Queensland Audit Office

Queensland state government: 2014–15 financial statements

Report 10: 2015–16

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QUEENSLAND

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Queensland Audit Office

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December 2015

The Honourable P Wellington MP
Speaker of the Legislative Assembly
Parliament House
BRISBANE QLD 4000

Dear Mr Speaker

Report to Parliament

This report is prepared under Part 3 Division 3 of the *Auditor-General Act 2009*, and is titled Queensland State Government: 2014–15 financial statements.

In accordance with s.67 of the Act, would you please arrange for the report to be tabled in the Legislative Assembly.

Yours sincerely

Andrew Greaves
Auditor-General

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Contents

Summary

What is covered in this report

In this report we summarise the results of our audit of the Audited Consolidated Financial Statements 2014–15—Government of Queensland.

The Treasurer prepares Queensland Government financial statements annually. These statements provide a consolidated view of the revenues, expenses, assets, liabilities, equity and cash flows of all entities controlled by the state government.

The statements provide a comparison between actual results and the original budget published in parliament, as well as explanations for major variances between them.

The statements show how government has obtained its revenues. They also show how it uses these revenues to fund its day-to-day operations; to replace, renew and add to its asset base; and to pay down its debt.

To audit the financial statements, we need to understand the state's operations. We also need to understand the significant risks that could result in a material misstatement (an error that could affect the judgement or opinion of readers) of the financial statements or affect the state's future financial viability.

As part of this audit, we examined the state's financial performance, financial position, financial sustainability and budgeting performance.

Who is covered in this report

The financial statements report on the consolidated position of the state, which is the total state sector (TSS). They also report on the results of the general government sector (GGS), which is part of the TSS.

GGS entities receive most of their revenue from parliamentary appropriations approved through the annual budget process. This year, for the first time, GGS entities individually reported their actual performance against budgets and provided explanations for major differences. This adds to the transparency of public sector reporting.

In addition to the GGS, the TSS includes public financial corporations (PFCs) and public non-financial corporations (PNFCs). We have listed these at Appendix C. Both types of public corporations are largely self-funded from their operations and do not receive direct appropriations. The state is the owner of the corporations and receives taxation and dividends from them.

The Treasurer and Queensland Treasury have ultimate responsibility for the state government financial statements for both the TSS and the GGS.

Audit results

We issued an unqualified audit opinion on the financial statements for 2014–15. This means that we assessed them as representing a true and fair view of the operations and financial position of the state.

The financial statements were prepared within the statutory time frame, although 13 days later than last year.

The quality of the process for preparation of the financial statements was sound.

We note that there were material restatements of the operating statement and balance sheet for the prior year.

Financial snapshot

To understand the performance of the state, we focus on:

- the operating revenues and expenses
- changes in the value of assets and liabilities
- movements in the state's net worth.

Net operating balance

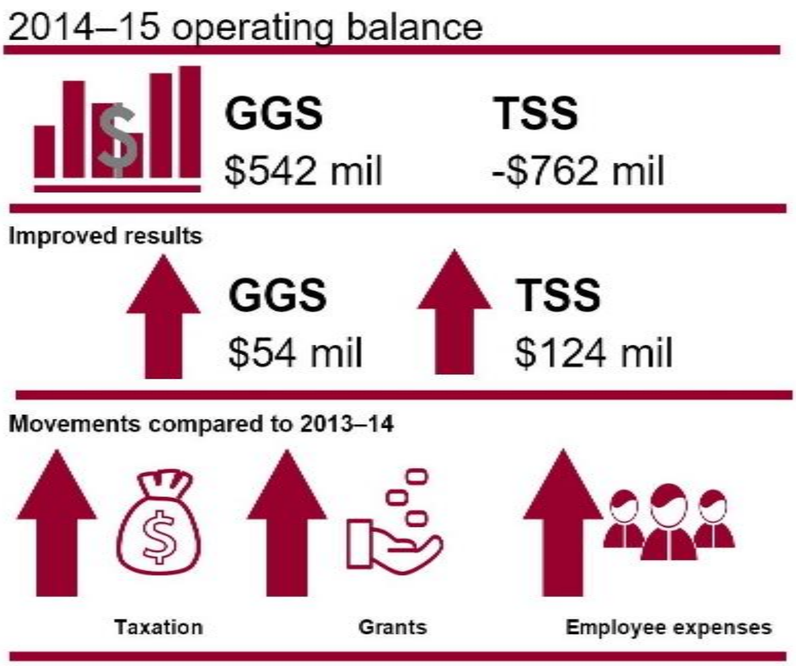
The net operating balance is a key measure of financial performance. It shows the revenue earned and expenses incurred on day-to-day operations.

For the GGS, the net operating balance was positive for the second year in a row. Both revenue and expenses increased by 6.5 per cent.

The TSS continued to record an operating loss, as it has done for the past eight years. The TSS's losses have reduced by 14 per cent this year to $762 million. For the past two years, the losses have also been less than $1.0 billion.

As shown in Figure A, across the TSS (including the GGS), the state is collecting more in taxes, receiving more in Australian Government grants, and spending more on employees.

Figure A
GGS and TSS operating balance



Source: Queensland Audit Office

The state can control costs such as employee and operating expenses and it can influence the revenue earned through economic policy and pricing. However, it cannot directly control grants revenue, which depends on the federal government.

The GGS operating revenue increased by $3.06 billion in 2014–15. The Australian Government increased Queensland's allocation of goods and services tax, and there was less volatility in federal grants revenue this year than there has been in the past five years.

The state earned $12.6 billion in revenue from taxation, including transfer duties and payroll tax. The increase of 6.2 per cent exceeded the state's economic growth of 0.5 per cent, as measured by the annual change in gross state product and inflation of 1.5 per cent.

In an accounting sense, GGS entities own the equity in public corporations, and earn returns from this investment in the form of dividends and income tax. This year, for Energex Limited, Ergon Energy Corporation Limited and Powerlink Queensland, the state increased the portion of profit paid to the GGS as dividends from 80 per cent to 100 per cent.

These additional dividends, together with improved public corporation financial performance, resulted in a $579 million increase in revenues. This made a significant difference to the bottom line as it represents more than 100 per cent of the net operating balance.

Between 2012 and 2014, the GGS employed 10 645 fewer people. As a result, we estimate that the state saved $1.12 billion in employee expenses in 2013–14.

In 2014–15, this trend changed. The state increased its workforce by 7 309 employees, representing an extra average annual cost of $763.5 million. The number of people employed by the state grew by 3.67 per cent, exceeding the average growth of 0.5 per cent in Queensland's labour force. The Australian Government paid additional grants of $470 million to the state this year, supporting growth in health and education sector employees.

Operating result

The net operating balance reported in the financial statements is adjusted for balance sheet valuation changes and capital changes to give an operating result for the state. The operating result is a key indicator of the longer term operating performance.

The GGS's operating result for 2014–15 was a surplus of $4.1 billion, representing a $3.3 billion improvement from the previous year. This is the second year the GGS has achieved a positive operating result, after five years of operating losses.

In addition to the increase in dividends reported as part of the net operating balance, the operating result also included an additional $3.1 billion of dividends from Energex Limited, Ergon Energy Corporation Limited and Powerlink Queensland, which the state owns. This is a one-off payment.

The additional dividends extracted will also change the balance sheets of these electricity transmission and distribution entities—increasing their borrowings and reducing their equity—and reduce the value of the GGS's investment in the corporations.

The TSS's operating result was also positive, although most of the positive earnings were from unrealised gains in valuations for the state's assets and investments.

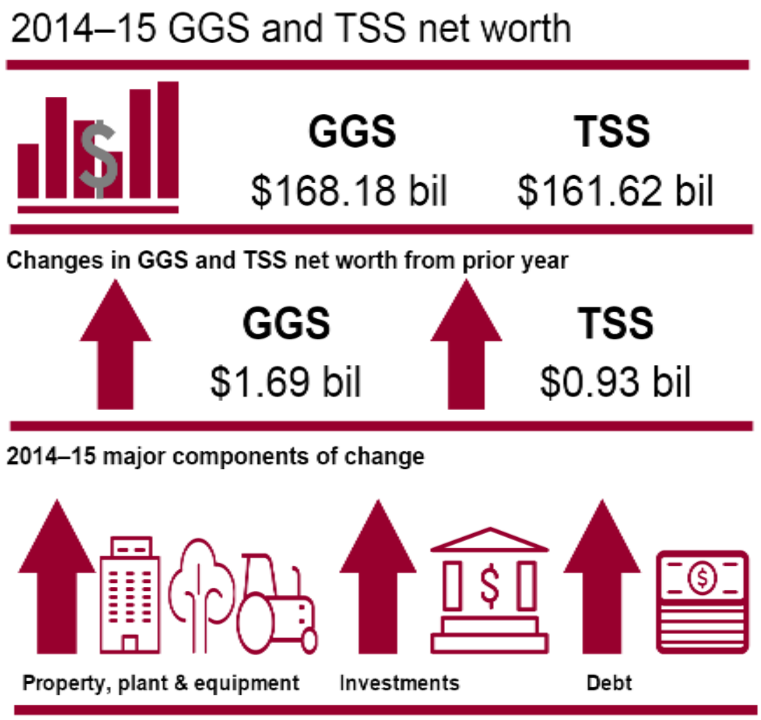
There has been annual volatility in the valuation of the state's investments. This is not a major concern, because they are long-term investments and we expect there to be year-on-year volatility. They fund the defined benefit superannuation scheme, which is for certain state employees.

Under this scheme, the state has an obligation to make payments of set amounts, regardless of the performance of the superannuation investments. The scheme is now closed. The Office of the State Actuary reported that the state's investments are likely to earn a sufficient return in the long term to fund its defined benefit superannuation liabilities.

Financial position

In 2014–15, the net worth of the state—the net position of assets less liabilities—was $168.2 billion for the GGS and $161.6 billion for the TSS.

Figure B
GGS and TSS net worth



Source: Queensland Audit Office

The most significant change in liabilities over the last five years has been an increase in borrowings of $27.4 billion for the GGS, and $34.1 billion for the TSS. The state has signalled it intends to use the one-off additional dividend payment from the electricity transmission and distribution entities to pay down GGS debt by $3.1 billion in 2015–16.

Other assets increased by $1.55 billion, mainly from an increase in the instrument linked to assets held to fund long-term liabilities. This is because the earnings and contributions to the investments were greater than the benefit payments.

In future years, net withdrawals will increase as the government has decided not to contribute additional investments to meet the defined benefit obligation. The value of the asset will decline. As time progresses and the defined benefit fund matures, the value of the liability will also decline.

GGS debt increased by $1.8 billion this year. The gross debt of the GGS represents $9 123 per head of population, an increase from $838 per head of population ten years ago.

Sustainability

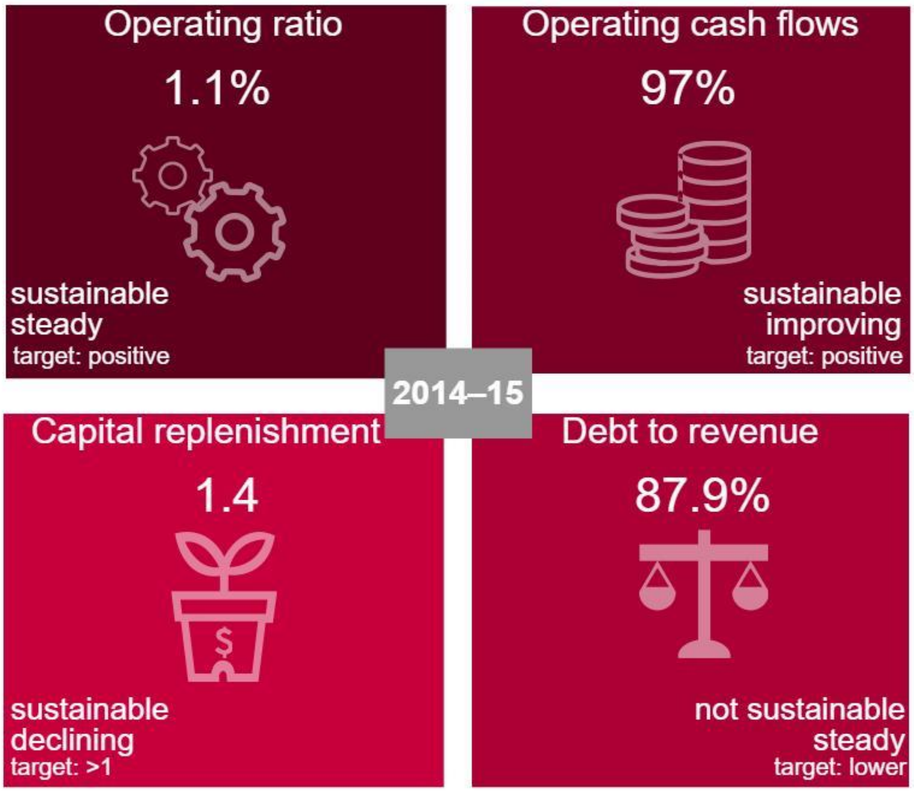
The state's financial sustainability has improved over the last two years, and government projections included in the state budget for 2015–16 indicate a consolidation of this improvement over the next four years.

We assess financial sustainability using the audited financial statements and the state budget to calculate target and actual results for four key ratios:

- operating ratio—this indicates the capacity of the state to meet recurrent expenditure from recurrent operating revenues. A positive ratio indicates that the state has surplus funds available for capital expenditure
- ratio of net operating cash flows to net purchases of non-financial assets (assets with a physical value)—this indicates the state's ability to self-finance asset acquisitions from operations, rather than relying on debt. When the ratio is more than positive 100 per cent, the state can fully fund non-financial assets from its operating cash flows
- capital replenishment ratio—this indicates whether the state's rate of capital outlays on non-financial assets is keeping pace with the depreciation of those assets. A ratio of more than one suggests the state's asset base is expanding
- debt to revenue ratio—this indicates the capacity of the state to repay debt principal and interest. The lower the ratio, the greater the ability to repay debt.

Our overall findings for the GGS are summarised in Figure C.

Figure C
GGS sustainability



Source: Queensland Audit Office

In 2014–15, the operating sustainability of the GGS improved, with a second year of positive results. Day-to-day revenue and expenses for the state have both increased.

The ability of the state to grow revenue continues to depend on economic factors that influence the amount of taxation and royalties earned and on the state's share of the goods and services tax from the Australian Government.

Queensland depends on the Australian Government for funding 75 per cent of recovery costs for future natural disasters. Any reduction in this level of support from the Australian Government will adversely affect the financial sustainability of the state, other things being equal.

Current expenses show the state has returned to increased spending patterns. The increase was included in the 2014–15 state budget and was supported by equal revenue growth.

Employee costs, together with supplies and services, are the largest expenses for the state. They form 67.3 per cent of the operating expenses. These expenses increased by 7.07 per cent this year, after stabilising last year. This is faster than this year's inflation of 1.5 per cent and gross state product growth of 0.5 per cent, though it is in line with the 2014–15 state budget.

Queensland's gross debt continues to be higher than that of every other state in Australia, and the ability of the state to repay gross debt from revenue earned has not improved this year.

The state budget for 2015–16 includes an action plan to reduce GGS debt over the next five years by $9.5 billion, with four key actions:

- Move $3.5 billion of debt from the GGS to the energy network public corporations. This action will not decrease the borrowings for the TSS, nor will it reduce the whole-of-government interest expense for the TSS.
- Increase the portion of profit paid as dividends by the energy transmission and distribution entities to the GGS from 80 to 100 per cent—an increase of $600 million in revenue for the GGS over next five years. This action will improve the operating performance for the GGS.
- Stop contributions of around $2.0 billion over the next five years to the investments put aside to fund defined benefit superannuation liabilities. This action will reduce GGS and TSS borrowings.
- No longer put money aside to pay for future long service leave costs for state employees. The $3.4 billion in current investments will reduce GGS borrowings in 2015–16, and long service leave payments will be funded through debt in future years. This will deliver an initial reduction in debt, but it moves the need to take out more debt into the future for the GGS and TSS.

The state continues to replenish its assets at least at the rate of depreciation, indicating that the overall asset base is expanding.

