

## CHAPTER 2: BUDGET POSITION AND OUTLOOK

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- The revised 2006-07 net result from transactions for the general government sector is \$418.6 million, an increase of \$101.8 million compared with the May 2006 Budget estimate of \$316.8 million. This increase mainly reflects higher than originally projected taxation income and Commonwealth specific purpose grants.
- The net result from transactions is expected to average \$404.8 million a year from 2007-08 to 2009-10.
  - Including the non-cash impact of actuarial adjustments and revaluations, the net result for the general government sector is projected to be a surplus of \$513.9 million in 2006-07, which is higher than the May 2006 Budget estimate of a \$275.6 million surplus, reflecting better-than-expected returns on superannuation assets.
- Net infrastructure investment is projected to be \$3 125.1 million in 2006-07. Over the forward estimate period, from 2007-08 to 2009-10, net infrastructure investment is expected to average \$3 390.4 million a year.
- Net debt is projected to increase from \$1 769.1 million as at 30 June 2006 (or 0.8 per cent of GSP) to \$7 588.7 million by 30 June 2010 (or 2.7 per cent of GSP).
- The broader measure of net financial liabilities is projected to increase from \$14 665.6 million as at 30 June 2006 (or 6.3 per cent of GSP) to \$21 061.0 million by 30 June 2010 (or 7.5 per cent of GSP).

This chapter provides an overview of the revised budget position for the period 2006-07 to 2009-10 for the general government sector.

The budget and forward estimates are based on the economic projections outlined in Chapter 1, *Economic Conditions and Outlook*, and reflect the accounting policies and assumptions documented in Chapter 4, *Estimated Financial Statements and Notes*. The estimates take into account the financial impacts of all policy decisions taken by the Victorian Government prior to the issue of election writs on 31 October 2006, as well as Commonwealth funding revisions and other information, that affect the projected general government sector financial statements. Specific policy decisions that have been taken since the May 2006 Budget, that affect the Budget position are summarised in Appendix A, *Specific Policy Decisions Affecting the Budget Position*.

The 2006-07 Budget and forward estimates years, 2007-08 to 2009-10, represent planning projections based on unchanged policy and other assumptions throughout the forecast period. Outcomes will differ from these projections for many reasons, including the implementation of new policies by an incoming Government and any materialisation of the risks described in Chapter 3, *Statement of Risks*.

The estimates from 2006-07 (as detailed in Chapter 4, *Estimated Financial Statements and Notes*) and used in this chapter are presented on the basis of the Australian equivalents to International Financial Reporting Standards (A-IFRS).

## **FORWARD ESTIMATES OUTLOOK 2006-07 TO 2009-10**

Table 2.1 sets out the projected aggregate outlook over the budget and forward estimates period for the general government sector. A more detailed operating statement is provided in Chapter 4, *Estimated Financial Statements and Notes*.

As Table 2.1 shows, the net result from transactions is forecast to be \$418.6 million in 2006-07. The net result from transactions is projected to be \$423.0 million in 2007-08, \$429.4 million in 2008-09 and \$361.9 million by the end of the forward period.

The net result is obtained when various revaluation gains and losses on assets and liabilities and provisions for doubtful receivables are added to the net result from transactions. These revaluations are closely related to market movements and as such are highly volatile. As Table 2.1 shows, the net result for the general government sector is projected to be a surplus of \$513.9 million in 2006-07.

As discussed below in *Other economic flows*, the revised 2006-07 net result is higher than the revised net result from transactions largely due to better-than-expected returns on superannuation assets for the financial year to 27 October 2006. This favourable investment performance gave rise to an actuarial non-cash gain of \$483.5 million. However, this was partially offset by the non-cash impact on the unfunded superannuation liability of movements in the long-term Commonwealth bond rate. The Commonwealth bond rate that underpins the discount rate used to value superannuation liabilities has decreased since 30 June 2006, which increased the reported superannuation liability, and thereby reduced the actuarial gain by \$371.6 million. Changes in the reported value of the superannuation liability resulting from movements in the discount rate have no impact on the amount of cash required to fund this liability but are reported in accordance with the relevant accounting standard.

