CONSULTATIVE REFERENCE COMMITTEE ON PROPOSED CHANGES TO ELECTRICITY SUPPLY IN NSW

Submission of
Prof Bob Walker, University of Sydney
and
Betty Con Walker, Centennial Consultancy

February 2008
# Contents

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>OVERVIEW</td>
<td>i-ii</td>
</tr>
<tr>
<td>1. INTRODUCTION</td>
<td>1</td>
</tr>
<tr>
<td>2. NSW TOTAL INFRASTRUCTURE AND POWER ASSETS</td>
<td>4</td>
</tr>
<tr>
<td>3. PROFITABILITY OF NSW POWER ASSETS &amp; THEIR CONTRIBUTION TO THE STATE BUDGET</td>
<td>5</td>
</tr>
<tr>
<td>3.1 Profits</td>
<td>5</td>
</tr>
<tr>
<td>3.2 Assets and Equity</td>
<td>6</td>
</tr>
<tr>
<td>3.3 Return on Assets and Equity</td>
<td>6</td>
</tr>
<tr>
<td>3.4 Contributions to the State Budget</td>
<td>10</td>
</tr>
<tr>
<td>4. ANALYSIS OF THE NSW GOVERNMENT’S JUSTIFICATION FOR THE SALE OF ITS POWER ASSETS</td>
<td>11</td>
</tr>
<tr>
<td>4.1 Claim: All infrastructure assets will stay in public ownership</td>
<td>11</td>
</tr>
<tr>
<td>4.2 Claim: Proposal will be secured at no cost to taxpayers</td>
<td>12</td>
</tr>
<tr>
<td>4.3 Claim: Proposal will save taxpayers up to $15 billion</td>
<td>13</td>
</tr>
<tr>
<td>4.4 Claim: Investment of sale proceeds will yield revenue at least equal to current energy dividends</td>
<td>15</td>
</tr>
<tr>
<td>4.5 Claim: Ratings Agencies have indicated there is little room to further increase infrastructure spending without jeopardising out triple a credit rating</td>
<td>16</td>
</tr>
</tbody>
</table>
5. ARGUMENTS FOR THE SALE OF PUBLIC ASSETS ARE NOT NEW: SELLING GOVERNMENT ASSETS TO AVOID DEBT

6. PRIVATISATION IN CONTEXT

7. DETERMINING RETENTION VALUE v. SALE VALUE
   7.1 Calculation of Retention Value
   7.2 Lessons from Past Experience in Use of Private Sector Cost of Capital (Sale of SBNSW)

REFERENCES
OVERVIEW

The Costa proposal involves the privatisation of valuable, essential, profit earning assets. It is not based on a sound economic rationale or financial imperatives. It is simply based on ideological beliefs by individuals who have not learned from past mistakes. As such it is bad for the Government, and, most importantly, bad for the State.

The suggestion that the underlying assets will remain in government hands after privatisation is misleading. In substance, long term leases are the equivalent of a sale.

The State's investment in electricity generation and distribution is currently producing higher returns than could be expected from the reinvestment of any sale proceeds in any 'fund'.

The audited financial statements of the three state-owned generators record that at 30 June 2007 they had incurred losses on cash flow hedges of some $2.7 billion (losses that were mainly treated as adjustments to shareholders' equity). These losses should not be regarded as affecting the prospective earnings of the underlying businesses if retained in State ownership, provided the Government establishes better governance arrangements and imposes more stringent limitations on the use of financial instruments. However the Government's decision to sell these generators so soon after the publication of the 2007 annual reports may reflect efforts by Treasury or shareholding ministers to avoid accountability for those losses, since the presence of hedging arrangements would previously have been disclosed in the statement of corporate intent which the shareholding ministers had agreed and signed.

Retention of the State's electricity generation will allow the Government to responsibly deal with the challenges of green house emissions, and be accountable for its performance. Sale of the generation businesses, possibly to off-shore owners, will reduce that responsibility and accountability.

In any event, the State Government is likely to have to indemnify operators for costs associated with site remediation and possibly for the costs involved in upgrading equipment to meet new greenhouse emission standards. These costs have not been mentioned in the Government's proposal.