Reliability of state budget

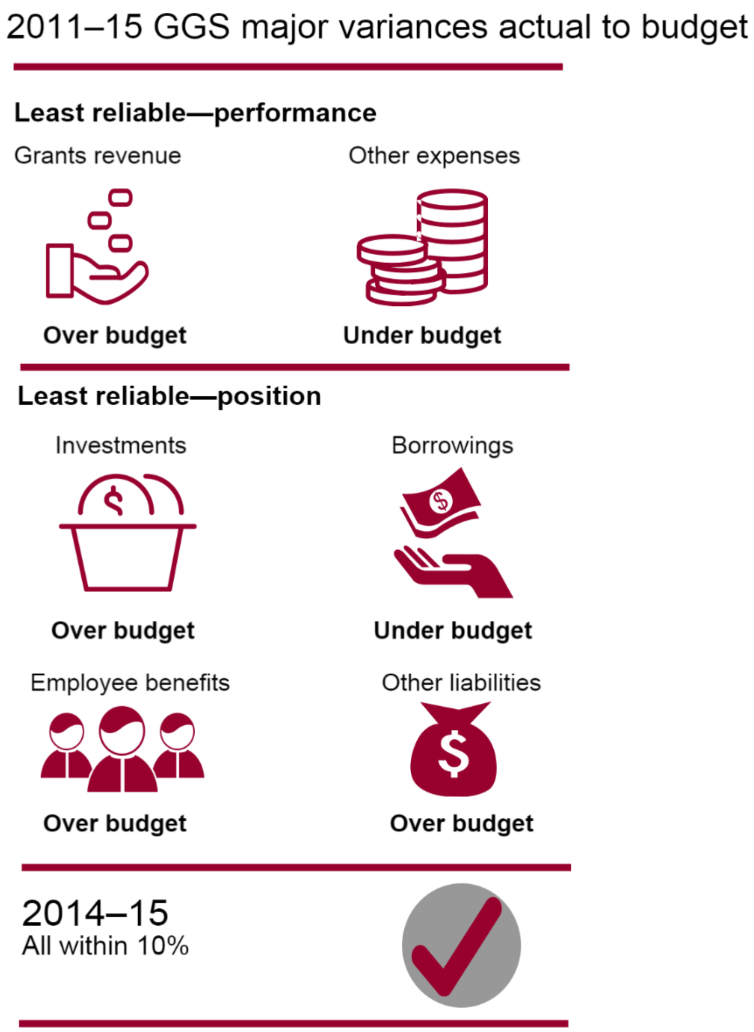
By comparing actual performance to budget, we can assess the robustness of the budget process and the accuracy of predictive models. Our findings are summarised in Figure D.

The actual performance for the GGS has been generally reflective of the budget for the past five years, with the exception of estimates of grants revenue. There, the difference between budget and actual performance was greater than 10 per cent in 2011–12.

Budgeting for these grants is challenging, as it is difficult to predict the extent of natural disasters and the scheduling of recovery works in advance, along with the timing of grant receipts from the Australian Government.

The state faces challenges in preparing budgets for its balance sheet as the assumptions it uses to value assets and liabilities, such as discount rates, are beyond its control. (Discount rates are used to record future cash flows in today's values.) Other factors, such as construction costs, sources of funding, and timing of capital works, have also affected the reliability of the budget.

Figure D
Summary of GGS budget variances



Source: Queensland Audit Office

1. Context

Legal requirements for state government financial statements

Preparation

The Treasurer is responsible for consolidating the financial data of all state-controlled entities into state government financial statements. This must be done within six months of the end of each financial year, or by a later date agreed with the Auditor-General.

The state government financial statements are prepared in accordance with the *Financial Accountability Act 2009* and the Australian Accounting Standards Board (AASB), including AASB 1049 *Whole of Government and General Government Sector Financial Reporting*.

The Treasurer, the Under Treasurer and the most senior officer of Queensland Treasury responsible for preparing the state government financial statements are each required to certify whether, in their opinions, the statements have been properly drawn up under the prescribed requirements to present a true and fair view of:

- the financial operations and cash flows of the Queensland Government for the financial year
- the financial position of the Queensland Government at the end of the financial year.

The Treasurer is required to send the state government financial statements to the Auditor-General as soon as practicable after they have been prepared and certified.

Audit

Section 42 of the *Auditor-General Act 2009* requires the Auditor-General to audit the state government financial statements and prepare a report on them. The report states whether the Auditor-General:

- has received all the information and explanations required
- considers the financial statements to be properly drawn up, under prescribed requirements, to give a true and fair view of the financial operations and cash flows of the state for the financial year and of the financial position at the end of that financial year.

The audit report, which includes the audit opinion, provides assurance about the reliability of the financial report, including its compliance with legislative requirements. Under Australian Auditing Standards, we may issue one or more of four audit opinion types:

- *an unmodified opinion* means the financial statements comply with relevant accounting standards and prescribed requirements
- a *qualified opinion* means the financial statements as a whole comply with relevant accounting standards and legislative requirements, but with particular exceptions
- an *adverse opinion* means the financial statements as a whole do not comply with relevant accounting standards and legislative requirements
- a *disclaimer of opinion* means we are unable to express an opinion about whether the financial statements comply with relevant accounting standards and legislative requirements.

We may also include an *emphasis of matter* paragraph with the audit opinion to highlight an issue of which we believe the users of the financial statements need to be aware. The inclusion of an emphasis of matter paragraph does not modify the audit opinion.

As soon as reasonably practicable after the Auditor-General prepares the report, he must give the financial statements and the report to the Treasurer.

Tabling in parliament

The Treasurer is required to table the audited state government financial statements and report in parliament within 14 days of receiving them from the Auditor-General.

Sectors of government

The state government financial statements separately disclose transactions and balances for the total state sector (TSS) and for the general government sector (GGS).

The general government sector

In Queensland, the GGS includes the entities funded for the delivery of services through state budget appropriations. This includes all departments. We have listed the 71 parent GGS entities in Appendix B of this report, along with the entities they control.

The total state sector

The GGS is part of the TSS, but the TSS also includes the three public financial corporations (PFCs) and 16 public non-financial corporations (PNFCs) listed in Appendix C. According to AASB 1049:

- public financial corporations are made up of government-controlled entities providing financial services including borrowing and making investments for the state and managing financial risks
- public non-financial corporations are made up of government-controlled entities engaged in producing market goods and providing non-financial services including energy generation and distribution, water distribution, and rail and port services.

The entities classified as public corporations are usually the state's commercially viable enterprises. Public corporations pay revenue to the GGS through dividends and income tax, and some of the entities receive community services obligation payments from the GGS to support any non-commercial business activities required by government.

The financial statements of the material public corporations the state directly controls are consolidated in the state government financial statements. (An entity is considered material if its operating result exceeds $4 million or its net assets exceed $50 million.)

Some material public sector entities such as universities and local governments are not included in the financial statements because the state does not directly control them.

Consolidation process

While Queensland Treasury prepares the state government financial statements, every entity included in the TSS, as listed in Appendices B and C, prepares a package of audited financial information for consolidation purposes.

To do so, each entity has to map its audited financial statements to the classifications used in the state government financial statements. Queensland Treasury removes any transactions and balances between state entities to give an overall state position.

Reference to comments

In accordance with s.64 of the *Auditor-General Act 2009*, we provided a copy of this report to the Treasurer and Under Treasurer with a request for comments.

We have considered the Treasurer's and Under Treasurer's views in reaching our audit conclusions and finalising this report.

The comments received are included in Appendix A of this report.

Report structure and cost

The structure of this report is as follows:

Chapter	Description
Chapter 2	includes the results of the audit, including our audit opinion and our assessment of the overall quality and timeliness of the financial statements. We also include our assessment of the key estimates and judgements made by management that have the most significant effect on the amounts in the financial statements.
Chapter 3	examines the state's financial performance, financial position, and variances between actual results and the original budget.
Chapter 4	provides our analysis of the state's financial sustainability, including risks to the state's capacity to maintain and grow government services.
Chapter 5	details the significant impact that natural disasters have had on the state's operating and capital expenses in recent years, and the funding arrangements for these expenses.
Appendix A	contains responses received from the Under Treasurer.
Appendix B	contains a list of the entities included in the general government sector.
Appendix C	contains a list of the public corporations included as part of the total state sector.
Appendix D	provides details of the key financial sustainability ratios used in Chapter 4.

The cost of preparing this report was $80 000.

2. Results of audit

In brief

Queensland Treasury provides a framework that allows it to set policies, monitor changes, maintain a chart of accounts, establish time frames, analyse information, maintain systems and promote a cooperative culture. The quality and timeliness of the state government financial statements depend largely on Queensland Treasury's capacity to provide this framework.

We perform our audit in accordance with Australian Auditing Standards. Consequently, we focus our audit procedures on the areas that we assess as having greater risk of material misstatement. 'Material misstatement' means an error or omission in the financial statements that could affect a reader's opinion or judgement. We apply both a value threshold and subjective judgement to decide if an error or omission is a material misstatement.

Conclusions

The state government financial statements for 2014–15 were fairly stated and were finalised on 4 December 2015, 27 days ahead of the statutory deadline.

We assess the overall quality of the system and process to be sound.

The state values its infrastructure assets according to accounting standards set by the Australian Accounting Standards Board (AASB). This year, the AASB clarified how to depreciate long-lifed infrastructure. This led to a decrease in last year's operating result of $0.2 billion to $0.8 billion. The state responded appropriately by making a retrospective adjustment.

The regulated energy transmission and distribution entities made a change to the way they account for the difference between what they charge and the maximum they are allowed to charge (by the regulator). In the past, they recorded this as a receivable asset, because they believed they could recover the under-billed amounts in future regulatory periods.

Following advice from the AASB, they have appropriately stopped doing this. As a result, the state wrote off $0.5 billion of the operating result of the total state sector for the adjustment made prior to 2014–15.

Background

Queensland Treasury is the lead agency for the preparation of the state government financial statements. It maintains a framework for the timely preparation of high quality consolidated financial statements each year. Components of this framework include:

- setting accounting policies that produce information that is relevant, consistent and able to be reliably measured by all controlled entities
- monitoring changes in accounting standards and developing whole-of-government solutions for implementing new requirements
- maintaining a clearly defined whole-of-government chart of accounts, and a system that enables entities to efficiently record their account balances based on this chart of accounts
- establishing time frames for the provision of consolidation packages by entities and monitoring compliance with this timetable
- analysing the information provided by entities against budgets and prior year results
- maintaining systems for the reliable consolidation of entity data, including removing internal transactions and balances
- promoting a culture that encourages the prompt raising and addressing of any queries and issues.

A well-developed framework is only effective if each entity included in the consolidation provides financial information that is timely and stated in accordance with the prescribed accounting policies.

Each entity included in the consolidation must obtain an unqualified audit opinion of its general purpose financial statements. Each entity must also accurately translate its financial statements to the whole-of-government chart of accounts within the time frames set by Queensland Treasury.

Our audit approach is risk-based, in accordance with Australian Auditing Standards. As a result, we devote more audit effort to the areas we assess as having a greater risk of material misstatement. These areas typically involve significant or unusual transactions, or transactions, balances or disclosures that require significant management judgement.

Conclusions

We issued an unqualified audit opinion on the state government financial statements for 2014–15. This means we assessed them as being a true and fair view of the state's finances.

The Treasurer signed the statements on 3 December 2015 and we signed them on 4 December 2015, which was 27 days before the statutory deadline of 31 December 2015.

Prior period adjustments were identified for the general government sector (GGS) and the total state sector (TSS). The most significant of these adjustments was a $0.5 billion reduction to the revenue previously reported for 2013–14. This related to how the electricity transmission and distribution entities recorded the difference between what the regulator allows them to charge their customers and what they actually charge.

Our audit emphasised the valuation and depreciation of infrastructure assets and buildings, as we assessed this to be the area of the financial statements with the greatest risk of containing a material misstatement.

Overall audit opinion

We issued an unqualified audit opinion on the 2014–15 state government financial statements. They presented a true and fair view in accordance with prescribed requirements of the:

- financial operations and cash flows of the Queensland Government for the financial year 1 July 2014 to 30 June 2015
- financial position as at the end of that year.

Timeliness

Audit received the first full draft of the 2014–15 state government financial statements on 7 October 2015, compared to 26 September 2014 for the previous year's statements.

Of the entities included in the consolidation, 94.4 per cent finalised their audited financial statements by 31 August 2015.

We certified the audit opinion for the 2014–15 state government financial statements on 4 December 2015, 13 days later than for 2013–14.

Quality

Audit opinions for controlled entities

The quality of the consolidated financial statements largely depends on the reliability of the information provided to Queensland Treasury by entities. All of the entities included in the state government financial statements achieved an unmodified audit opinion on their general purpose financial statements for 2014–15.

Consolidation work papers

The consolidated financial statements and supporting work papers prepared by Queensland Treasury were of a high standard and we did not identify any material errors in the consolidation process.

Change to prior year's financial statements

The state adjusted the GGS 2013–14 operating result by $0.2 billion (20.0 per cent) from the amount reported in the previous year's financial statements.

The state reduced the TSS operating result by $0.6 billion. This took it from $2.6 billion to $2.0 billion and reduced the prior year's net worth by $2.8 billion.

Key audit matters

Key audit matters are those areas that, in our professional judgement, pose a higher risk of material misstatement of the financial statements. These matters often relate to significant events or transactions that occur during the period. In other cases, they are financial statement areas that involve significant management judgements, such as accounting estimates that have high estimation uncertainty.

We designed our audit procedures to address these matters in the context of our audit of the consolidated financial statements as a whole.

Additional dividends paid by energy transmission and distribution entities to the GGS

Impact on the state

In its 2015–16 budget, the government announced plans to transfer debt from the GGS to public non-financial corporations (PNFCs). To achieve this capital return, it required the energy transmission and distribution entities to pay additional dividends to the GGS.

In prior years, these three entities (Energex Limited, Ergon Energy Corporation Limited and Powerlink Queensland) paid dividends on 80 per cent of their profits to the GGS, which owns the equity in them.

Because of the government's decision, the entities will now pay dividends on 100 per cent of their net profits (a total of $1.36 billion in 2014–15) to the GGS. They will also pay additional dividends of $3.13 billion. These dividends will be drawn from the accumulated surplus of the entities ($3.0 billion) and from asset revaluation reserves of $1.41 billion. (When assets are revalued, any increase is kept in reserve.)

The GGS reported as revenue the dividends of $1.36 billion it received from net profits. This formed part of its operating balance. It reported the additional dividends of $3.13 billion as a capital return. This was in line with the government's intent to transfer cash from the entities to the GGS.

The GGS reports its equity in the public sector entities at fair value (the amount someone would be willing to pay for the asset) on its balance sheet. Because the energy transmission and distribution entities have paid $3.13 billion more, the value of the GGS's equity in the entities has now reduced by $3.13 billion.

The transfer of money will not affect the TSS overall and it will not reduce total state borrowings or total state interest expense. The government has moved the debt from the GGS to PNFCs.

Impact on the energy sector

Because they will pay more in dividends in 2015–16, the energy transmission and distribution entities will need to increase how much they borrow. This means the ratio of how much they owe compared to how much they have in equity will rise from an average of 55 per cent to between 70 and 75 per cent.

This will take them above the 60 per cent benchmark set by the Australian Energy Regulator for efficient network businesses. The three entities may have less funding to pay for capital works, and/or they may need to extend the life of their assets by increasing maintenance.

Transport and Main Roads change to asset valuation (GGS)

In 2014–15, the Department of Transport and Main Roads (DTMR) changed the way it calculates the value of its road assets, and correctly adjusted its figures for the prior year accordingly.

In the past, DTMR has not depreciated parts of road assets that it intended to reuse. In May 2015, the Australian Accounting Standards Board (AASB) clarified that depreciation is required for such assets, and that entities should depreciate the assets on a component basis. (Various components have different useful lives and are depreciated differently.)

As a result, the department now depreciates over a long period the road assets it is intending to reuse.

This change affects both the value of the assets and the depreciation expense (the portion of the cost of an entity's assets that it records each year). As a result, DTMR decreased its asset—property plant and equipment—by $2.5 billion, which is 1.5 per cent of net worth. It also increased depreciation expense for the previous year by $1.0 billion.

Under-recovery of revenue for regulated energy transmission and distribution entities (TSS)

The regulator of Energex Limited, Ergon Energy Corporation Limited and Powerlink Queensland specifies a maximum price that the entities are allowed to charge customers. In previous periods, where the amount billed by these entities in a year was less than the regulated amount allowed, they recorded the difference as an asset, because they believed they could recover it in future from their customers.

In January 2015, the AASB formalised its position on rate-regulated activities, stating that it does not believe these sorts of regulatory deferral account balances meet the definition of assets and liabilities.

This triggered a change in the accounting treatment of the $1.5 billion that had been recognised as a TSS receivable at 30 June 2014. This was written off as an adjustment to the TSS’s accumulated surplus.

Seqwater valuation change (TSS)

Seqwater owns $11.4 billion of infrastructure to enable it to manufacture, store, distribute and treat the water it sells. It values this infrastructure using a discounted cash flow approach. This means it estimates the expected net income to be earned in the future, estimates a sale price for the asset, and records the future cash flows in today's value.