**Table 2.1 Summary operating statement for the period 2006-07 to 2009-10** <sup>(a)(b)</sup>

	(\$ million)				
	2006-07 Budget	2006-07 Revised	2007-08 Estimate	2008-09 Estimate	2009-10 Estimate
Taxation	10 971.0	11 201.8	11 391.5	11 806.7	12 253.7
Dividends and income tax equivalent and rate equivalent revenue <sup>(c)</sup>	1 251.2	1 260.0	1 094.5	1 046.9	1 155.1
Grants	15 077.9	15 160.3	15 987.2	16 449.4	16 936.2
Sales of goods and services	2 552.4	2 532.2	2 570.3	2 635.2	2 640.3
Other income <sup>(d)</sup>	2 589.7	2 630.9	2 673.1	2 844.8	2 640.5
<b>Total income from transactions</b>	<b>32 442.1</b>	<b>32 785.2</b>	<b>33 716.5</b>	<b>34 783.0</b>	<b>35 625.8</b>
% change			2.8%	3.2%	2.4%
Employee benefits	12 019.5	12 085.2	12 366.3	12 719.8	12 978.8
Superannuation	1 710.4	1 673.9	1 684.8	1 719.5	1 751.8
Depreciation and amortisation	1 322.1	1 366.6	1 438.0	1 506.0	1 586.1
Finance costs	428.0	473.4	499.0	604.2	677.5
Grants and transfer payments	6 207.2	6 404.0	6 116.0	5 934.9	5 923.4
Supplies and services	10 437.7	10 363.2	11 188.9	11 868.7	12 345.7
Other expenses	0.5	0.5	0.5	0.5	0.5
<b>Total expenses from transactions</b>	<b>32 125.3</b>	<b>32 366.7</b>	<b>33 293.5</b>	<b>34 353.7</b>	<b>35 263.8</b>
% change			2.9%	3.2%	2.6%
<b>Net result from transactions</b>	<b>316.8</b>	<b>418.6</b>	<b>423.0</b>	<b>429.4</b>	<b>361.9</b>
Actuarial gains/(losses) on superannuation defined benefit plans	..	111.8	..	..	..
Other gains/(losses) from other economic flows <sup>(e)</sup>	( 41.2)	( 16.5)	( 35.7)	( 30.7)	( 30.3)
<b>Total other economic flows</b>	<b>( 41.2)</b>	<b>95.3</b>	<b>( 35.7)</b>	<b>( 30.7)</b>	<b>( 30.3)</b>
<b>Net result</b>	<b>275.6</b>	<b>513.9</b>	<b>387.4</b>	<b>398.7</b>	<b>331.6</b>

Source: Department of Treasury and Finance

Notes:

- (a) Table may not add due to rounding.
- (b) This is an abbreviated operating statement. The full operating statement for the general government sector is reported in Chapter 4, Estimated financial statements and notes.
- (c) Includes dividends and income tax equivalent and rate equivalent revenue, and interest revenue.
- (d) Other income comprises regulatory fees and fines, fair value of assets received free of charge, inter-sector capital asset charge and other miscellaneous income (such as unclaimed monies refunds and donations to schools and hospitals).
- (e) This includes gains and losses on the disposal of physical assets and other income and expenses from other economic flows.

## Alternative measures of financial performance

Alternative measures of financial performance are set out in Table 2.2. These include Government Finance Statistics (GFS) measures used by the Australian Bureau of Statistics and the net result.

**Table 2.2 A-IFRS and GFS budget measures**

	(\$ million)				
	2006-07 Budget	2006-07 Revised	2007-08 Estimate	2008-09 Estimate	2009-10 Estimate
A-IFRS Net result from transactions / GFS net operating balance	316.8	418.6	423.0	429.4	361.9
A-IFRS Net result	275.6	513.9	387.4	398.7	331.6
GFS net lending/(borrowing) <sup>(a)</sup>	( 582.2)	( 837.4)	( 812.3)	(1 051.0)	( 839.2)
GFS cash surplus/(deficit) - excluding the impact of finance leases <sup>(b)</sup>	157.1	101.2	( 565.6)	( 761.2)	( 858.1)

Source: Department of Treasury and Finance

Notes:

- (a) *GFS net borrowing, or fiscal balance, includes net capital expenditure but excludes depreciation, thereby giving a measure of the State's call on financial markets. GFS net borrowing also equals net transactions in financial assets less net transactions in liabilities.*
- (b) *International Monetary Fund/GFS cash surplus/deficit equals the net cash flows from operating activities less investments in non-financial assets, and excludes acquisitions under finance leases.*

The *GFS net operating balance* is identical to the net result from transactions. Both measures exclude the effects of revaluation (holding gains or losses) arising from changes in market prices and other changes in the volume of assets. The GFS net operating balance is the conceptual basis for budgets in most other Australian states and the Commonwealth, and provides comparability with these jurisdictions.

The *GFS net lending/borrowing* result is equal to the GFS net operating balance less net acquisitions of non-financial assets. GFS net borrowing represents, in broad terms, the extent to which the general government sector's net acquisition of physical assets has been funded by incurring liabilities to other sectors. As the net lending/borrowing takes into account total spending on fixed assets during the period, rather than just the current year's expense, it is lower than the GFS net operating balance and the net result from transactions. The GFS net borrowing measure is projected to be \$837.4 million in 2006-07. Over the forward period, it is projected that the general government sector will remain in a net borrowing position.

The *GFS cash surplus/deficit* result is equal to net cash flows from operating activities, less net cash investment in non-financial assets and excludes acquisitions under finance leases. Although both net borrowing and the cash surplus include the immediate impact of expenditure on fixed assets, the cash surplus removes non-cash revenues and expenses (including the imputed superannuation interest cost and employee benefits) and allows for cash contributions made to the unfunded superannuation liability. The projected general government sector GFS cash surplus is \$101.2 million in 2006-07.

Over the forward estimates period, both GFS net borrowing and GFS cash deficits reflect the profile of infrastructure spending over the period. In particular GFS net borrowing is projected to peak in 2008-09, reflecting the completion of *Partnerships Victoria* projects, which are further explained below.

