State of capping cannot be properly assessed until a significant period of operation under the new contracts has elapsed.

It is also important to note that the Franchise Agreement provides the State with the right to take alternative action in cases of train and tram operators' continuous underperformance. This right was exercised by the Director of Public Transport on 10 July 2010 by withholding $4 million from the train operator (which is returnable if agreed performance targets are achieved).

Yours sincerely,

Gillian Miles

Acting Secretary
1/10/2010

RESPONSE provided by the Chief Executive Officer, Transport Ticketing Authority

Transport Ticketing
Authority

ABN 735 9524 2024
Level 38, 55 Collins Street
Melbourne Victoria 3000
Telephone: (03) 9651 8111
Facsimile: (03) 9651 7578

PO Box 18023
Collins Street East Victoria 8003

1 October 2010

Mr DDR Pearson

Auditor General
Level 24, 35 Collins Street
Melbourne VIC 3000

Dear Des 1/10

Subject: Audit Act 1994, s16(3)-Proposed Audit Report – *Auditor-General's Report on the Annual Financial Report of the State of Victoria, 2009-10*

I refer to your letter of 16 September, which attached relevant extracts from the proposed AFR for 2009/10.

Subsequent to receipt of your letter we have received, via email, several revisions of the extracts.

We acknowledge that the extracts directly related to the myki project are fairly and accurately presented.

Other parts of the 2009/10 AFR, in the Transport sections, include indirect references to myki in the context of discussions about the Farebox revenue guarantee arrangements that have been established by the Director of Public Transport with the Train and Tram franchisees, Metro and Yarra Trams.

Whilst the TTA is not a party to the arrangements, we understand they are one component of the franchise arrangements between the State and the operators

Our understanding of the arrangements is that the State has agreed to bear the revenue shortfall risks, and take the benefit of any revenue excess, due to any cause whatsoever for the duration of the arrangements. During 2009/10 it is our view that virtually all of the relevant payment relates to a slow down in the rate of metropolitan patronage growth compared to the growth assumptions estimated by the bidders.

In accordance with the above discussion it is TTA's strong view that any costs or benefits arising from the arrangements relate primarily to the operator franchising arrangements, not to the myki project.

Thank you for this opportunity to comment on the AFR.

Yours sincerely,

B Carolan

Bernie Carolan
Chief Executive Officer

1 Victoria The Place To Be

Auditor-General’s reports

Reports tabled during 2010–11

Report title	Date tabled
Portfolio Departments: Interim Results of the 2009–10 Audits (2010–11:1)	July 2010
Taking Action on Problem Gambling (2010–11:2)	July 2010
Local Government: Interim Results of the 2009–10 Audits (2010–11:3)	August 2010
Water Entities: Interim Results of the 2009–10 Audits (2010–11:4)	August 2010
Public Hospitals: Interim Results of the 2009–10 Audits (2010–11:5)	September 2010
Business Continuity Management in Local Government (2010–11:6)	September 2010
Sustainable Farm Families Program (2010–11:7)	September 2010
Delivery of NURSE-ON-CALL (2010–11:8)	September 2010
Management of Prison Accommodation Using Public Private Partnerships (2010–11:9)	September 2010
Soil Health Management (2010–11:10)	October 2010
Sustainable Management of Victoria's Groundwater Resources (2010–11:11)	October 2010
The Department of Human Services’ Role in Emergency Recovery (2010–11:12)	October 2010
Access to Ambulance Services (2010–11:13)	October 2010
Management of the Freight Network (2010–11:14)	October 2010
Security of ICT Management and Control Systems for Water and Trains (2010–11:15)	October 2010

VAGO’s website at <www.audit.vic.gov.au> contains a comprehensive list of all reports issued by VAGO. The full text of the reports issued is available at the website.

VAGO

Victorian Auditor-General's Office

Auditing in the Public Interest

Availability of reports

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

- Information Victoria Bookshop
  505 Little Collins Street
  Melbourne Vic. 3000
  AUSTRALIA

  Phone: 1300 366 356 (local call cost)
  Fax: +61 3 9603 9920
  Email: <bookshop@diird.vic.gov.au>

- Victorian Auditor-General's Office
  Level 24, 35 Collins Street
  Melbourne Vic. 3000
  AUSTRALIA

  Phone: +61 3 8601 7000
  Fax: +61 3 8601 7010
  Email: <comments@audit.vic.gov.au>
  Website: <www.audit.vic.gov.au>