In the past, Seqwater has used pre-tax cash flows and discount rates when reporting the valuation of its infrastructure assets. In 2014–15, in accordance with the requirements of AASB 13 *Fair Value Measurement*, it amended these inputs to reflect the use of post-tax cash flows discounted using a post-tax discount rate.

Seqwater increased the valuation in the prior year's balance sheet by $1.4 billion, and made a corresponding adjustment to the TSS's equity reserves.

3. Financial performance and position

In brief

The Queensland Government financial statements show the consolidated financial performance and position of the total state sector (TSS), and the general government sector (GGS), which forms part of the TSS. The financial statements include an operating statement, a balance sheet, a statement of changes in equity and a cash flow statement.

The operating statement contains two key measures of financial performance—the net operating balance and operating result.

The net operating balance is a measure of the normal, or day-to-day, activities of the state. It tells us whether the state is earning more than it spends. The operating result takes the normal activities and adjusts for changes in balance sheet values.

Net worth, or the amount by which assets exceed liabilities, is a measure of the state's financial position. The degree to which assets exceed liabilities indicates the extent to which the state government would be able to absorb unexpected adverse economic shocks.

We consider all of these aspects of the financial statements.

We also compare actual performance to the annual state budget produced by the Queensland Government, as the financial statements include disclosure of the actual and budgeted figures for the GGS, together with explanations for major variances. This enables us to assess the robustness of the budget process and the accuracy of the predictive models used.

Conclusions

The GGS's operating result for 2014–15 was a surplus of $4.1 billion. This was a $3.3 billion improvement on the previous year. Underpinning this surplus was a $3.1 billion additional dividend from electricity transmission and distribution entities controlled by the state.

Both day-to-day revenue and cost of operations of the GGS increased by 6.5 per cent. Expenses increased by $3.0 billion, including a 7.1 per cent increase in employee expenses and in supplies and services. These expenses increased in line with revenue after a period of stabilisation.

The most significant change in assets and liabilities over the last five years has been an increase in borrowings of $27.4 billion (167.0 per cent) for the GGS and $34.1 billion (48.4 per cent) for the TSS.

In 2012–13, the state used some of the GGS borrowings to fund operating expenses. The state had improved operating results in 2013–14 and 2014–15. As a result, it did not need to borrow as much in these years.

Net worth at 30 June 2015 was $168.2 billion for the GGS and $161.6 billion for the TSS (which also includes the public corporations). This is consistent with the prior year. It represents a significant surplus of assets over liabilities—208.7 per cent for the GGS and 107.2 per cent for the TSS.

The state budgets over the past five years have forecast total GGS revenues, expenses, assets and liabilities with reasonable accuracy.

Background

We measure the Queensland Government's financial performance by the operating result reported in the Audited Consolidated Financial Statements 2014–15—Government of Queensland (the state government financial statements).

The financial statements include an operating statement, a balance sheet, a statement of changes in equity and a cash flow statement. It also includes notes showing details about the line items in the statements.

The operating statement has two key measures for performance: the net operating balance and the operating result. The net operating balance is a measure of the normal, or day-to-day, activities of the state—it tells us whether the state is earning more than it spends.

The operating result takes the normal activities and adjusts for changes in balance sheet values. Changes to the funding structure of public corporations, including adjustments to the debt equity mix, are included here. Operating results reflect the state's capacity to maintain service levels and construct new infrastructure from internal funding.

The balance sheet reports the net position of the state's assets and liabilities, known as net worth. Net worth tells us whether the state has more assets than liabilities and trends over time indicate the financial health of the state. The degree to which assets exceed liabilities indicates the extent to which the state government would be able to absorb unexpected adverse economic shocks.

The cash flow statement tells us where the state has earned and spent its money. It is divided into three types of cash flows: operating, or day-to-day; investing, or assets purchased and sold; and financing, or taking out and repaying borrowings.

The Queensland Government produces a state budget annually, compiling forward estimates on a rolling five-year basis. A robust budgeting process is fundamental to providing parliament and other parties (such as ratings agencies and the community) with an accurate picture of the financial outlook for the general government sector (GGS), including for the government's prioritised policy initiatives.

The budget process also acts as a key control for monitoring and preventing excessive expenditure by government entities. The state government financial statements disclose the actual and budgeted figures for the GGS. They also explain the reasons for major variances between the budget and actual.

Conclusions

The operating result of the GGS improved by $3.3 billion to $4.1 billion in 2014–15. This was because increases in revenues and other economic flows (an increase of $6.3 billion or 13.4 per cent) significantly exceeded the escalation in expenses ($3.0 billion or 6.5 per cent).

The day-to-day cost of operations of the GGS increased by $3.0 billion. This was offset by a corresponding increase in revenue. The GGS continues to earn more than it spends on day-to-day operations, as demonstrated by its net operating balance.

The increase in revenue includes an increase in dividends of $267 million from the public non-financial corporations (PNFC) sector. This was because the Queensland Government, as part of its debt reduction action plan, required the electricity transmission and distribution entities to pay dividends on 100 per cent of their profits rather than the 80 per cent on which they previously paid.

Employee expenses and supplies and services expenses increased in 2014–15.This was after they stabilised in 2012–13 and reduced in 2013–14.

Other revenues and expenses (classified as other economic flows) of the GGS increased by $3.27 billion. These relate mostly to changes in valuations of assets and liabilities and returns made by the PNFC sector. They included a $3.1 billion additional dividend paid by the entities to the GGS.

Total assets exceeded total liabilities at 30 June 2015 by $168.2 billion for the GGS and by $161.6 billion for the total state sector (TSS). This makes it clear that the state's financial position is sound. The net worth value has fluctuated by less than 8 per cent over the five years to 30 June 2015, indicating stability in financial position.

Over the last five years, borrowings have increased by $27.4 billion (167.0 per cent) for the GGS and $34.1 billion (48.4 per cent) for the TSS. For the GGS, this increase is significant when compared to property, plant and equipment acquisitions of $33.4 billion over the same period. In 2012–13, the GGS used some of its borrowings to fund operating expenses rather than asset acquisitions that provide future benefits to the community.

Within the same five years, the annual state budgets have forecast total GGS revenues, expenses, assets and liabilities with reasonable accuracy. The budgeted revenues and expenses have been conservative over this period, with actual operating results exceeding budget each year.

Revenues, expenses and operating result

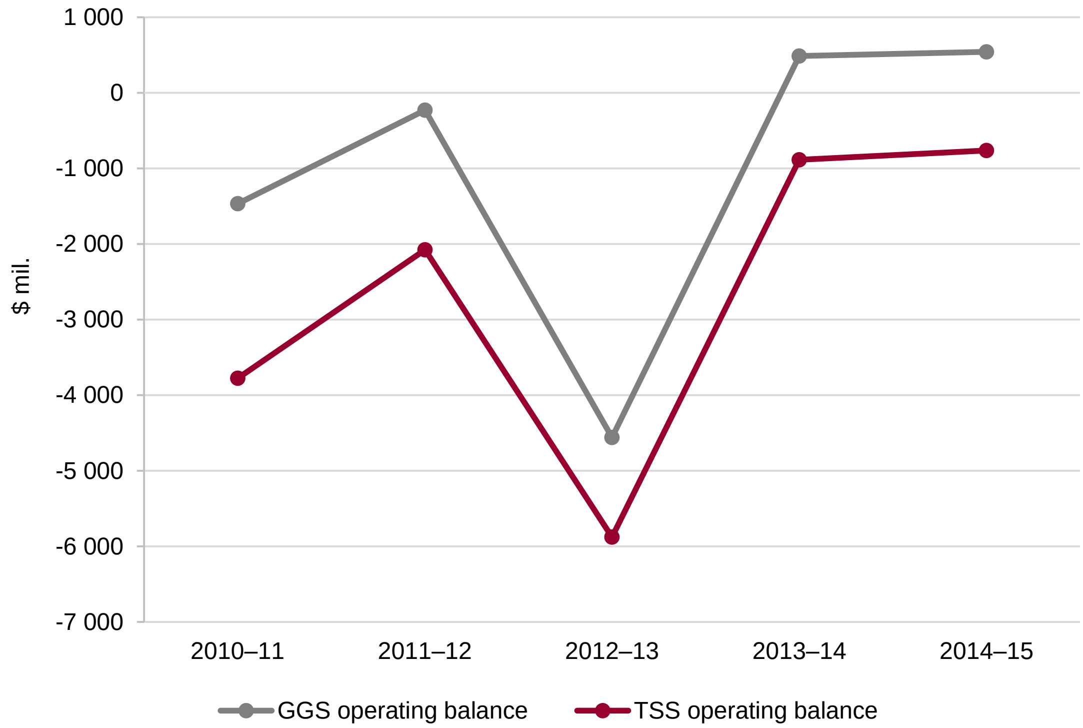
The operating statement reports two key indicators of performance: net operating balance and operating result. The net operating balance shows the results of day-to-day operations of government. The operating result adjusts for changes in balance sheet values including fluctuations in the value of the investments in public corporations (because of changes in the debt/equity structure).

Net operating balance

For the second year in a row, the GGS earned more than it spent on expenses, reporting a net operating balance of $542 million.

The TSS made an operating loss of $762 million. This operating loss continues to reduce with revenue growing faster than expenses by 0.3 per cent, as shown in Figure 3A.

Figure 3A
GGS and TSS net operating balance



Source: Queensland Audit Office

The state can control employee and operating expenses and can also influence the revenue earned through economic policy and pricing. However, it cannot influence grants revenue. This is dependent on the federal government.

GGS revenue from transactions comprises grants revenue, taxation revenue, sales of goods and services, dividends and taxation from public corporations and other sources. The revenue in each of these categories increased this year with the exception of royalties (charged for natural resources extracted and sold by the private sector). These declined in line with a fall in coal prices.

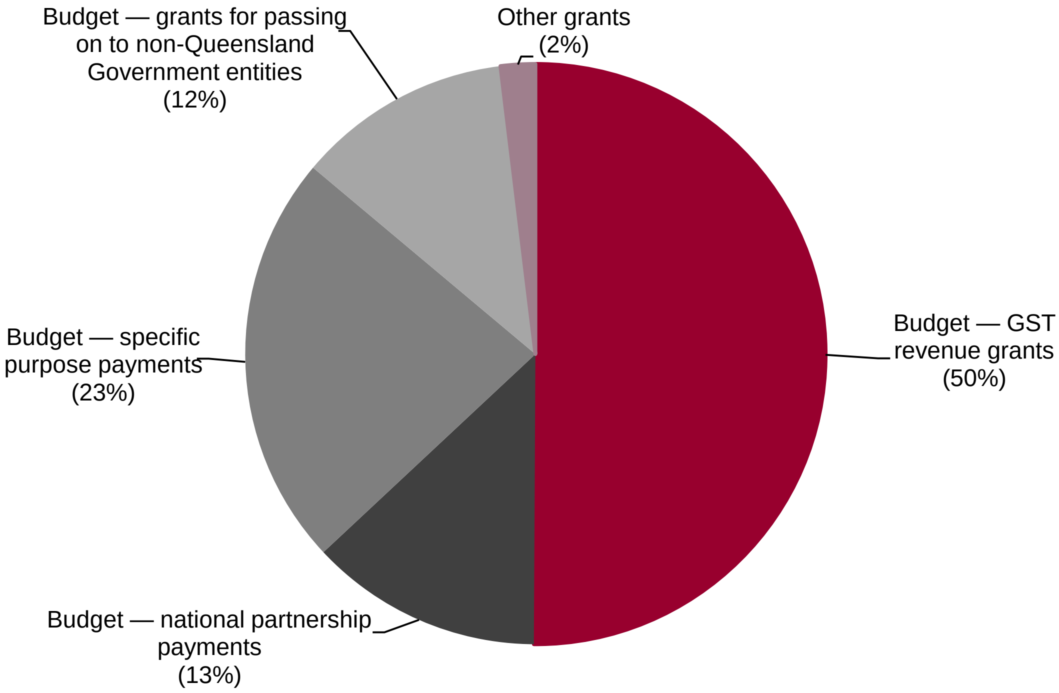
Expenses comprise supplies and services, employee expenses, grants (provided to the private sector when it delivers public services) and depreciation.

In the following sections, we provide our analysis of the nature of each significant change in revenue and expense, and where available, a comparison to external factors.

Grants revenue

In 2014–15, 98 per cent of grants were from the Australian Government. The types of grants are shown in Figure 3B.

Figure 3B
GGS grants revenue 2014–15



Source: State government financial statements 2014–15

The state can spend GST revenue at its own discretion, but all other grant funding must be spent to achieve the Australian Government's objectives for health, education and disaster recovery.

Natural disasters vary from year to year and there is up to a three-year delay between the disasters occurring and the receipt of funding. The timing of budget grants fluctuates from year to year, resulting in volatility in the net operating balance.

GST revenue grew by $900 million or 8.44 per cent over 2014–15, significantly contributing to the increased net operating balance. This revenue growth will support the state in improving its net operating balance, and contribute to reducing debt and providing infrastructure.

Taxation and royalty revenue

The GGS collects all of the state's taxation revenue—$12.6 billion, and royalty revenue—$2.06 billion.

Taxation revenue consists of transfer duties, payroll tax, vehicle registration fees and gaming taxes and levies. As mentioned earlier, the state charges royalties for natural resources, such as coal and liquefied natural gas, extracted and sold by the private sector. The state sets charges for taxation and royalties, with the overall revenue earned mainly dependent on the level of business activity, the housing market and commodity prices in Queensland.

On average, taxation revenue has grown by 6.06 per cent per year over the five past years, exceeding the average growth in the Queensland economy of 2.4 per cent (as represented by the average growth in the gross state product measured by the Australian Bureau of Statistics and average inflation of 2.3 per cent).

Queensland Treasury expects the Queensland economy to grow to 4.5 per cent in future periods. If this occurs, taxation and royalty revenue will continue to improve the state's net operating balance.

Forecasts for royalties have a history of fluctuating significantly from year to year, mainly due to changes in exchange rates and commodity prices. Uncertainty about when exports would begin for the newly established liquid natural gas industry also contributed to the variations in revenue forecasts in recent years. As these factors are beyond the state's control, volatility in royalties represents a major risk for the state's financial performance.

Dividends and taxation from public corporations

The GGS receives dividends, income tax and other fees from public corporations. The revenue is dependent on the performance of the public corporations and the payout ratio. This year, Energex Limited, Ergon Energy Corporation Limited and Powerlink Queensland increased their payout ratio from 80 to 100 per cent of profits.

Dividends and taxation from public corporations represents 5.1 per cent of operating revenue for the GGS. The payout ratio increase for Energex Limited, Ergon Energy Corporation Limited and Powerlink Queensland, together with an improvement in underlying entity performance, resulted in a 29.3 per cent increase from 2013–14.

Employee and superannuation expenses

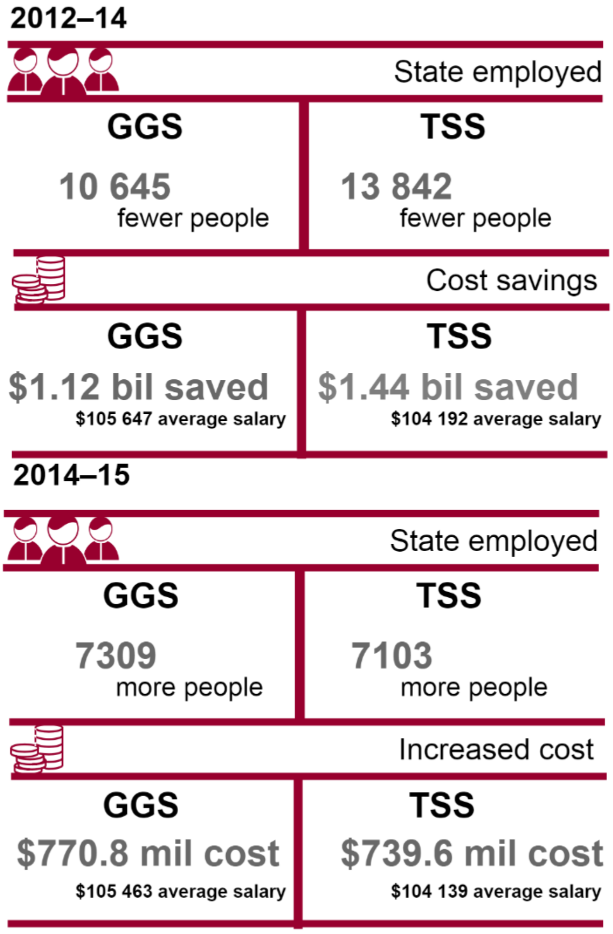
Employee expenses make up more than 37.7 per cent of expenses for the GGS and 35.3 per cent of expenses for the TSS. The number of people employed by the state and the amount paid per employee both affect employee expenses.