## **Income from transactions**

Total income from transactions in 2006-07 is projected to be \$32 785.2 million. When compared to the 2006-07 Budget estimate published in May 2006, total income from transactions has been revised upwards by \$343.1 million (or 1.1 per cent). The upward revision mainly reflects growth in taxation (\$230.8 million), and Commonwealth specific purpose grants (\$82.4 million).

From 2007-08, and over the remainder of the forward estimates period, total income from transactions is projected to grow on average by \$946.9 million (or 2.8 per cent).

Taxation income is projected to be \$11 201.8 million in 2006-07 and is expected to grow by an average of \$350.6 million (or 3.0 per cent) a year over the forward estimates period. The projected year-on-year growth in taxation income over the outlook period reflects the anticipated economic conditions for the State resulting in higher payroll tax income, combined with the current strength of the non-residential property market and high-end residential market influencing the level of land transfer duty.

Dividend and income tax equivalent and rate equivalent income in 2006-07 is anticipated to be substantially in line with the 2006-07 Budget estimate. This income is expected to decline by 17 per cent in 2007-08, largely reflecting lower distributions expected from the Transport Accident Commission and the Victorian WorkCover Authority and is consistent with the assumed average long-term market rate of return on their investments. Dividend and income tax and rate equivalent income is expected to decrease by a further 5.3 per cent in 2008-09 before increasing by 16.2 per cent in 2009-10. The increase in 2009-10 is consistent with projected higher dividends from the State Electricity Commission of Victoria.

When compared with the 2006-07 Budget estimate, income from Commonwealth grants has been revised upwards by \$82.4 million in 2006-07 due to additional specific purpose grants for a number of new and existing programs such as the Exceptional Circumstances Drought Relief Package, the Snowy River Environment Flows, the Macalister Irrigation Project, Wimmera Mallee Pipeline, Immunisation Program and Young People with Disabilities in Residential Aged Care. This additional Commonwealth funding has been partly offset by a downward revision to funding for the Australian Health Care Agreement and the Highly Specialised Drugs Program. Income from Commonwealth grants is projected to grow over the forward period by an average of \$592.0 million (or 3.8 per cent) a year mainly due to growth in GST revenue projected in the 2006-07 Budget estimates.

The estimates of GST revenue have not been revised since the 2006-07 Budget was published in May 2006, as the Commonwealth has not issued a formal revised estimate of the GST pool. However, there is a possibility that GST revenue over the forecast period may be higher than forecast in the 2006-07 Budget. For more detail, see Chapter 3, *Statement of Risks*.

Income from both the sale of goods and services and other income sources such as fines and regulatory fees and agency own-source revenue is projected to remain relatively stable over the forward period. Other income is projected to peak in 2008-09 reflecting the return of land to the State in relation to completion of EastLink.

### **Expenses from transactions**

Total expenses from transactions are projected to be \$32 366.7 million in 2006-07, an increase of \$241.4 million (or 0.8 per cent) compared to the 2006-07 Budget estimates published in May 2006. This increase largely reflects a combination of revisions, including:

- an upward revision to expenditure on employee entitlements by \$65.7 million, reflecting expenditure associated with an increase in hospital own-source revenue and a reclassification of expenditure by VicRoads from operating supplies and services to employee entitlements;
- an upward revision of finance costs by \$45.4 million and depreciation and amortisation expenses by \$44.5 million. These reflect required changes in accounting policy treatment that were adopted in the *2005-06 Financial Report for the State of Victoria*, including:
  - a change in asset recognition for projects associated with the State-wide Integrated Public Safety Communication Strategy; and
  - the requirement to capitalise, in 2005-06, the Victorian County Court and private prisons by recognising a finance lease agreement and the amended existing finance lease treatment for private prisons;
- an upward revision of grants and transfer payments by \$196.8 million mainly reflecting the on-passing of additional Commonwealth specific purpose grants, as well as an increase in transfer payments to the public non-financial corporations and public financial corporations sectors in relation to a number of new State Government drought and water-related initiatives.

These increases are partially offset in 2006-07 by downward revisions to:

- supplies and services of \$74.5 million, primarily reflecting a reduction in the projected operating lease payments associated with the changes in accounting treatment for finance leases explained above; and

- superannuation expense of \$36.5 million largely reflecting the results of the triennial actuarial review of the Emergency Services Superannuation Scheme (explained further below).

Consistent with forecast growth in total income from transactions over the forward period, total expenses are projected to increase by an average of \$965.7 million (or 2.9 per cent) a year from 2007-08 to 2009-10.

Year-on-year growth in employee entitlements over the forward estimates period is expected to average \$297.9 million (or 2.4 per cent) a year. This growth reflects existing enterprise bargaining agreement wage increases and the implementation of policy decisions by Government, including decisions between the May 2006 Budget and the issuing of election writs on 31 October 2006.

Over the forward estimates period, superannuation expenses are projected to increase on average by \$25.9 million (or 1.5 per cent) a year reflecting the year-on-year projected growth in employee entitlements.

Grants and transfer payments are projected to decline, before stabilising over the remaining forward estimates period, reflecting currently budgeted completion of programs such as the First Home Bonus, which ends on 30 June 2007.

Over the forward period, supplies and services expenditure is projected to increase by an average of \$660.8 million (or 6.0 per cent) a year. This year-on-year growth mainly reflects the implementation of output decisions announced by Government combined with additional expenditure associated with the projected increase in own-source revenues (income received through fees charged by agencies for services) particularly in the TAFE and hospital sectors.

### **Other economic flows**

Differences between the net result from transactions and the net result are due to other economic flows. This includes actuarial adjustments, gains and losses on the disposal of physical assets and income and expenses from other economic flows.

Other economic flows in 2006-07 are primarily driven by better-than-expected returns on superannuation assets for the financial year to 27 October 2006, giving rise to an actuarial gain of \$483.5 million. However, this was partially offset by the impact of movements since 30 June 2006 in the long-term Commonwealth bond rate that underpins the discount rate used to value superannuation liabilities. This increased the reported superannuation liability and reduced the investment related actuarial gain by \$371.6 million. Changes in the reported value of the superannuation liability resulting from movements in the discount rate have no impact on the amount of cash required to fund this liability but are reported in accordance with the relevant accounting standard.

## RECONCILIATION OF FORWARD ESTIMATES TO PREVIOUSLY PUBLISHED ESTIMATES

Table 2.3 compares the revised outlook for the net result from transactions for the period 2006-07 to 2009-10 to the estimates published in the 2006-07 Budget in May 2006.

**Table 2.3 Reconciliation of estimates to the 2006-07 Budget <sup>(a)</sup>**

	(\$ million)			
	2006-07 Revised	2007-08 Estimate	2008-09 Estimate	2009-10 Estimate
<b>Net result from transactions: 2006-07 Budget <sup>(b)</sup></b>	<b>316.8</b>	<b>305.4</b>	<b>331.3</b>	<b>311.9</b>
<b>Plus: Variations in income from transactions since 2006-07 Budget</b>				
<b>Policy decision variations</b>	<b>0.2</b>	<b>15.5</b>	<b>77.9</b>	<b>77.3</b>
<b>Economic/demographic variations</b>				
Taxation	230.8	224.2	159.5	69.3
Investment income <sup>(c)</sup>	8.8	( 3.3)	( 27.6)	75.2
<b>Total economic/demographic variations</b>	<b>239.6</b>	<b>220.9</b>	<b>132.0</b>	<b>144.5</b>
<b>Commonwealth grant variations</b>				
General purpose grants	..	..	..	..
Specific purpose payment grants	82.4	61.7	( 6.7)	( 67.0)
<b>Total Commonwealth grant variations</b>	<b>82.4</b>	<b>61.7</b>	<b>( 6.7)</b>	<b>( 67.0)</b>
<b>Increase in own-source revenue</b>	<b>55.0</b>	<b>43.7</b>	<b>46.2</b>	<b>48.2</b>
<b>Administrative variations</b>	<b>( 34.1)</b>	<b>( 88.1)</b>	<b>( 61.0)</b>	<b>( 77.0)</b>
<b>Total variation in income from transactions since 2006-07 Budget</b>	<b>343.1</b>	<b>253.6</b>	<b>188.3</b>	<b>126.0</b>
<b>Less: Variations in expenses from transactions since 2006-07 Budget</b>				
<b>Policy decision variations <sup>(d)</sup></b>	<b>121.5</b>	<b>79.8</b>	<b>106.8</b>	<b>105.4</b>
<b>Commonwealth variations</b>	<b>67.2</b>	<b>28.4</b>	<b>5.7</b>	<b>( 7.1)</b>
<b>Variations due to changes in own-source revenue</b>	<b>63.7</b>	<b>52.5</b>	<b>51.2</b>	<b>49.8</b>
<b>Administrative variations</b>				
Superannuation variations	( 36.5)	( 76.0)	( 64.7)	( 64.9)
Other administrative variations	25.4	51.3	( 8.7)	( 7.4)
<b>Total administrative variations</b>	<b>( 11.1)</b>	<b>( 24.7)</b>	<b>( 73.4)</b>	<b>( 72.3)</b>
<b>Total variation in expenses from transactions since 2006-07 Budget</b>	<b>241.4</b>	<b>136.0</b>	<b>90.3</b>	<b>75.8</b>
<b>Revised net result from transactions</b>	<b>418.6</b>	<b>423.0</b>	<b>429.4</b>	<b>361.9</b>

Source: Department of Treasury and Finance

Notes:

- (a) Table may not add due to rounding.
- (b) 2006-07 Budget Net result from transactions as published in the May 2006 Budget.
- (c) Investment income includes dividends, income tax and rate equivalent revenue and interest.
- (d) The total expenditure for each year may differ to Appendix A, Specific Policy Decisions Affecting the Budget Position, for certain decisions due to the impact of departmental reprioritisations being included in Appendix A.

## Variations to income from transactions

Compared to the estimates published in the 2006-07 Budget, total income from transactions is expected to be \$343.1 million higher in 2006-07 and \$189.3 million a year higher on average over the remainder of the forward estimates period.