Employee expenses stabilised in 2012–13, and then reduced the following year. This was because employee numbers were reduced from 209 949 at 30 June 2012 to 199 304 at 30 June 2014.

This year, employee numbers increased in the GGS by 3.67 per cent, which is 68 per cent of the 10 645 employees reduced between 2012 and 2014. In the TSS they increased by 3.25 per cent, which is 51 per cent of the 13 842 employees previously reduced. This increase exceeds the state employment growth of 0.5 per cent and expected population growth of 1.5 per cent in 2014–15.

The staffing figures and estimated costs are shown in Figure 3C.

Figure 3C
Number of employees



Source: Queensland Audit Office

Supplies and services

Supplies and services represent 28.0 per cent of total operating expenses from transactions, supplies and services for the GGS and 26.8 per cent for the TSS. The expenses relate to a wide range of costs such as outsourced service delivery, building rent, utility costs, contractors and consultants, repairs and maintenance, and travel expenses.

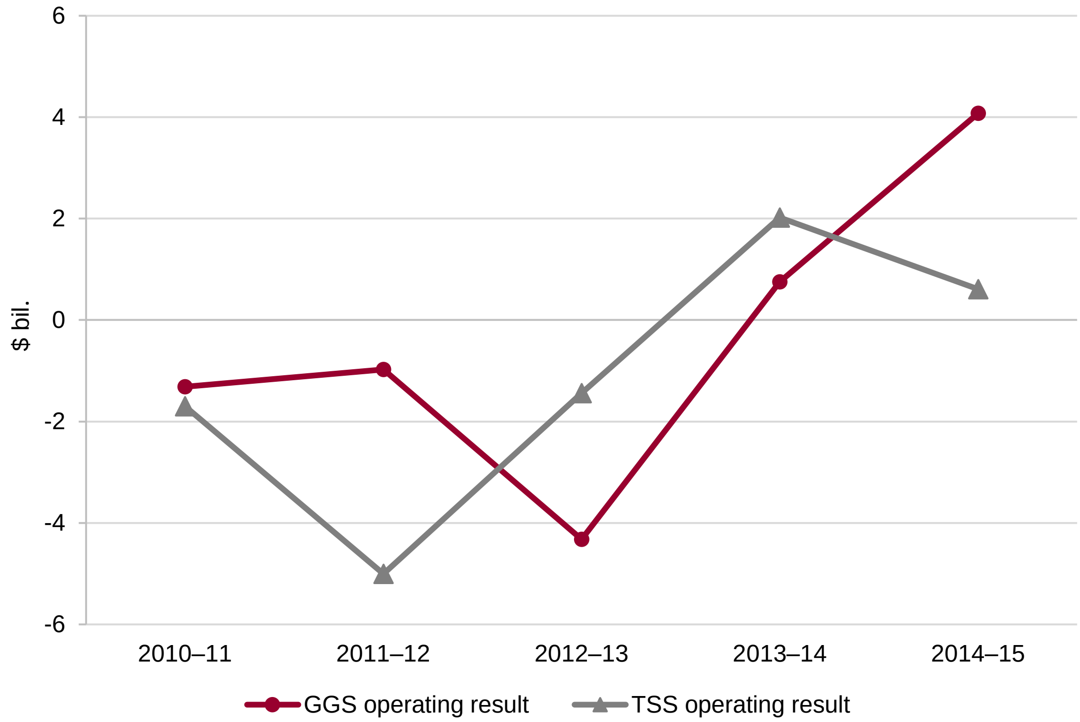
Operating result

The operating result adjusts the net operating balance for changes in balance sheet values and capital movements, which are known as ‘other economic flows’.

Other economic flows are separately reported in the operating statement as they represent a change in value of a balance sheet item, rather than earnings or expenditure of government. They are a reflection of valuation increases or decreases in assets and liabilities, including investments in public corporations.

Figure 3D shows that the operating result for both the GGS and TSS has remained positive for the second year in a row, but while the GGS has improved, the TSS went backwards after two positive years.

Figure 3D
Operating result



Source: State government financial statements 2011–12 to 2014–15

Other economic flows

Other economic flows for the GGS were $3.5 billion for 2014–15, an increase of $3.3 billion from the prior year. In contrast, the TSS's other economic flows were $1.4 billion for 2014–15, a decrease of $1.5 billion.

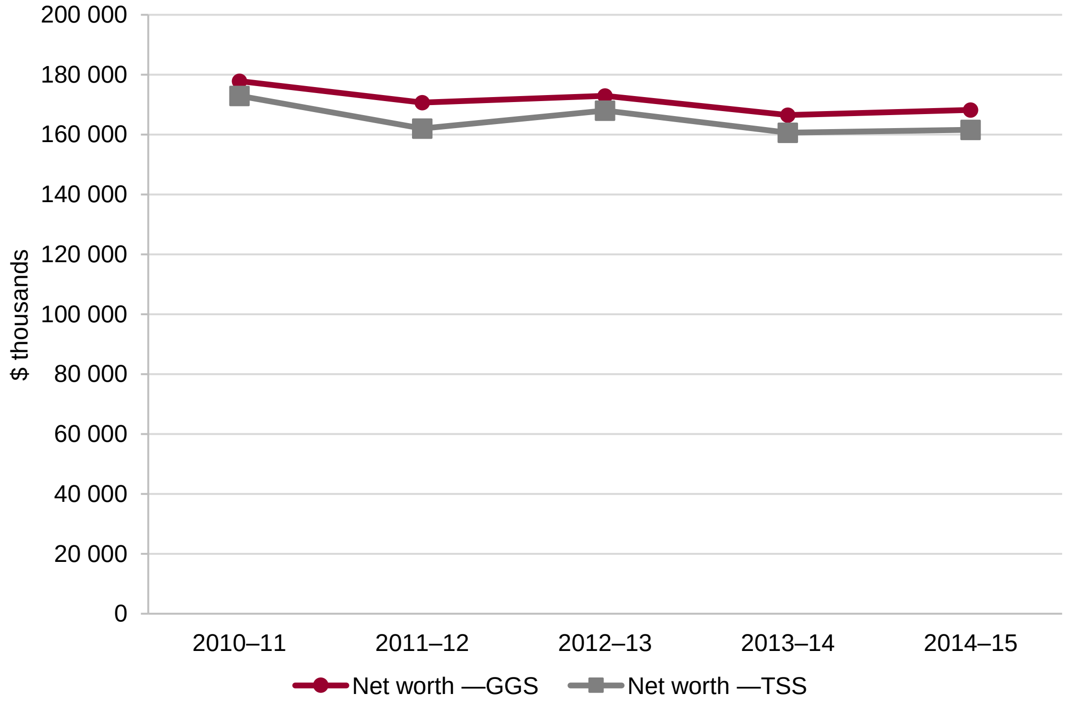
This is because Energex Limited, Ergon Energy Corporation Limited and Powerlink Queensland were required to pay additional dividends of $3.13 billion. These are reported as a capital adjustment in the state's accounts. While the state now has the ability to use the $3.1 billion within the GGS, the extra dividend payment reduces the value of the state's investment in Energex, Ergon and Powerlink.

Also, last year, the gain on sale of Queensland Motorways Limited was included in the TSS economic flows, resulting in a higher operating result than the current year.

Assets, liabilities and net worth

The net worth of both the GGS and TSS has been relatively stable over the last five years, as illustrated in Figure 3E.

Figure 3E
GGS and TSS net worth



Source: State government financial statements 2011–12 to 2014–15

Net worth represents the surplus of assets over liabilities. The state's current net worth indicates that is in a sound financial position.

In the following sections, we provide details about the nature of each material class of assets and liabilities.

Property, plant and equipment

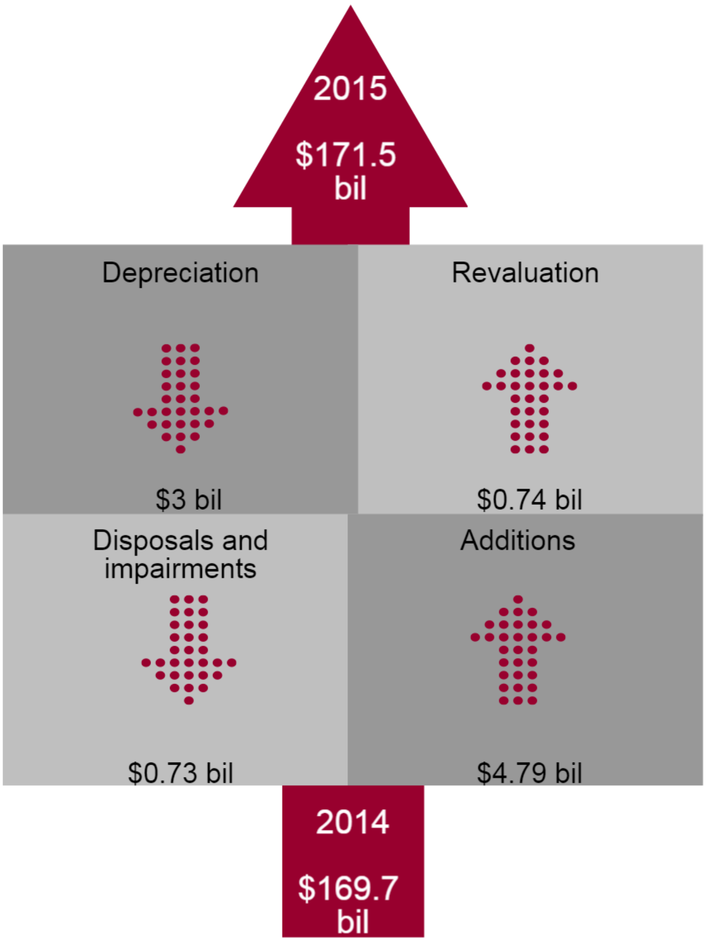
Property, plant and equipment is the most significant item in the balance sheet and represented 68.9 per cent of total GGS assets at 30 June 2015 (TSS: 73.8 per cent).

The primary assets are land administered by the Department of Natural Resources and Mines, the road network, education and health buildings and assets of public corporations.

Public corporations' assets are included in the TSS. They provide energy, water and rail networks.

This year, the value of property plant and equipment increased by $1.7 billion for the GGS.

Figure 3F
Property, plant and equipment movements



Source: Queensland Audit Office

Property, plant and equipment is valued at fair value, which represents the amount someone would be willing to pay for the asset. Mostly, state infrastructure in the GGS is valued at today's cost to replace the remaining value of the asset, as there is no more reliable way to measure fair value. This process involves determining the component costs and the condition of the asset. It contains significant uncertainty.

Securities other than shares

The GGS funds its long-term employee obligations. This means it has assets (investments) set aside which will fund the defined benefit superannuation payments in the future. Assessments conducted by The Office of the State Actuary show the state has fully funded the liability.

The Queensland Treasury Corporation (QTC) and Queensland Investment Corporation (QIC) manage the investments on behalf of the GGS. The investment values change each year, depending on the performance of domestic and international markets, but in the longer term, the returns are expected to match the obligations of the state.

To avoid volatility in its operating result from annual unrealised changes in investment value, the GGS has a fixed rate note in place with QTC. This means QTC records changes in investment values, but this does not affect the GGS. The fixed rate note is an asset of the GGS and represents the amortised cost of the investment. QTC and the TSS record any annual unrealised changes in the fair value of the investment.

The value of the fixed rate note in the GGS increased by $1.0 billion this year, as the state withdrew less money than contributions and earnings from the funds to pay for defined benefit obligations. In future years, the net withdrawals will increase as the Queensland Government has decided not to contribute additional funding for the defined benefit obligation. As a result, the amortised cost value of the asset will decline.

In the TSS, the value of the investments held to fund the long-term obligations increased by $1.57 billion.

Investments in public sector entities

The GGS's investment in public sector entities is $23.4 billion, a decrease of $2.8 billion from 2013–14. The investment represents the net asset value of public corporations.

The additional dividend of $3.1 billion paid by energy transmission and distribution entities this year was recorded as a capital return, which decreased the value of the investment. This means that the state has moved $3.1 billion in assets from PNFCs to the GGS with an intention to use this money to reduce GGS debt.

Borrowings

Borrowings and advances held by the GGS at 30 June 2015 totalled $43.7 billion, of which Queensland Treasury administered 91.8 per cent.

Figure 3G shows that while gross debt for the GGS has stabilised in 2014–15, TSS gross debt has increased by 7.8 per cent. This increase is because of increased borrowings by PNFCs to $32.1 billion at 30 June 2015, and forward borrowings by QTC.

Figure 3G
GGS and TSS change in gross debt

Source: State government financial statements 2010–11 to 2014–15

Employee benefit obligations

At 30 June 2015, the state had total TSS employee benefit obligations of $31.0 billion. These were made up of:

- defined benefit superannuation liabilities ($25.6 billion)
- long service leave liabilities ($3.2 billion)
- annual leave liabilities ($1.7 billion)
- other ($0.5 billion).

These liabilities have increased by less than 1 per cent this year and the GGS accounts for the majority of them (98.7 per cent).

Capital acquisitions and related funding

Major capital acquisitions

Although the overall value of property, plant and equipment has not significantly changed over the last five years, capital acquisitions have been greater than depreciation and disposals during this time, as shown in Figure 3H.

This shows the state has increased its overall asset base to provide community services, mainly in road assets and health.

Figure 3H
Property, plant and equipment movements for the five years to 30 June 2015

	GGS $ bil.	Public corporations $ bil.	TSS $ bil.
Opening balance—1 July 2010	**166.4**	**54.2**	**220.6**
Acquisitions	33.4	19.0	52.4
Disposals	(3.0)	(1.4)	(4.4)
Revaluations	(10.6)	2.8	(7.8)
Depreciation	(13.7)	(11.0)	(24.7)
Other	(1.0)	(4.5)	(5.5)
Closing balance—30 June 2015	**171.5**	**59.1**	**230.6**

Source: State government financial statements 2011–12 to 2014–15

As shown in Figure 3I, the Department of Transport and Main Roads, Department of Health and the electricity transmission and distribution entities make the majority of property, plant and equipment acquisitions.

Figure 3I
Property, plant and equipment acquisitions by entity

Entity	2010–11 $ bil.	2011–12 $ bil.	2012–13 $ bil.	2013–14 $ bil.	2014–15 $ bil.	Total $ bil.
Department of Transport and Main Roads	3.2	4.1	3.9	3.8	3.3	18.3
Department of Health	1.3	1.7	1.3	1.0	0.7	6.0
Electricity transmission and distribution entities	2.3	2.6	2.3	2.0	2.2	11.4
Other entities	6.4	3.4	2.8	2.3	1.7	16.6
Total	**13.2**	**11.8**	**10.3**	**9.1**	**7.9**	**52.3**

Source: Queensland Audit Office

Department of Transport and Main Roads

The department manages a road network of approximately 33 000 kilometres, constructed mainly in the 1960s and 1970s.

Capital expenditure by the department consists of numerous projects that are individually immaterial (less than 5 per cent of the balance) in most cases. These projects include upgrades to existing roads and the replacement of components that have reached the end of their useful life, including due to damage caused by natural disasters such as floods.

In addition, the department has undertaken the following significant rail projects over the last five years:

- projects finalised or practically completed by 30 June 2015
  - Gold Coast (Southport to Broadbeach) Rapid Transit System ($1.4 billion, of which $0.6 billion was expensed as grants to Gold Coast City Council)
- projects in progress at 30 June 2015
  - Moreton Bay Rail Link (Petrie Station to Kippa-Ring Station) ($0.7 billion).

Department of Health

The Department of Health has spent $3.3 billion on three new hospitals in recent years:

- projects finalised or practically completed by 30 June 2015
  - Gold Coast University Hospital ($1.4 billion)
  - Lady Cilento Children's Hospital ($1.3 billion)
- projects in progress at 30 June 2015
  - Sunshine Coast Public University Hospital ($0.6 billion).

In addition, the department has redeveloped or expanded a number of locations including Cairns, Mackay, Rockhampton and Townsville.

The Department of Health transfers such assets to the relevant Hospital and Health Service once they are completed.

Electricity transmission and distribution entities

The electricity transmission and distribution entities are Energex, Ergon Energy and Powerlink Queensland. These entities spent $11.3 billion on numerous projects, primarily for the extension, replacement and upgrade of the energy supply network. The entities' regulator approved this capital expenditure.