Policy decisions of Government resulting in changes to taxation income estimates include:

- continuation of the Environmental Contribution Levy. As part of the Government's 2004 *White Paper-Securing Our Water Future Together* statement, urban and rural water authorities were required to pay a proportion of their existing revenue base to fund water-related initiatives. Water authorities were initially required to contribute until June 2008, but this has now been extended to June 2012 to provide funding for new water initiatives; and
- changes to the Prescribed Industrial Waste Levy. In July 2006, the Government committed to apply differential levies to each class of prescribed industrial waste to reduce the generation of waste, effective from 1 July 2007. The revenue generated from the differential levies will be re-invested in waste reduction programs by the Environment Protection Authority in partnership with industry.

Favourable economic and demographic changes have caused taxation estimates to be revised upwards by \$230.8 million in 2006-07, and \$151.0 million a year on average to 2009-10, including:

- payroll tax has been revised upwards in 2006-07 by \$16.4 million and upwards over the remaining forward estimates period from 2007-08 by an average of \$25.8 million a year. This is largely due to stronger than expected employment growth;
- taxes on immovable property income have been revised upwards in both 2006-07 (\$34 million) and 2007-08 (\$10 million) mainly due to a one-off carry forward in land tax revenue from 2005-06 to 2006-07 following a delay in the issue of assessments for properties held by trusts; and
- income from financial and capital transactions, largely comprising duty on land transfers revenue, has been revised upwards by \$247.1 million in 2006-07, \$220.9 million in 2007-08, \$149.9 million in 2008-09 and \$59.8 million in 2009-10. The upward revision to land transfer duty over the forward estimates period largely reflects the current robust nature of the non-residential property market, which has experienced solid growth in both prices and activity. There is some evidence that the growing pool of superannuation funds is contributing to strong institutional activity.

In the residential market, high-value properties have proven resilient, with apparent growth in prices and turnover. Tempering this is the uncertain impact of recent interest rate rises, high levels of household debt and declining housing affordability on the first home buyers' market as well as the market for lower to middle range residential properties, although these factors do not appear to have significantly affected the market at this stage.

This is expected to lead to slower growth in property turnover over the forward estimates period, albeit from a higher level compared with 2006-07 Budget estimates.

These increases have been only partly offset by the effects of rising interest rates and petrol prices, including:

- a downward revision to gambling taxation income by \$38 million (or 2.4 per cent) in 2006-07, \$12 million in 2007-08, and \$7 million in 2008-09, with income in 2009-10 expected to remain in line with the 2006-07 Budget. The downward revision for 2006-07, 2007-08 and 2008-09, is the consequence of the lower-than-expected 2005-06 actual outcome for gambling taxation income, which reflected the effects of restrained gambling expenditure by households due to higher petrol prices and interest rate increases; and
- a downward revision to motor vehicle taxation income by \$31.7 million in 2006-07, with estimates reduced by an average of \$34.1 million a year over the forward estimates period. The weaker outlook over these years is due to the lower level of new and private sale transactions, which reflects the impact of higher petrol prices combined with lower than expected average duty per transaction as a result of motorists shifting purchases to smaller and cheaper motor vehicles.

Variations to taxation income also reflect the progressive recognition of concession fees. In accordance with the CityLink Concession Deed, CityLink Melbourne Limited is required to pay concession fees to the State in the form of semi-annual concession notes during the concession period. In 2006-07, the State assigned to the Transurban Group the concession notes it currently holds and all future concession notes it was to receive over the remaining concession period. In exchange, Transurban agreed to a payment stream to the State totalling \$614 million over a 4-year period. The consideration is to fund the upgrade of the Monash and Westgate freeways. Transurban will fund the CityLink works while the State will fund the non-CityLink works. Based on independent accounting advice, the upfront consideration received is to be progressively recognised as revenue over the remaining life of the concession term.

Investment income (which includes dividend and income tax and rate equivalent income and interest) in 2006-07 is anticipated to be substantially in line with the 2006-07 Budget estimate. This income is expected to be revised upwards by \$8.8 million in 2006-07 and downwards by \$3.3 million in 2007-08 and \$27.6 million in 2008-09 partly due to lower projected profits from the metropolitan water sector including the impact of water restrictions and the success of water-use campaigns. The upwards revision in 2009-10 is consistent with projected higher dividends from the State Electricity Commission of Victoria.

Compared to the 2006-07 Budget estimates, Commonwealth specific purpose payments have been revised upwards by \$82.4 million in 2006-07, upwards by \$61.7 million in 2007-08, downwards in 2008-09 by \$6.7 million and downwards in 2009-10 by \$67 million, reflecting variations including:

- an increase in Commonwealth funding in 2006-07 for the Exceptional Circumstances Drought Relief Package;
- additional funding in 2006-07 and over the forward estimates period for the Snowy River Environment Flows, Macalister Irrigation District and revised funding estimates for the Wimmera Mallee Pipeline – State and Commonwealth Components, as the majority of Stage One works will now be completed in 2006-07;
- revised funding estimates for capital expenditure on roads programs;
- an average \$20 million a year downward revision over the forward estimates period for Australian Health Care Agreement funding, based on recent changes to both Australian Bureau of Statistics population data estimates and the Commonwealth wage cost index used in the agreement; and
- reduced Commonwealth funding for the Highly Specialised Drugs Program to reflect new inclusions in the Pharmaceutical Benefits Scheme. This downward revision in Commonwealth health funding is partially offset by an upward revision over the forward estimates period in Commonwealth special purpose payments for the Immunisation and Young People with Disabilities in Residential Aged Care programs.