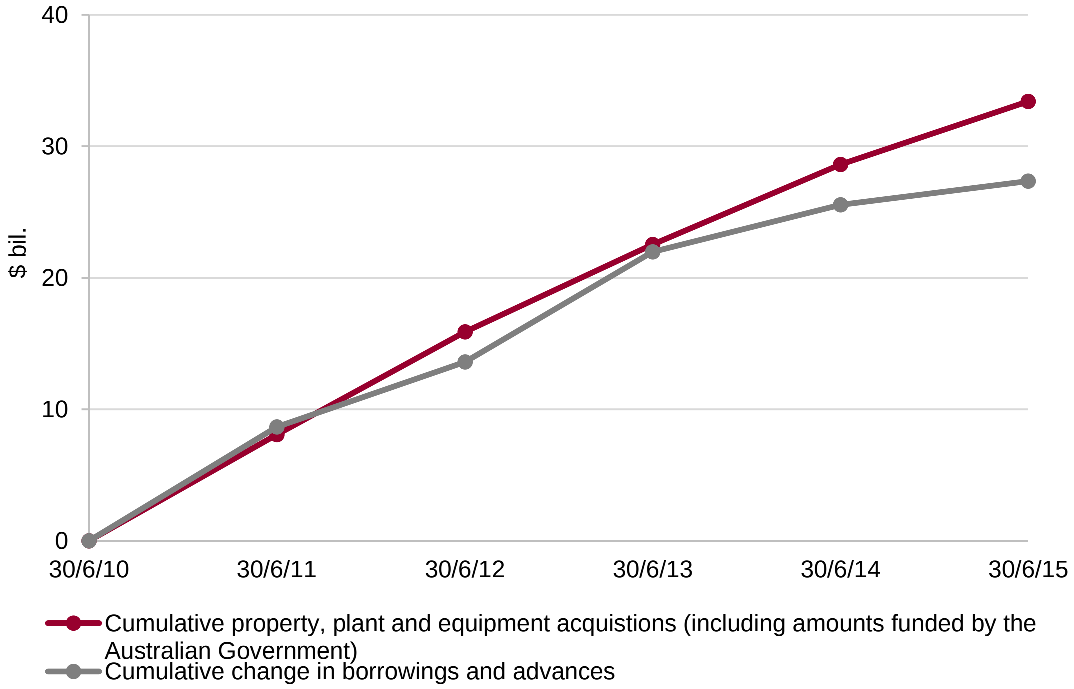
Funding of capital expenditure

GGS borrowings have grown by $27.4 billion or 167.0 per cent over the last five years from $16.4 billion at 30 June 2010 to $43.7 billion at 30 June 2015.

This increase in debt is similar to the cumulative amount of asset acquisitions over the same period, as illustrated in Figure 3J. However, grants from the Australian Government funded some of these acquisitions, including several billion dollars for reconstructing assets damaged by natural disasters.

Therefore, the increase in GGS debt exceeded the level of state-funded capital acquisitions. This indicates that some GGS borrowings were used to fund operating activities, particularly for the three years to 30 June 2013. From 30 June 2013, GGS capital acquisitions have been higher than changes in debt, indicating that debt is unlikely to have been used for operating activities from this time.

Figure 3J
GGS capital acquisitions (including amounts funded by grants) and changes in debt



Source: State government financial statements 2011–12 to 2014–15

As long as an appropriate repayment plan is in place, it can be reasonable for governments to borrow funds for acquiring infrastructure. The future benefits to the community provided by these assets compensate for the debt repayment costs.

In contrast, the use of debt by governments to fund operating expenses creates a burden for future generations, which is not offset by future community benefit.

Debt has grown at a slower rate than capital acquisitions for the TSS as a whole, indicating that PNFCs have funded some of their asset purchases from operating profits.

Budget variances

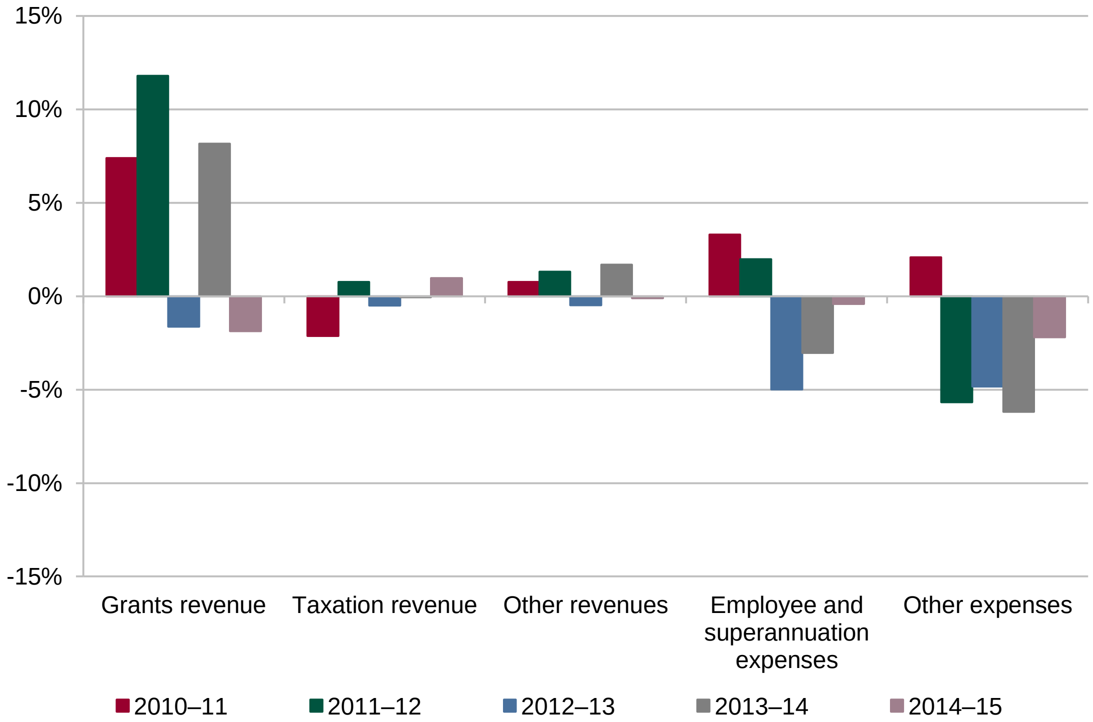
Budgeted values for the GGS have generally been reliable over the last five years. The actual operating result for the GGS has been higher than the amount forecast in the original budget for each of the last five years, indicating that the government has been conservative in its short-term projections for revenues and expenses.

Major variances have occurred for some transactions and balances. We analyse the variances in the following sections.

Revenues and expenses from transactions

Figure 3K shows the variances between budgeted and actual for GGS revenues and expenses for the last five years.

Figure 3K
Variances between budgeted and actual for GGS revenues and expenses



Source: State government financial statements 2011–12 to 2014–15

Major variances over five years

The only material line item with a variance exceeding 10 per cent in the last five years was grants revenue in 2011–12, where actual grants of $22.7 billion exceeded the budget by $2.4 billion. Of this variance, $1.8 billion related to subsidies from the Australian Government for natural disaster recovery.

Natural disasters and the scheduling of recovery works are inherently difficult to predict and include in a budget. The state cannot always influence the timing of grant receipts from the Australian Government.

Budget to actual for this year

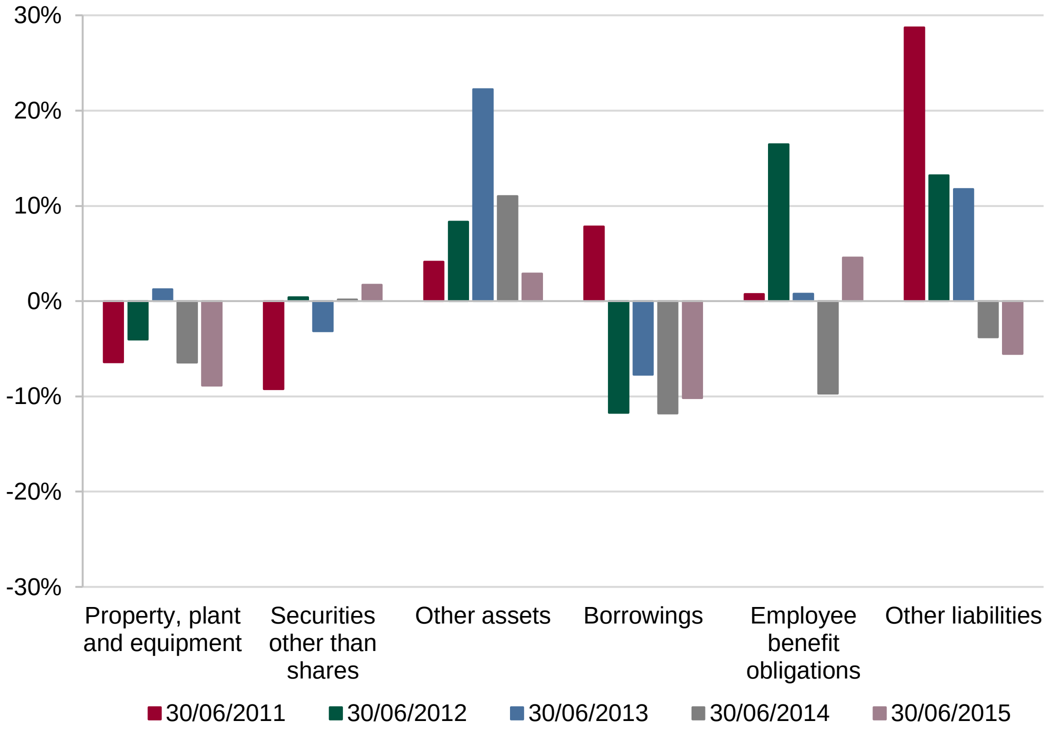
Revenue from transactions was under budget by $0.4 billion or 0.7 per cent, due to the impact of lower than forecast commodity prices on royalty revenue (charged for natural resources extracted and sold by the private sector). Royalty revenue is dependent on a number of factors including commodity prices, the foreign exchange rate, and the Queensland economy.

Expenses from transactions were $0.7 billion or 1.4 per cent under budget. Savings of $1.3 billion in expenses were offset by the transfer and write-off of $0.6 billion in assets associated with the Gold Coast Light Rail.

Assets and liabilities

Figure 3L shows the variances between budgeted and actual for GGS assets and liabilities over the past five years.

Figure 3L
Variances between budgeted and actual for GGS assets and liabilities



Source: State government financial statements 2011–12 to 2014–15

Major variances over five years

In the figure above, 'other assets' mostly represents the value of the GGS's investments in public corporations. Budgeting for the future value of the physical and financial assets owned by these corporations is challenging. It requires an estimate of inputs such as changes in land values, construction costs, interest rates and share market indexes. These fluctuate in a manner that is difficult to predict.

The amount of new borrowings required in each of the last four years has been below budget, mainly because alternative funding was available from higher than expected operating cash flows. The state prepares an annual state borrowing program to authorise any change in borrowings for the year. This program is based on the state budget. QTC updates the borrowing program throughout the year with other factors; however, any inaccuracies in the budget may lead to the QTC borrowing more or less than the state needs.

The discount rate for valuing employee benefits and superannuation liability varied between the actual at 30 June 2012 (3.2 per cent) and the budget prepared 12 months earlier (5.3 per cent). Discount rates record future cash flows at today's values. They are difficult to forecast one year into the future.

For the years ending 30 June 2011, 30 June 2012 and 30 June 2013, liabilities were between $0.5 billion and $0.8 billion higher than budget. This was partly because the volume of infrastructure and natural disaster emergent works conducted by the Department of Transport and Main Roads near year end was greater than anticipated in the budget.

4. Financial sustainability

In brief

The state's long-term financial sustainability ultimately depends on its revenue and expenditure policies, and on what it spends on public infrastructure. We can gain critical insights into the state's financial health and long-term sustainability by analysing the key indicators from the state government financial statements and from forecasts within the latest state budget.

Conclusions

The state's operating sustainability has improved over the last two years, and government projections for the next four years indicate a consolidation of this improvement.

However, Queensland's debt is higher than that of every other state in Australia. The percentage of debt compared to the state's economy continues to grow, making it less affordable. The state budget for 2015–16 includes a plan to reduce general government sector (GGS) debt by approximately $7.5 billion. This plan involves making one-off payments.

Part of the government's plan moves the debt from the GGS to public non-financial corporations and increases dividend payments to the GGS. The sustainability of the public non-financial corporations will depend on their ability to adapt to increased borrowings, increased interest expense, and having to pay higher dividends.

If it is to reduce GGS debt over the long term, the state will need to apply more permanent solutions, such as increasing net cash flows from operating activities.

Other risks to financial sustainability include the state's dependency on the Australian Government for goods and services tax revenue, and proposals by the Productivity Commission to reduce the Australian Government's contribution to costs incurred in natural disaster recovery.

The state continues to replenish its asset base, although the ratio of replacement is declining.

Background

The state manages its finances over the long term to fund its liabilities and provide social services and infrastructure to the community. To do this, it must have appropriate revenue and expenditure policies.

'Financial sustainability' refers to the state's ability to absorb reasonably foreseeable adverse financial risks and exposures without having to alter its revenue settings (for example, what it charges for royalties).

It is financially sound to fund a portion of infrastructure through debt; however, the state must ensure it will be able to service the debt, including interest.

We can assess financial management and sustainability through the information presented in the state government financial statements. We can also use historical analysis to identify trends that may affect current decision-making.

Similarly, we can reach an understanding of the government's short- and medium-term strategies for funding liabilities, services and asset acquisitions through the forecasts in the state budget.

We assess financial sustainability by analysing performance against four ratios:

- operating ratio—this indicates the state's capacity to meet recurrent operating expenditure from recurrent operating revenues
- net operating cash flow to net purchases of non-financial assets ratio—this indicates the state's ability to self-finance asset acquisitions from operations, rather than relying on other funding sources such as debt
- capital replenishment ratio—this indicates whether the state's rate of capital outlays on non-financial assets is keeping pace with the rate of depreciation of those assets
- gross debt to operating revenue ratio—this indicates the capacity of the state to service and reduce debt.

In Appendix D, we provide further details about the key ratios.

We analyse the financial sustainability of the general government sector (GGS) using the key ratios, but not the public corporations. This is because they fund their operations and service borrowings from their earnings.

Conclusions

Our ratio analysis indicates that the state's financial sustainability has improved since 2012–13.

The only ratio that indicated financial stress in 2014–15 was the gross debt to operating revenue ratio. GGS debt at 30 June 2015 was $43.7 billion compared to total revenues from transactions for the year of $49.8 billion, a ratio of 87.8 per cent. This represents an increase from 2010–11 when the ratio was 59.6 per cent.

In 2014–15, the annual interest expense for the GGS was $2.3 billion, up from $1.1 billion five years earlier. Debt continues to increase, even though annual capital expenditure on infrastructure and property, plant and equipment has decreased from $8.1 billion in 2010–11 to $4.8 billion in 2014–15..

The state budget for 2015–16 shows that the performance against financial sustainability ratios will either improve or remain stable over the medium term. The budget includes a debt action plan designed to improve the gross debt to operating revenue ratio in 2015–16 by 11.9 per cent to 75.9 per cent.

The debt action plan includes transferring debt of approximately $3.5 billion to public non-financial corporations (PNFCs). While this action will reduce GGS borrowings, it will not affect the total state debt. It moves debt from the GGS to the PNFCs.

Another aspect of the debt action plan is to reallocate investments of approximately $3.4 billion that were previously set aside to fund long service leave liabilities. The state will use these to pay down GGS debt. Although the approach of not setting aside assets to pay for these liabilities is common in other jurisdictions, this action will result in future budgets needing to include funding for long service leave payments.

In addition to the risks associated with high debt levels, other risks to financial sustainability include the following:

- The state is highly dependent on grants from the Australian Government, which constitute almost half the revenue earned by the GGS. While allocations of the goods and services tax have been increasing each year, other federal grants have fluctuated significantly, mainly because funding for recovery from natural disasters varies depending on their severity and on the timing of grants.
- The Australian Government's Productivity Commission has recommended changes to funding arrangements for natural disasters. If adopted, these changes will result in a material decrease in GGS revenues if natural disasters continue to cause significant damage to state assets.
- It is difficult to forecast royalty revenue because of the volatility in commodity prices and exchange rates. Projections for royalties have decreased significantly over the last three years.

Equally, favourable movements in the above factors have the potential to improve the state's financial sustainability.

Public corporations have been, and remain, financially sustainable in the short to medium term.

The debt action plan included in the state budget will move $3.1 billion in debt from the GGS to electricity transmission and distribution public corporations. The sustainability of the public corporations is dependent on their ability to adapt to increased borrowings, increased interest expense, and having higher dividend payout ratios.