Own-source revenue (income received through fees charged by agencies for services) has been revised upwards by \$55 million in 2006-07 and is projected to increase over the forward estimates period by an average of \$46 million a year. The upward revision to the estimates primarily reflects:

- growth in hospital own-source revenue, consistent with higher than expected income received in 2005-06;

- growth in TAFE own-source revenue reflecting higher volumes of international students consistent with higher than expected income received in 2005-06; and
- an increase in other income in 2006-07, and over the forward estimates period, associated with funding from various sources, including the Murray Darling Basin Commission for the Goulburn System Strategic Measurement project and the New South Wales and South Australian Governments for the Living Murray Initiative.

Administrative variations have resulted in a downward revision of \$34.1 million in 2006-07, and on average a year-on-year reduction of \$75.4 million. This reflects the impact of variations including:

- a downward revision to estimates of the Development Contribution Levy which have been revised consistent with the timing and scope of infrastructure projects contained within the Initial State Development Contribution Plans;
- a downward revision to the estimates relating to the establishment of VicForests and appropriate treatment of forestry revenues which are now recognised in the VicForests public non-financial corporation entity; and
- offset by an increase in income arising from the liquidation and return of capital to the State from Tri-Continental Holdings Limited, which was the merchant banking arm of the former State Bank of Victoria. Liquidation is scheduled to be completed in 2006-07.

### **Variations to expenses from transactions**

When compared to the 2006-07 Budget estimates, total expenses from transactions are expected to be \$241.4 million higher in 2006-07 and \$100.7 million higher on average a year over the remainder of the forward estimates period.

New output policy decisions taken since the 2006-07 Budget account for additional expenses of \$121.5 million in 2006-07 (with the impact on operating expenses in this year offset by forward estimates contingency funding) and \$97.3 million a year on average over the forward estimates period.

Details of specific policy decisions since the 2006-07 Budget are summarised in Appendix A, *Specific Policy Decisions Affecting the Budget Position*.

Changes to Commonwealth grant funding are projected to increase expenditure in 2006-07 by \$67.2 million, reflecting the on-passing of additional Commonwealth specific purpose grants, as well as an increase in transfer payments to the public non-financial corporations and public financial corporations sectors in relation to a number of new State Government drought and water-related initiatives.

Expenditure associated with the increase in own-source revenue described earlier is projected to be \$63.7 million higher in 2006-07 and an average of \$51.2 million a year higher over the remaining forward estimates period.

Administrative variations are expected to decrease expenses by \$11.1 million in 2006-07, and are projected to be an average \$56.8 million lower a year over the forward estimates period. The major variations include:

- a downward revision to superannuation expense by \$36.5 million (or 2.2 per cent) in 2006-07, with an average projected downward revision of \$68.5 million a year over the forward estimates period. These adjustments are due to the results of the triennial actuarial review of the Emergency Services Superannuation Scheme which was conducted as at 30 June 2006. As a result of this review, a number of assumptions used to calculate the superannuation expense were changed to reflect recent experience and the economic outlook. In particular, the annual expected investment return on assets was increased (by 0.5 percentage points), allowance was made for improvements in mortality and the rates at which members leave the scheme were revised;
- a reduction in the contingency provision in 2006-07 to fund new output decisions since the 2006-07 Budget;
- a net increase in operating expenses on average over the forward years of \$44 million, reflecting required changes in accounting policy treatment for finance lease arrangements that were adopted in the *2005-06 Financial Report for the State of Victoria*;
- an increase in operating expenses of \$35 million in 2006-07 and increase in the forward period due to accounting policy related reclassifications of expenditure from capital to operating to better reflect the nature of bus, rail and roads projects; and
- the bring forward of \$59.3 million of roads related expenditure to 2006-07 from 2008-09 and 2009-10, reflecting updated forecasts for road projects milestones, including the project's operating expenditure profile.

## **SUMMARY STATEMENT OF FINANCIAL POSITION**

Table 2.4 provides a summary of the general government sector balance sheet. A more detailed balance sheet is provided in Chapter 4, *Estimated Financial Statements and Notes*.

**Table 2.4 General Government sector summary balance sheet as at 30 June <sup>(a)(b)</sup>**

	(\$ million)				
	2006 Actual <sup>(c)</sup>	2007 Revised	2008 Estimate	2009 Estimate	2010 Estimate
<b>Assets</b>					
Capital stock <sup>(d)</sup>	56 350.6	60 419.8	64 720.0	69 684.3	74 767.5
Financial assets <sup>(e)</sup>	5 462.9	4 893.7	4 876.2	4 499.5	4 050.6
Other assets	2 565.9	2 606.5	2 763.8	2 949.6	3 041.1
<b>Total assets</b>	<b>64 379.4</b>	<b>67 920.0</b>	<b>72 360.0</b>	<b>77 133.4</b>	<b>81 859.1</b>
<b>Liabilities</b>					
Superannuation	12 896.5	13 276.7	13 420.9	13 502.8	13 472.3
Borrowings	6 180.4	6 826.7	8 369.7	9 708.7	10 543.5
Other liabilities	7 777.4	7 887.5	8 137.6	8 325.9	8 462.7
<b>Total liabilities</b>	<b>26 854.3</b>	<b>27 991.0</b>	<b>29 928.3</b>	<b>31 537.5</b>	<b>32 478.6</b>
<b>Net assets</b>	<b>37 525.1</b>	<b>39 929.0</b>	<b>42 431.7</b>	<b>45 595.9</b>	<b>49 380.6</b>

Source: Department of Treasury and Finance

Notes:

- (a) Table may not add due to rounding.
- (b) This is an abbreviated balance sheet. The full balance sheet for the general government sector is reported in Chapter 4, *Estimated Financial Statements and Notes*.
- (c) As published in the 2005-06 Financial Report for the State of Victoria.
- (d) Capital stock includes land and buildings, plant and equipment, roads and earthworks, intangibles, cultural and other assets.
- (e) Financial assets include cash assets, investments, loans and placements.

General government sector net assets are expected to grow by 31.6 per cent from \$37 525.1 million as at 30 June 2006 to \$49 380.6 million at 30 June 2010. This growth reflects the projected increase in the value of capital stock over the forward estimates period associated with the purchase of property, plant and equipment to support the general government sector's infrastructure investment, as well as the projected upwards revaluations of non-current physical assets.

This increase is partly offset by growth in the value of the unfunded superannuation liability over the forward estimates period. The projected unfunded superannuation liability has increased since the 2006-07 Budget, primarily due to the results of the triennial actuarial review of the Emergency Services Superannuation Scheme conducted as at 30 June 2006. As part of this review, a number of valuation assumptions were changed to reflect recent experience and the potential economic outlook. In particular, an allowance for improving mortality and fewer resignations increased the superannuation liability. However, the increase in the liability that resulted from the actuarial review was partially offset by an increase in the long term Commonwealth bond rate that underpins the discount rate used to value the superannuation liability. While having no impact on funding requirements, the discount rate used for the revised Budget estimates is higher than that used for the May 2006 Budget estimates, which reduced the reported superannuation liability.

Over the forward period borrowings (particularly the general government sector's non-current interest bearing liabilities) are projected to grow reflecting the growth in the general government sector's capital stock explained above. More commentary on the general government sector's projected net debt level is provided below.

## CASH FLOWS

Table 2.5 provides a summary of cash generated through the operations of Victorian Government departments and other general government sector agencies, and how that cash is applied to infrastructure investment, and the impact on net debt.

**Table 2.5 Application of cash resources** <sup>(a)</sup>

	(\$ million)				
	2006-07 Budget <sup>(b)</sup>	2006-07 Revised	2007-08 Estimate	2008-09 Estimate	2009-10 Estimate
<b>Net result from transactions</b>	<b>316.8</b>	<b>418.6</b>	<b>423.0</b>	<b>429.4</b>	<b>361.9</b>
Add back: Non-cash income and expenses (net) <sup>(c)</sup>	2 060.6	1 897.9	1 684.2	1 382.8	1 566.7
<b>Net cash flows from operating activities</b>	<b>2 377.4</b>	<b>2 316.5</b>	<b>2 107.2</b>	<b>1 812.2</b>	<b>1 928.7</b>
Less:					
<b>Net investment in fixed assets</b>					
Expenditure on approved projects	3 294.1	3 278.6	3 356.7	2 572.9	1 766.9
Unallocated provision for future investment <sup>(d)</sup>	..	..	463.0	715.0	1 332.0
Meeting Our Transport Challenges Reserve to be allocated in future <sup>(e)</sup>	20.0	20.0	65.6	114.8	199.7
Proceeds from asset sales	( 130.8)	( 173.5)	( 204.8)	( 115.1)	( 95.5)
<b>Total net investment in fixed assets<sup>(f)</sup></b>	<b>3 183.3</b>	<b>3 125.1</b>	<b>3 680.5</b>	<b>3 287.5</b>	<b>3 203.1</b>
Finance leases <sup>(g)</sup>	..	398.7	..	231.4	..
Other investment activities (net)	146.4	13.0	( 0.8)	22.6	22.9
<b>Decrease/(increase) in net debt</b>	<b>( 952.3)</b>	<b>( 1 220.4)</b>	<b>( 1 572.5)</b>	<b>( 1 729.3)</b>	<b>( 1 297.3)</b>

Source: Department of Treasury and Finance

Notes:

- (a) Table may not add due to rounding.
- (b) The balances shown do not reconcile directly to the cash flow statement as published in the 2006-07 Budget Papers in May 2006 due to the restatement of opening balances to reflect the actual balance as at 30 June 2006 and due to the accounting reclassification of inventory from supplies and services to purchases of non-financial assets consistent with the accounting treatment as published in the 2005-06 Financial Report for the State of Victoria.
- (c) Includes depreciation and non-cash movements in liabilities such as unfunded superannuation and employee benefits.
- (d) Amount available to be allocated to specific departments and projects in future budgets, including contributions to other sectors.
- (e) Reflects the unallocated balance of the Meeting Our Transport Challenges Reserve which was announced in the May 2006 Budget.
- (f) Includes purchases of property, plant and equipment plus contributions to other sectors less proceeds from asset sales.
- (g) Reflects the recognition of new finance lease arrangements which are being delivered under the Partnerships Victoria model, with an equivalent increase in fixed assets following their expected completion and handover. Projects include Southern Cross Station in 2006-07 and the Royal Women's Hospital in 2008-09.