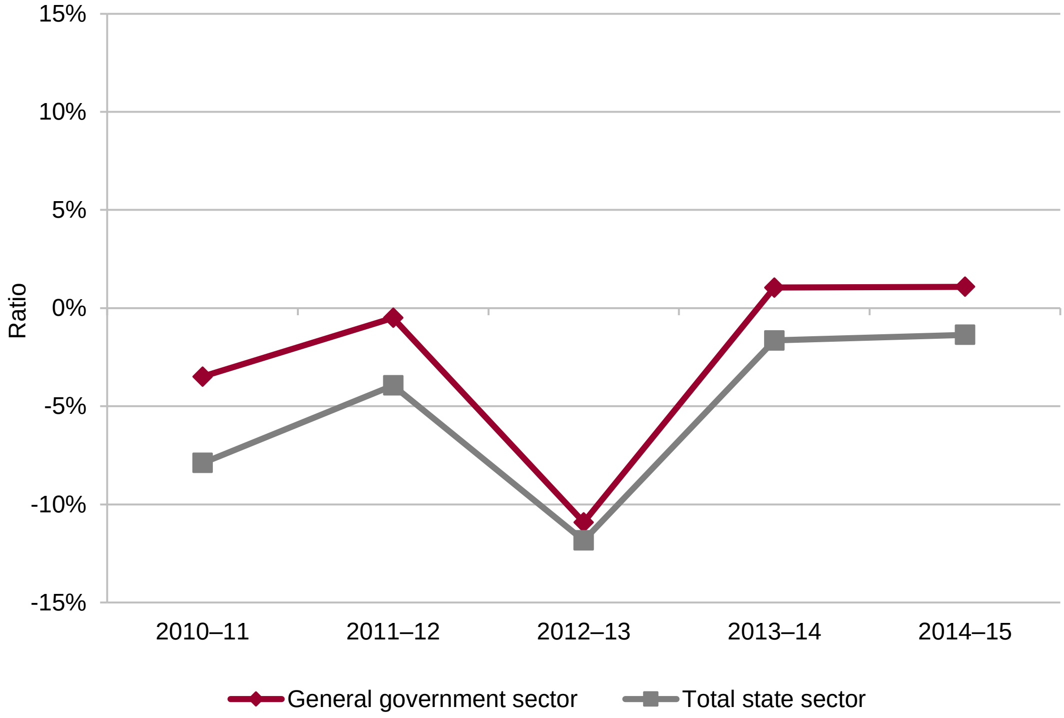
Operating and investing sustainability

Operating ratio

We use the operating ratio to measure the extent to which revenues cover operating expenses. A positive ratio indicates that surplus funds are available for capital expenditure, which means the state will not have to borrow to fund all of its new assets.

Figure 4A shows that the operating ratio has improved each year since 2010–11 except for 2012–13, when the GGS incurred a $4.3 billion operating deficit due to the differences in timing of grants revenue from the Australian Government and actual expenditure.

Figure 4A
Operating ratio



Source: Queensland Audit Office

The state budget for 2015–16 forecasts that the GGS's operating ratio will be positive for each of the next four years and will range between 2.4 per cent and 4.1 per cent.

The operating ratio for the TSS has been negative for each of the last five years. Prolonged negative ratios place significant pressure on the state's capacity to maintain current service levels. There is a limit to the additional borrowings the state can sustain.

Net operating cash flows to net purchases of non-financial assets ratio

We use the ratio of net operating cash flows to net purchases of non-financial assets (assets with a physical value) to calculate the state's capacity to self-finance acquisitions of property, plant and equipment from operations. If it can do this, it does not have to raise money from other sources such as borrowings, asset sales or public private partnership arrangements. The state has continued to look to the private sector to provide community services and assets.

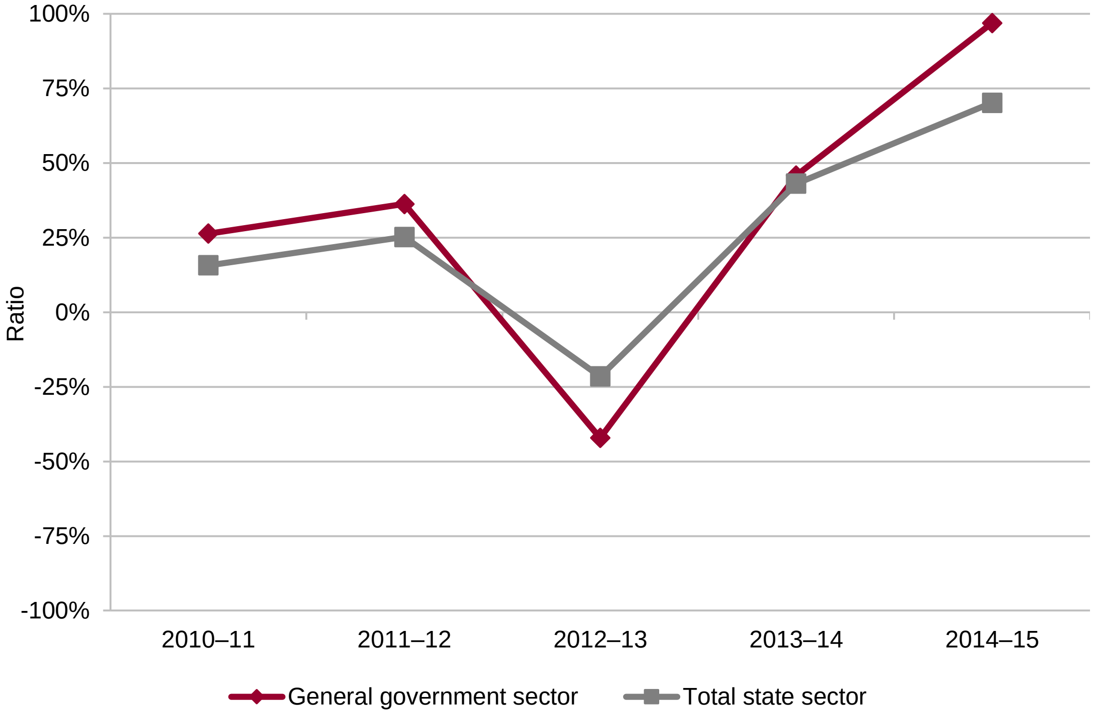
Full funding of the net purchases of non-financial assets from net operating cash flows is possible when the ratio is more than positive 100 per cent. The state can improve its ratio by spending less on capital works and increasing operating cash flows.

We can read this ratio in conjunction with the capital replenishment ratio to ensure that assets are at least being replaced at the rate of depreciation.

Figure 4B shows that the ratio was approaching the target of 100 per cent in 2014–15 and has improved in four of the last five years.

GGS achieved this outcome by increasing net operating cash flows and decreasing net purchases of non-financial assets by over the five-year period. Capital spend, as indicated by the capital replenishment ratio, is declining but continues to be sustainable.

Figure 4B
Net operating cash flows to net purchases of non-financial assets ratio



Source: Queensland Audit Office

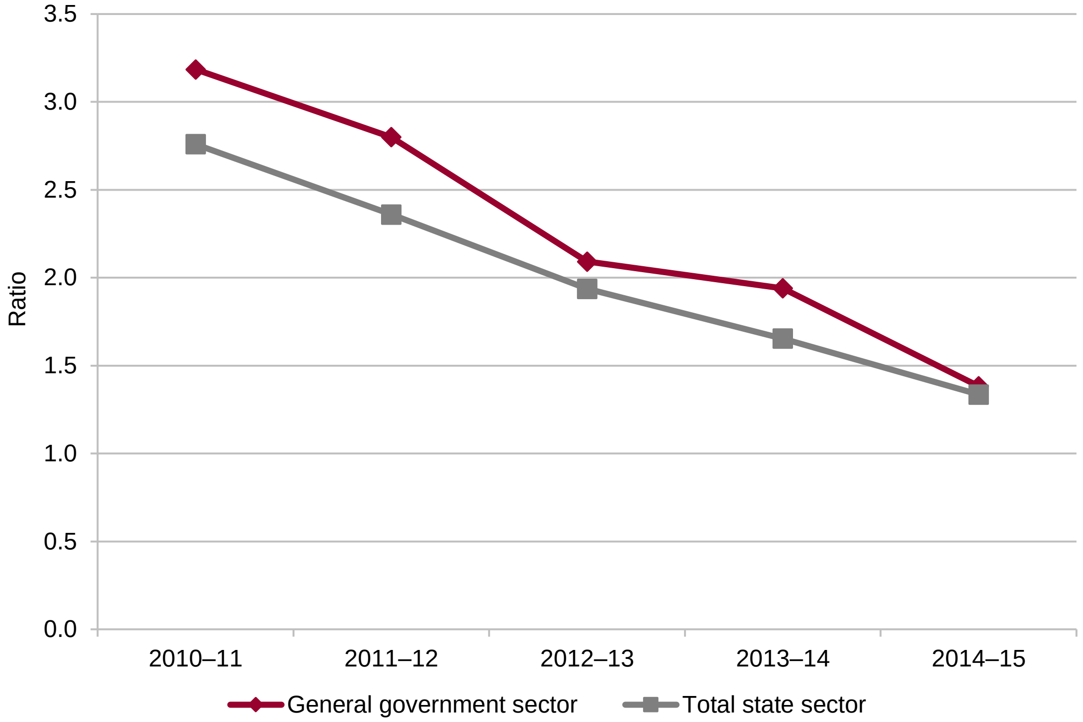
The state budget for 2015–16 predicts a strong average annual ratio of 91.8 per cent over the four years to 30 June 2019.

Capital replenishment ratio

The capital replenishment ratio is a measure of investing sustainability. This ratio compares annual net purchases of non-financial assets to annual depreciation expense. A ratio of less than one indicates that the size or condition of the overall asset base is diminishing, and a ratio of greater than one suggests an expanding asset base.

Figure 4C shows that the ratio has been above one for the last five years but has fallen each year. It remains sustainable.

Figure 4C
Capital replenishment ratio



Source: Queensland Audit Office

Net purchases of non-financial assets for the GGS have decreased from $8.0 billion (TSS: $12.7 billion) in 2010–11 to $4.4 billion (TSS: $7.4 billion) in 2014–15.

In contrast, the GGS depreciation expense has increased annually from $2.4 billion (TSS: $4.6 billion) to $3.2 billion (TSS: $5.6 billion) over this period. This indicates that while the asset base has been expanding, the rate of expansion has been declining to more sustainable levels.

The state budget for 2015–16 projects that the ratio will stabilise at between 1.6 and 1.7 for the GGS over the four years to 30 June 2019.

Risks to operating and investing sustainability

The net cash flows from operating activities over the past five years have been insufficient to fund all of net capital expenditure. This has meant the state has increased its borrowings.

The state would improve its operating sustainability if it improved its revenues relative to its operating expenses (other than depreciation) and capital expenses. Below, we have outlined the key risks to achieving this objective.

Lack of flexibility with funding from the Australian Government

Nearly half of the GGS's revenue is in the form of grants from the Australian Government. The reliance on federal funding, which it cannot always directly control, reduces the state's budgetary flexibility.

Potential reductions in federal funding for natural disasters

The Australian Government's Productivity Commission has recommended that the Australian Government reduce the amount it contributes for natural disaster grants from 75 per cent to 50 per cent. Any reduction in funding from the budget will affect the state's sustainability and ability to replace or repair assets damaged through future natural disasters.

In 2013–14, the state's contribution to repair and replacement of damaged assets peaked at $5.6 billion, of which the Australian Government funded $4.2 billion. A change in federal funding to 50 per cent would have reduced the state's revenue by $1.05 billion.

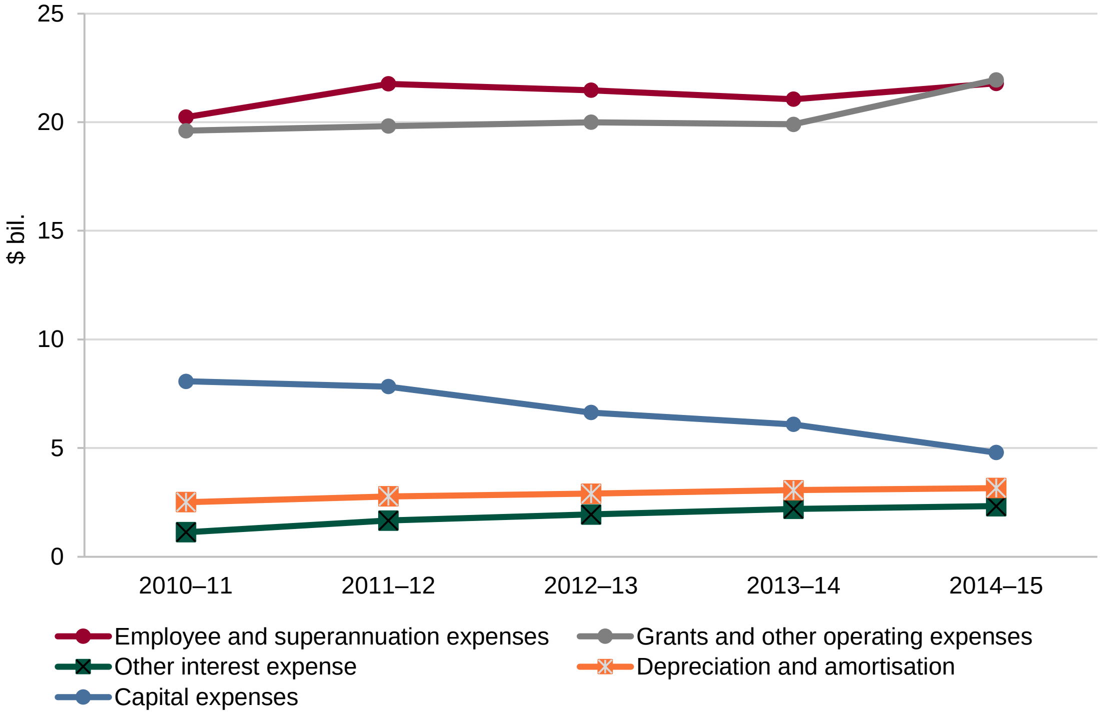
Expenditure management

Achieving value for money and financial sustainability requires the government to rigorously evaluate, plan and manage expenses. The state can improve sustainability by reducing operating and capital expenditure. It is concerning that after two years of stabilising and reducing employee and other expenses, the state has increased spending in these two areas. This increase was planned in the 2014–15 budget.

The state does not have flexibility in interest costs unless it reduces its debt. In the last five years, interest expense has more than doubled for the GGS from $1.1 billion to $2.3 billion.

Figure 4D shows the trends in GGS expenditure for the five years to 30 June 2015.

Figure 4D
General government sector expenditure trends

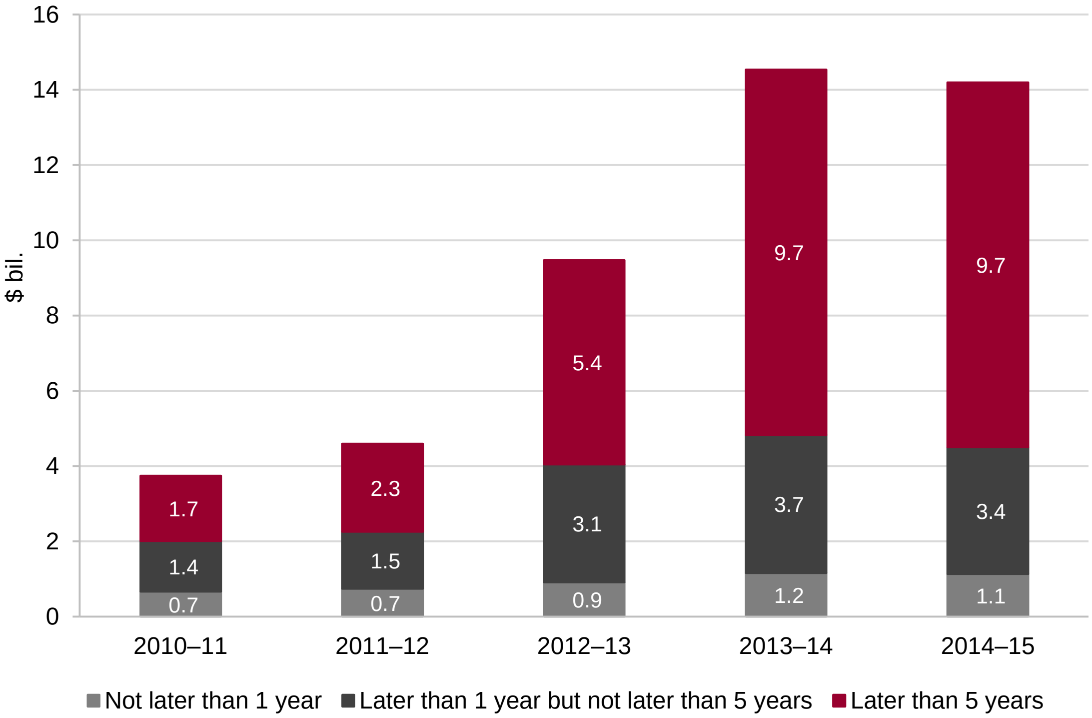


Source: State government financial statements 2011–12 to 2014–15

For capital projects, we need to assess whole-of-life costs when considering financial sustainability.

Agreements such as contracts and leases lock in a portion of future expenses. Total GGS commitments for public private partnerships and operating leases at 30 June 2015 were significant at $14.2 billion (TSS: $15.5 billion). However, as Figure 4E shows, the commitments have stabilised in 2014–15 and are spread over a number of future years.

Figure 4E
GGS commitments for public private partnerships and operating leases



Source: State government financial statements 2011–12 to 2014–15

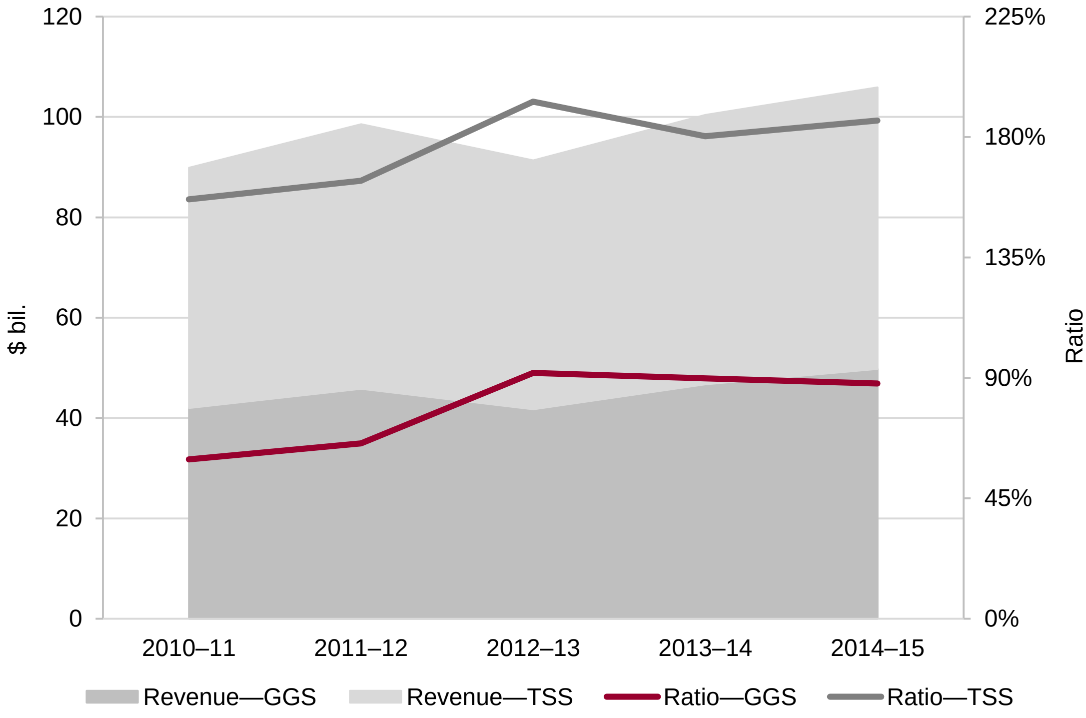
Gross debt to operational sustainability

We use debt sustainability to assess the state's capacity to make principal and interest payments on debt. We also use it to assess the state's capacity to meet long-term obligations to employees and insurance schemes while maintaining its assets and community services.

The gross debt to operating revenue ratio is a measure of the state's capacity to service debt from its revenues. As the state has sufficient investments in place specifically to pay for its long-term employee and insurance obligations, we have excluded these liabilities from gross debt in calculating the ratio.

Figure 4F shows the trend for the ratio over the last five years.

Figure 4F
Gross debt to operating revenue ratio



Source: Queensland Audit Office

Although the stabilisation of the ratio since it peaked at 91.8 per cent in 2012–13 is a positive development, it remains high relative to historical levels and the Queensland economy.

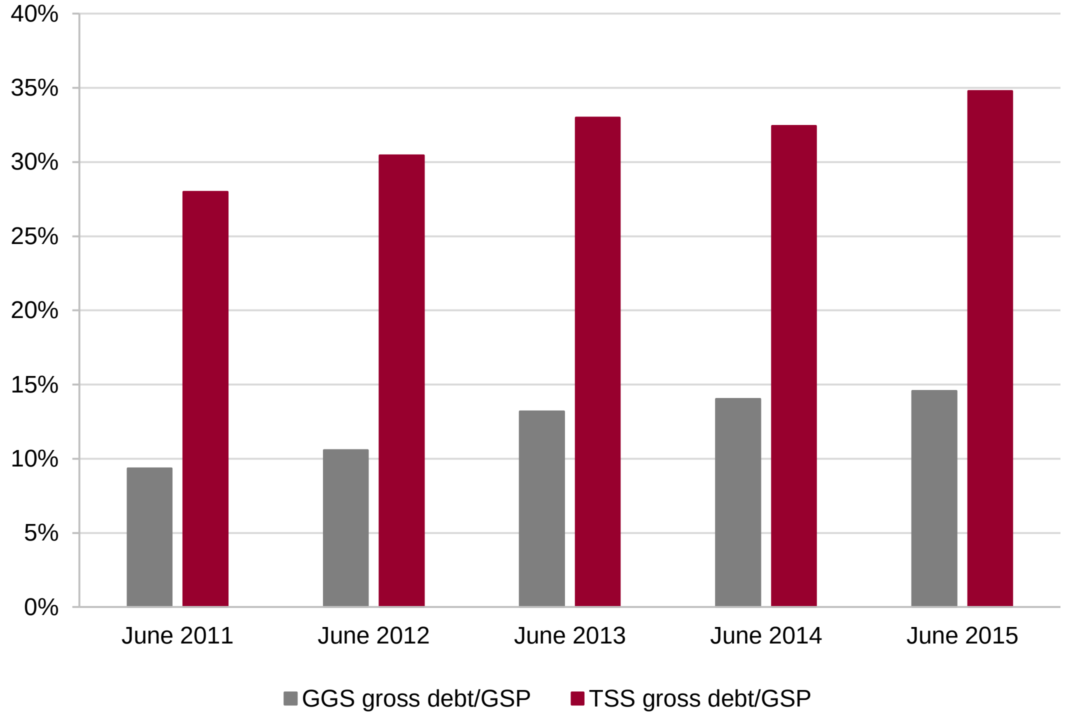
The state has less capacity to repay debt today than in the past.

Debt as a portion of gross revenue has grown to 88 per cent this year from 60 per cent five years ago, and from 8.7 per cent in 2006–07. Projections included in the state budget for 2015–16 indicate that the gross debt to operating revenue ratio for the GGS will improve marginally to between 71 per cent and 75 per cent during the four years to 30 June 2019.

We can also determine how manageable the state's debt is by comparing gross debt to the state's economy, indicated by the gross state product (GSP) as calculated by the Australian Bureau of Statistics.

Figure 4G shows that the state's debt as a portion of the Queensland economy has increased to 14.5 per cent for the GGS, from 9 per cent five years ago.

Figure 4G
Gross debt as a percentage of the state's economy



Source: State government financial statements 2010–11 to 2014–15, ABS 5220.0 Australian National Accounts: State Accounts (GSP 2010–2015),

The ratio for the TSS is much higher than for the GGS, not only because of the level of PNFC borrowings, but also because Queensland Treasury Corporation, as the state's central financing authority, borrows:

- in advance of requirements as part of its interest rate risk management strategy. This added approximately 21.4 per cent to the ratio in 2014–15
- on behalf of, and then on-lends to, non-state government entities such as local governments. This added approximately 12.3 per cent to the ratio in 2014–15.

State credit rating

Standard & Poor's Rating Services downgraded its long-term credit rating of the state in 2009 by one level from the highest possible level of AAA to the current rating of AA+. This was largely due to increases in debt levels.

The additional interest cost of this downgrade compared to AAA-rated state governments is roughly 0.2 per cent or $0.2 billion per year for the TSS.

Government debt action plan in 2015–16 state budget

The state budget for 2015–16 includes a plan to reduce GGS debt by approximately $7.5 billion or 17.2 per cent by 30 June 2016, as summarised in Figure 4H.

Figure 4H
Government debt action plan in 2015–16 state budget

Action	Budgeted GGS debt reduction amount $ bil.
Transfer GGS debt to controlled entities	3.5
Increase dividend payout ratio for energy corporations	0.6
Use assets set aside to fund long service leave liabilities to pay down debt	3.4
Suspend contributions to the defined benefit superannuation investments	2.0
Total	**9.5**

Source: Queensland Budget 2015–16

These actions are short-term strategies that cannot be relied upon indefinitely.

To reduce GGS debt levels over the long term, the state will need to apply more permanent solutions. These could include increasing its net cash flows from its operating activities and generating larger operating surpluses.

The debt action plan includes transferring $3.1 billion of debt to the energy network businesses (Energex Limited, Ergon Energy Corporation Limited and Powerlink Queensland) this year and $400 million in subsequent years.

After the transfer, the net debt to regulated asset base ratio for these entities will be between 70 per cent and 75 per cent. Considering that these levels will be near the upper end of the range observed in the industry of 80 per cent, the transfer of debt to these entities is a one-off solution.

Consistent with the approach adopted by other states, Queensland will now fund long service leave from operating revenues and future borrowings. The assets set aside to pay for the long service leave will be used to reduce GGS borrowings.

At 30 June 2015, Queensland was a rare jurisdiction in that it fully funded its defined benefit superannuation liabilities. The government advised in its 2015–16 budget that contributions to the defined benefit plans will be suspended.

Instead, the suspended contributions of $2.0 billion will be directed to paying down GGS debt over the next five years. The state expects to continue to fully fund its long-term defined benefit superannuation liabilities without the need to make additional contributions.

Sustainability of public corporations

Public corporations have been, and remain, financially sustainable in the short to medium term.

The sustainability of the energy transmission and distribution entities depends on future revenues, which are regulated, and on their ability to adapt to increased borrowings, increased interest expense, and to paying higher dividend payout rations.

The public corporations are generally generating sufficient income to replace and add to their stock of assets at a rate faster than they are depreciating, and they are maintaining stable debt levels when compared to the revenue generated.

5. Financial impact of natural disasters

In brief

In 2011, the Queensland Government established the Queensland Reconstruction Authority (the QRA) in response to the 2011 disaster events. QRA's role was subsequently extended to cover historical and continuing disaster events in Queensland.

The state, through the QRA, prepares an annual financial statement claim form acquitting Natural Disaster Relief and Recovery Arrangements (NDRRA) funding to the Australian Government. In this submission, the QRA compiles claims for financial assistance for NDRRA expenditure incurred on eligible disasters in the preceding financial year.

Over the past four years, the state has submitted claims amounting to almost $10.8 billion in state expenditure. A further $2.4 billion will be acquitted in the next three financial years.

Since the establishment of the QRA in 2011, the state has received $7.9 billion in NDRRA funding to support repair and recovery from natural disasters. The majority of relief measures under the NDRRA are funded 75% by the Australian Government and 25% by the Queensland Government. These provide disaster relief and recovery payments and infrastructure restoration to assist communities to recover from the impacts of natural disasters.

The state uses this funding to repair state-owned assets and to provide funding to local governments.

The state has a process in place to acquit expenditure to the Australian Government. We audit the expenditure to ensure that only eligible costs are claimed. For the majority of expenditure, a cost can only be claimed when it results in an asset not exceeding its pre-disaster standard, updated to current building and engineering standards.

Conclusions

After obtaining additional audit evidence, we provided revised unqualified audit opinions on amended claim forms for 2009–10, 2010–11 and 2011–12, amounting to $813 million (84 per cent of the amount that was previously subject to a qualified audit opinion). This confirmed that our original qualification was appropriate.

We provided unqualified audit opinions for the 2012–13 and 2013–14 acquittals, amounting to state expenditure of $2.65 billion and $5.73 billion respectively. This confirmed that the reported expenditure in the claim forms was only in respect of eligible measures of natural disaster relief and recovery. It also confirmed that the expenditure conformed to the NDRRA determination (which defines the relief and restoration measures that attract federal government assistance).

If the Australian Government were to reduce its funding (as recommended by the Australian Productivity Commission in its report), it would have a direct impact on the financial position and sustainability of the state and local governments. They would have to meet more of the cost of repairs through increased revenue, reduced expenditure in other areas, and/or additional borrowings.

Background

The Australian Government provides financial assistance to the Queensland Government through Natural Disaster Relief and Recovery Arrangements (NDRRA) to support recovery after major natural disasters. The Australian Government reimburses up to 75 per cent of eligible costs incurred by the states and territories, with the states and territories bearing the remaining 25 per cent. These costs primarily relate to the restoration of state and local government roads and other public infrastructure.

The Queensland Reconstruction Authority (the QRA) coordinates the NDRRA relief measures for state and local governments.

The QRA prepares an annual financial statement claim acquitting NDRRA funding to the Australian Government for eligible disasters. This in accordance with the NDRRA determination (the determination), which defines the nature of natural disasters and the associated relief and restoration measures that are eligible for federal government assistance.

Entities have two years from 30 June, in the year a natural disaster occurred, to complete restoration works under NDRRA, unless they obtain an extension. The Australian Government may not make the NDRRA contribution if works are not completed within the two years.

The QRA estimates the total cost of the NDRRA program to be $13.1 billion over the past six years. So far, the QRA has acquitted $10.8 billion to the Australian Government in the annual returns, with a further $2.4 billion to be acquitted in the next three years.

There is a risk of reduced contributions from the Australian Government if restoration works are not completed within the time frames prescribed in the determination. If this occurred, state agencies and local councils would need to meet the cost of restorations.

Conclusions

The NDRRA claim to the Australian Government is a significant source of funding for the state in its recovery from various natural disasters.

The original claims for 2009–10, 2010–11 and 2011–12 were partly qualified, as we could not obtain sufficient evidence to assess the pre-disaster condition and post-disaster reparation of assets. We subsequently issued revised unqualified audit opinions on the claim forms amounting to $813 million (84 per cent of the qualified amount). This confirmed that our original qualification was warranted.

Since its establishment, the QRA has made significant improvements in the supporting documentation. This has resulted in unqualified opinions on the 2012–13 claim for $2.65 billion and the 2013–14 claim for $5.73 billion in state expenditure.

The Australian Productivity Commission issued its final report in May 2015. In it, the commission recommended significant changes to current natural disaster funding arrangements. If implemented, they are likely to affect the financial position and sustainability of the state, its agencies and local councils.

Regulatory framework

As stated before, the NDRRA determination defines the nature of natural disasters and the associated relief and restoration measures that are eligible for federal government assistance. Some areas in this framework are not clear and require the application of professional judgement. This has led to different interpretations by the state and federal governments.

The determination allows states to claim for the cost of restoration or replacement to pre-disaster standard, updated to current building and engineering standards. Application of this in practice is highly subjective and is a specific area of risk for our audits of NDRRA expenditure.