Table 2.5 shows an expected net result from transactions for 2006-07 of \$418.6 million and averaging \$404.8 million over the remainder of the forward estimates period. Adjusting for a number of expense and income items that do not require or provide cash resources during the year (principally depreciation, but also including growth in unfunded superannuation liabilities and employee benefit liabilities) yields a projected net cash inflow from operating activities for 2006-07 of \$2 316.5 million, and an average of \$1 949.4 million a year for the remaining period.

Total net investment in fixed assets (which includes total purchases of property, plant and equipment, capital contributions to other sectors of government and net proceeds from sale of assets) is projected to peak in 2007-08 before stabilising over the remainder of the forward estimates period. This profile reflects the scheduled completion of major capital projects, including:

- expected projected completion of several road programs such as the Geelong Bypass, Calder Highway and Deer-Park Bypass;
- the scheduled completion and transfer of projects being undertaken by the public non-financial corporation sector such as New Ticketing Solution.

Projected infrastructure spending from 2007-08 includes an unallocated capital provision that will be used to fund new projects in future budgets. This is in accordance with existing budget practice to ensure realistic forward projections of asset investment.

## **NET DEBT AND NET FINANCIAL LIABILITIES**

The key measures of financial position are the GFS measures of net debt and net financial liabilities. The international credit rating agencies focus on both net debt and net financial liabilities of the general government sector as measures of overall indebtedness. Table 2.6 highlights these key measures for the general government sector.

**Table 2.6 General government sector net debt and net financial liabilities as at 30 June** <sup>(a)(b)</sup>

	(\$ million)				
	2006 Actual <sup>(c)</sup>	2007 Revised	2008 Estimate	2009 Estimate	2010 Estimate
<b>Financial assets</b>					
Cash and deposits	2 698.2	2 518.4	2 517.8	2 506.2	2 499.3
Advances paid	69.9	69.3	68.7	68.0	67.4
Investments, loans and placements	2 162.1	1 767.8	1 745.8	1 375.7	928.7
<b>Total financial assets</b>	<b>4 930.2</b>	<b>4 355.5</b>	<b>4 332.3</b>	<b>3 950.0</b>	<b>3 495.4</b>
<b>Financial liabilities</b>					
Deposits held	519.8	519.1	525.5	533.5	541.4
Advances received and borrowings	6 179.5	6 825.9	8 368.9	9 707.9	10 542.6
<b>Total financial liabilities</b>	<b>6 699.4</b>	<b>7 345.0</b>	<b>8 894.3</b>	<b>10 241.3</b>	<b>11 084.0</b>
<b>Net debt</b> <sup>(d)</sup>	<b>1 769.1</b>	<b>2 989.5</b>	<b>4 562.0</b>	<b>6 291.3</b>	<b>7 588.7</b>
Unfunded superannuation	12 896.5	13 276.7	13 420.9	13 502.8	13 472.3
<b>Net financial liabilities</b>	<b>14 665.6</b>	<b>16 266.2</b>	<b>17 983.0</b>	<b>19 794.1</b>	<b>21 061.0</b>
	(per cent)				
General government net debt to GSP	0.8	1.2	1.8	2.3	2.7
General government net financial liabilities to GSP	6.3	6.7	7.0	7.4	7.5

Source: Department of Treasury and Finance

Notes:

- (a) Table may not add due to rounding.
- (b) General government net financial liabilities are calculated as the sum of net debt and unfunded superannuation liabilities.
- (c) As published in the 2005-06 Financial Report for the State of Victoria.
- (d) Net debt is calculated as gross debt less liquid financial assets.

Net debt, which is a measure used to assess general government indebtedness, is determined by deducting liquid financial assets from gross debt. Net debt is a widely-recognised measure of the strength of a government's financial position. High levels of net debt impose a call on future revenue flows to service that debt.

As Table 2.6 shows, net debt is projected to increase from \$1 769.1 million (or 0.8 per cent of GSP) as at 30 June 2006 to \$7 588.7 million (or 2.7 per cent of GSP) at 30 June 2010. This is mainly due to the size of the projected infrastructure investment program over the forward period. Of the \$5 820 million increase in net debt from 30 June 2006, \$1 435 million will be funded by a reduction in financial assets accumulated from prior years' strong operating surpluses. The balance will be funded by additional borrowings.

Net financial liabilities, which is calculated as the sum of net debt and unfunded superannuation liabilities, is a broader measure of the general government sector's overall indebtedness and is important in gauging the strength of a government's fiscal position. This measure is commonly used by international credit ratings agencies as it targets the significant financial assets and liabilities held by most governments.

As Table 2.6 shows, net financial liabilities are projected to increase from \$14 665.6 million (or 6.3 per cent of GSP) as at 30 June 2006 to \$21 061.0 million (or 7.5 per cent of GSP) at 30 June 2010. The increase is driven by the increase in the unfunded superannuation liability and growth in net debt (as explained earlier).