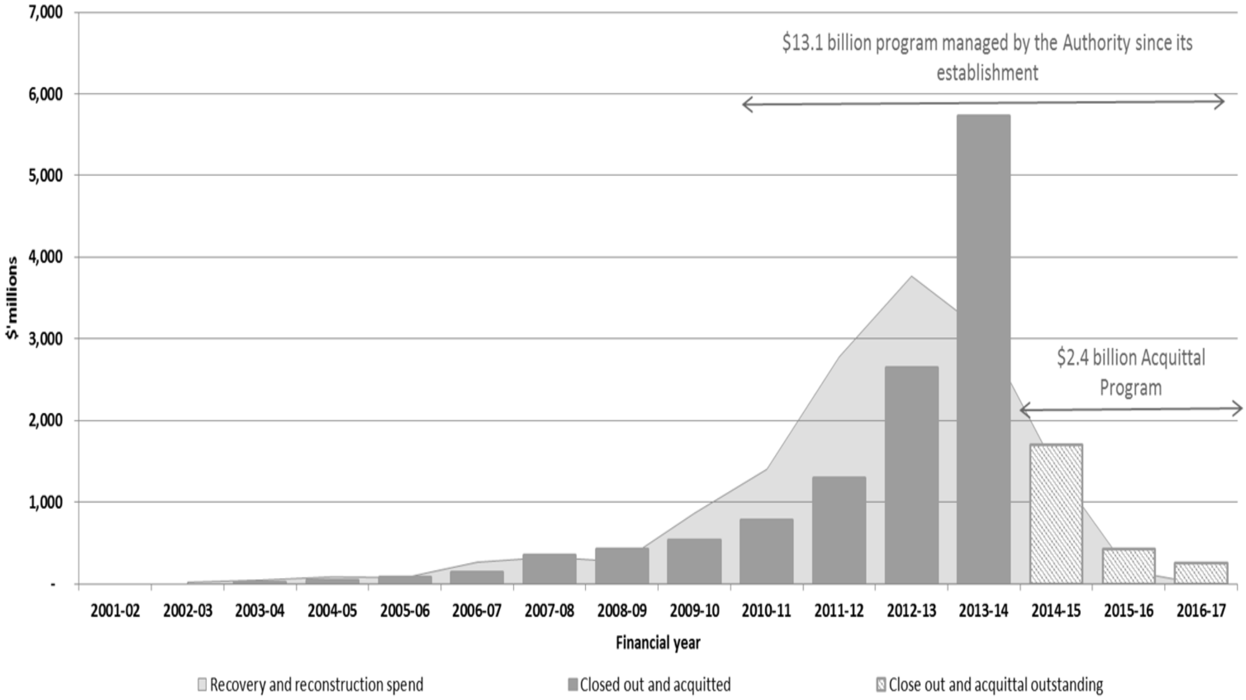
Since 2011, the state and federal governments have also entered into multiple national partnership agreements. The agreements, which expired on 30 June 2015, complemented NDRRA, and introduced requirements for the state to perform value for money assessments. While we do not certify as to the value for money criteria in our audit reports, we do audit the state's compliance with value for money criteria.

Audit of NDRRA claims

Figure 5A shows the amounts spent by the state on recovery and reconstruction, together with the profile of expenditure claimed and acquitted to the Australian Government since 2001–02.

The graph also shows the historical and projected annual expenditure on recovery and reconstruction by the delivery agents.

Figure 5A
Acquittal profile for Queensland



Source: Queensland Reconstruction Authority

2012–13 and 2013–14 audit opinions

In 2012–13 and 2013–14, the QRA was solely responsible for the administration of claims. It has established a clear understanding with state agencies and local councils about the compliance requirements within the NDRRA determination.

We issued unmodified audit opinions to the Australian Government on the state's financial statement claim forms for 2012–13 and 2013–14, specifically their compliance with the NDRRA determination. Our focus was on the following key areas of the determination:

- assets restored met the definition of an essential public asset
- damage was a direct result of a natural disaster
- restoration did not exceed the asset's pre-disaster standard updated to current building and engineering standards

- expenses claimed met the definition of state expenditure
- work was completed within the allowable time limit.

As well as providing an audit opinion, we explained the framework we adopted to evaluate compliance with the more subjective aspects of the determination.

2012–13 and 2013–14 expenditure and the audit procedures included in the claims

Figure 5B shows a breakdown of total state expenditure by measure for each of the claims.

Figure 5B
Breakdown of total state expenditure

Measure	2013–14 ($'000)	2012–13 ($'000)
Category A—Emergency assistance	9 177	137 580
Category B—Restoration or replacement of essential public assets	5 480 636	2 294 433
Category C—Community recovery packages	78 391	79 385
Category D—Exceptional circumstances	162 244	138 951
Total	**5 730 448**	**2 650 349**

Source: Queensland Audit Office

Emergency assistance (Category A) is given to individuals to alleviate their personal hardship or distress as a direct result of a natural disaster.

Historically, controls were insufficient to ensure only eligible applicants received funding. Subsequent investigations identified overpayments and potentially fraudulent claims amounting to $2.1 million. This amount was excluded from claims submitted to the Australian Government, and we were satisfied that the remaining claims were eligible.

The primary focus of our audits was Category B—Restoration or replacement of certain essential public assets damaged as a direct result of a natural disaster.

The NDRRA determination has not provided comprehensive guidance on the eligibility of expenditure in terms of the restoration or replacement of assets to pre-disaster standard, updated to current building and engineering standards.

We required evidence that assets were damaged as a direct result of a natural disaster, including indicative photographs of damage, certifications by an independent expert who inspected the assets shortly after the event, and historical flood maps indicating that inundation would have been a likely outcome of a flood in the area.

We also reviewed pre-disaster photographs, video recordings, maintenance records and asset condition ratings to provide assurance that there was no pre-existing damage to the assets.

As part of its internal processes, the QRA identified all materially ineligible expenditure. In the 2013–14 claim, $325 million was considered ineligible (5 per cent of the total cost claimed) and removed from the claim.

Revision of qualified claims

Prior to the establishment of the QRA in 2011, the former Department of Local Government and Planning administered NDRRA claims. The claims for 2009–10, 2010–11 and 2011–12 were partly qualified, meaning we could not obtain sufficient evidence to assess the pre-disaster condition and post-disaster reparation.

Claims amounting to $925 million from local councils and $42 million from state entities were considered ineligible for funding. Some examples of amounts assessed as ineligible were:

- those relating to asset enhancements which increased functionality and utility
- those in which pre-existing damage existed
- those in which gravel and/or formed roads were upgraded to sealed roads.

Subsequently, we worked with the QRA to identify any additional audit evidence that would enable us to reliably assess the pre-disaster condition of the damaged assets.

This allowed us to issue a revised unqualified audit opinion on a proportion of the amount that was previously subject to qualification. This then allowed the state to reduce the $967 million of ineligible expenditure and increase the allowable funding from the federal government.

As a result, $813 million was determined as eligible and funding was received from the federal government. The remainder of the claims ($153.9 million) continued to be ineligible.

Figure 5C
Revised ineligible funding

	2009–10 $ mil.	2010–11 $ mil.	2011–12 $ mil.	Total $ mil.
Total amount as per original claim form	520.1	748.0	870.4	2 138.5
Amounts subject to qualification	264.2	411.7	290.7	966.6
Adjustments for ineligible costs	(86.6)	(48.4)	(18.9)	153.9
Final adjusted (unqualified) amounts	177.6	363.3	271.9	812.7

Source: Queensland Audit Office

Current and future developments

Australian Productivity Commission

In April 2014, the Australian Government asked the Australian Productivity Commission to undertake a public inquiry into the effectiveness and sustainability of current natural disaster funding arrangements for disaster mitigation, resilience and recovery measures.

The commission issued its final report on 1 May 2015. Its principal finding was that current natural disaster funding arrangements are not efficient, equitable or sustainable. Specific matters identified and noted in the final report included the following:

- There is currently an over-investment by the Australian Government in post-disaster reconstruction and an under-investment in mitigation that would limit the impact of natural disasters in the first instance.
- States should bear a greater share of recovery costs through cost-sharing arrangements to sharpen incentives to manage, mitigate and insure against these risks. It is proposed that the Australian Government reduce from 75 per cent to 50 per cent the amount it contributes on eligible NDRRA measures.
- The current small disaster criterion set out in the determination is considered too low and an increased threshold of $2 million should be applied to events at the state level.

The Australian Government is considering the next steps regarding disaster recovery reforms. A change in the proposed cost-sharing arrangements would potentially place greater pressure on the finances of the Queensland state and local governments, particularly if natural disasters continue to cause significant damage to state assets.

Appendices

Appendix A—Comments

In accordance with section 64 of the *Auditor-General Act 2009*, we provided a copy of this report to Queensland Treasury with a request for comment.

Responsibility for the accuracy, fairness and balance of the comments rests with the head of this agency.

Comments received from the Under Treasurer, Queensland Treasury

RECEIVED
14 DEC 2015
QUEENSLAND AUDIT OFFICE

Queensland Government

Queensland Treasury

Our Ref: 04646-2015

14 DEC 2015

Mr A Greaves
Auditor-General of Queensland
Queensland Audit Office
PO Box 15396
CITY EAST QLD 4002

Dear ~~Mr Greaves~~ Andrew

Report on 2014-15 State Government Financial Statements

Thank you for your letter of 20 November 2015, seeking my comments on the above report.

I understand that our officers have met to clarify a number of points, resulting in some changes being made to the first draft of this report. I appreciate your agreement to make these changes.

The report highlights that the State's financial sustainability has improved since 2012-13, with financial sustainability ratios either improving or stable over the medium term. The contribution of the Government's debt action plan to reduce general government debt by $9.6 Billion by 2017-18 is also acknowledged.

However, there is some further context in relation to revising the capital structure of the Government's energy network businesses that needs to be emphasised. The approach taken in the 2015-16 Budget was recommended by the Independent Review of State Finances and increases their gearing to more commercial levels. Analysis by KPMG shows this measure is consistent with industry practice and enables the government to ration their equity investments without impacting prices, which are set by the regulator. Improving the efficiency of these businesses to the benefit of all Queenslanders was a key driver of the strategy.

I welcome the reference in your report to the need to increase net cash flows from operating activities and generate larger operating surpluses since this is also an important element of the Government's strategy.

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ABN 90 856 020 239

Comments received from the Under Treasurer, Queensland Treasury

- 2 -

As you would be aware, following consideration of the Review of State Finances, the Government has implemented revised fiscal principles as the key driver of its fiscal strategy. Fiscal Principles including: targeting an ongoing reduction in Queensland's debt burden, as measured by the General Government debt to revenue ratio; and targeting net operating surpluses that ensure any new capital investment is primarily funded through recurrent revenues, rather than borrowing, are critical to ensuring financial sustainability.

If your officers require further information in relation to this letter, they can contact Mr Glenn Miller, Acting Assistant Under Treasurer, Fiscal Strategy Division on (07) 3035 1962.

Thank you for the opportunity to comment on the report.

Yours sincerely

Jim Murphy
<u>Under Treasurer</u>
14/12/15.

Appendix B—General government sector

The entities in the general government sector are:

- Departments of government
  - Department of Aboriginal and Torres Strait Islander Partnerships (renamed on 16 February 2015 from Department of Aboriginal, Torres Strait Islander and Multicultural Affairs)
  - Department of Agriculture and Fisheries (renamed on 16 February 2015 from Department of Agriculture, Fisheries and Forestry)
  - Department of Communities, Child Safety and Disability Services
  - Department of Education and Training (renamed on the 16 February 2015 from Department of Education, Training and Employment)
  - Department of Energy and Water Supply
  - Department of Environment and Heritage Protection
  - Department of Housing and Public Works
  - Department of Infrastructure, Local Government and Planning (renamed on 16 February 2015 from Department of Local Government, Community Recovery and Resilience)
  - Department of Justice and Attorney-General
  - Department of National Parks, Sport and Racing (renamed on 6 February 2015 from Department of National Parks, Recreation, Sport and Racing)
  - Department of Natural Resources and Mines
  - Department of the Premier and Cabinet
  - Department of Science, Information Technology and Innovation (renamed on 16 February 2015 from Department of Science, Information Technology, Innovation and the Arts)
  - Department of State Development (renamed on 16 February 2015 from Department of State Development, Infrastructure and Planning)
  - Department of Tourism, Major Events, Small Business and the Commonwealth Games
  - Department of Transport and Main Roads
  - Public Safety Business Agency
  - Queensland Fire and Emergency Services
  - Queensland Health
  - Queensland Police Service
  - Queensland Treasury (renamed on 16 February 2015 from Queensland Treasury and Trade)
- Hospital and Health Services
  - Cairns and Hinterland Hospital and Health Service
  - Central Queensland Hospital and Health Service
  - Central West Hospital and Health Service
  - Children's Health Queensland
  - Darling Downs Hospital and Health Service
  - Gold Coast Hospital and Health Service
  - Mackay Hospital and Health Service
  - Metro North Hospital and Health Service
  - Metro South Hospital and Health Service
  - North West Hospital and Health Service
  - South West Hospital and Health Service
  - Sunshine Coast Hospital and Health Service
  - Torres and Cape Hospital and Health Service
  - Townsville Hospital and Health Service

  - West Moreton Hospital and Health Service
  - Wide Bay Hospital and Health Service

- Other general government entities
  - Anti-Discrimination Commission
  - Board of the Queensland Museum
  - City North Infrastructure Pty Ltd
  - Crime and Corruption Commission (renamed on 1 July 2014 from Crime and Misconduct Commission)
  - Electoral Commission of Queensland
  - Gold Coast 2018 Commonwealth Games Corporation
  - Gold Coast Waterways Authority
  - Legal Aid Queensland
  - Legislative Assembly of Queensland
  - Library Board of Queensland
  - Motor Accident Insurance Commission
  - Nominal Defendant
  - Office of the Governor
  - Office of the Health Ombudsman
  - Office of the Information Commissioner
  - Office of the Ombudsman
  - Prostitution Licensing Authority
  - Public Service Commission
  - QRAA
  - Queensland Agricultural Training Colleges (renamed on 1 July 2014 from Australian Agricultural College Corporation)
  - Queensland Art Gallery Board of Trustees
  - Queensland Audit Office
  - Queensland Building and Construction Commission
  - Queensland Curriculum and Assessment Authority (renamed on 1 July 2014 from Queensland Studies Authority)
  - Queensland Family and Child Commission (established 1 July 2014)
  - Queensland Mental Health Commission
  - Queensland Performing Arts Trust
  - Queensland Reconstruction Authority
  - Residential Tenancies Authority
  - South Bank Corporation
  - The Council of the Queensland Institute of Medical Research
  - The Public Trustee of Queensland
  - Tourism and Events Queensland
  - Trade and Investment Queensland.

Appendix C—Public corporations

The public non-financial corporations are:

- CS Energy Ltd
- Energex Ltd
- Ergon Energy Corporation Limited
- Far North Queensland Ports Corporation Limited
- Gladstone Area Water Board
- Gladstone Ports Corporation Limited
- Mount Isa Water Board
- North Queensland Bulk Ports Corporation Limited
- Port of Townsville Limited
- Powerlink Queensland
- Queensland Bulk Water Supply Authority (trading as Seqwater)
- Queensland Rail
- Queensland Treasury Holdings Pty Ltd
- Stadiums Queensland
- Stanwell Corporation Limited
- SunWater Limited.

The public financial corporations are:

- QIC Limited
- Queensland Treasury Corporation
- WorkCover Queensland.

Appendix D—Financial sustainability ratios

Figure D1 explains the ratios we used to assess financial sustainability in this report.

Figure D1
Financial sustainability ratios

Indicator	Description	Formula	Interpretation
Operating ratio	Capacity to meet recurrent operating expenditure from recurrent operating revenue	Net operating balance divided into total operating revenue Expressed as a percentage	A negative ratio indicates a net operating deficit and the larger the negative percentage, the worse the result. Net operating deficits cannot be sustained in the long term. A positive percentage indicates surplus revenue is available to support the funding of capital expenditure.
Net operating cash flows to net purchases of non-financial assets ratio	Capacity to self-finance non-financial asset acquisitions from operations rather than sources such as borrowings or asset sales	Net cash flows from operations divided into net purchases of non-financial assets (as reported in the cash flow statement) Expressed as a percentage	A negative ratio indicates the state has insufficient operating cash receipts to fund its total operating cash payments and any of its non-financial asset purchases (mainly property, plant and equipment). A positive ratio indicates the extent to which funding of non-financial assets can be sourced from net cash flows from operations.
Capital replenishment ratio	Comparison of the rate of net spending on non-financial assets with depreciation	Net purchases of non-financial assets divided into depreciation expense Expressed as a number	A ratio greater than one means property, plant and equipment is being replaced faster than it is being depreciated.
Gross debt to operating revenue ratio	Capacity of the state to repay debt and interest	Debt divided into total operating revenues Expressed as a percentage	This ratio indicates the extent to which operating revenues can cover the state's debt. The higher the ratio, the lower the capacity of the state to repay debt and interest.

Source: Queensland Audit Office

Auditor-General Reports to Parliament

Reports tabled in 2015–16

Number	Title	Date tabled in Legislative Assembly
1.	Results of audit: Internal control systems 2014-15	July 2015
2.	Road safety – traffic cameras	October 2015
3.	Agricultural research, development and extension programs and projects	November 2015
4.	Royalties for the regions	December 2015
5.	Hospital and Health Services: 2014-15 financial statements	December 2015
6.	State public sector entities: 2014-15 financial statements	December 2015
7.	Public non-financial corporations: 2014-15 financial statements	December 2015
8	Transport infrastructure projects	December 2015
9	Provision of court recording and transcription services	December 2015
10	Queensland state government: 2014–15 financial statements	December 2015

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