The State Government may also have to provide economic incentives to private sector operators to expand base load capacity. Nothing in Mr. Costa's announcements provides any assurance that bidders acquiring the generating
businesses will be obliged to invest in new capacity. Rather, Mr. Costa has taken the ideological position that 'the market' will solve any shortfall through new investment in base load (rather than seek to maximise short-term returns from their investments). Consequently private sector operators may be able to hold the Government to ransom to secure concessions and guarantees to underpin such new investment. The incentives that may have to be offered to secure new investment have not been described or admitted, let alone costed.

In summary, the State's electricity assets should not be sold. They provide essential services and ensure the maintenance of competition with any new private sector entrants.
1. **INTRODUCTION**

The NSW Government announced on 10 December 2007 changes to the electricity industry following the completion of the Report of the Inquiry into Electricity Supply in New South Wales undertaken by Professor Anthony Owen. The changes announced by the Government included:

- leasing existing electricity generators to private operators, while 'keeping them in public ownership';

- retaining the ‘poles and wires’ assets of the State-owned companies Energy Australia, Integral Energy and Country Energy in Government ownership, while their retail lists and functions would move to private operators; and

- introducing a number of safeguards to protect and create jobs, keep prices as low as possible and protect the environment.

The Premier subsequently established the Consultative Reference Committee to ‘test the impacts of changes to the State’s electricity industry’. Apparently, the Committee is to formulate an impact statement on the basis of the following criteria:

1. The direct and indirect social usefulness of a public asset, service or utility;
2. The original purpose of the enterprise and whether that purpose remains valid, is being appropriately addressed through existing arrangements or could be satisfied by alternative arrangements;
3. Where the original purpose (as discussed above) has become redundant, the other social, redistributive or regulatory roles that have evolved must be taken into account;
4. The retention value of the enterprise measured against its sale value. Any calculation of retention value should incorporate both commercial and non-commercial functions;
5. The current structure of the market place (i.e. monopoly, oligopoly or competitive) and the public sector’s role as a competitor and/or regulator in that market;
6. The impact on specific groups or regional areas especially those groups or areas that are already disadvantaged. The assessment should include all factors including the real costs of compensation and/or support that will be needed if the role of the public sector were to change;
7. The impact on employment, skills, training and conditions and the protection of the existing workforce and/or the reform of industrial relations practices in any new enterprise or project;
8. The existing competing demands on the NSW public sector and existing budgetary constraints and/or the alternative sources of funds for public sector investment;
9. The current environmental impact and the need to continue to enhance environmental protection;
10. The administrative economies of scale and coordination that [are] facilitated by public ownership and control;
11. Appropriate weighting of long-term as well as short to medium term considerations; and
12. Where the money is going (i.e. ensuring that the proceeds of the disposal of assets are responsibly directed to priority public capital needs).

It is with great disappointment that we make this submission in view of the fact that the NSW Government, apparently on the advice of Mr. Costa, has made a decision to sell valuable essential Government assets (a long term lease is as good as a sale) and it is attempting to do so with undue haste.

The process forced on this Committee is just one example of the less than genuine community consultation undertaken by the Government. Advertisements appeared in newspapers on 29 January 2008 asking for written submissions to be made by 8 February 2008 – giving just eight working days for the preparation of submissions. It is claimed by the NSW Department of Premier and Cabinet that the Owen Inquiry was based on an extensive public consultation process and that the Committee will also draw upon the submissions made to that Inquiry.

A great deal is expected from the Committee in a very short time since it is expected to review the submissions it has called for, the submissions made to the Owen Inquiry and to complete its ‘impact statement’ by 7 March 2008. It is a heavy burden to impose particularly on those people who do not possess economic and financial expertise.

In view of these and other factors we wonder whether the Government is engaging a lot of well meaning people in a process where there is a predetermined decision to sell the State’s power assets. That decision would be contrary to the wishes of the people of New South Wales and contrary to Australian Labor Party policy.
This submission examines:

- the significance of the NSW Government power assets;
- the profitability of the NSW Government power assets and their contribution to the State Budget;
- the NSW Government’s justification for the proposed sale of its power assets;
- the arguments presented for the privatisation of Government assets;
- privatisation in context; and
- determining retention v. sale value.
2. NSW TOTAL INFRASTRUCTURE AND NSW POWER ASSETS

One of the primary responsibilities of State governments is to manage, upgrade maintain and renew infrastructure, much of which was inherited from the activities of prior governments, and was paid for by previous generations of taxpayers.

The value of the State’s infrastructure is shown in the Table below, which shows ‘book values’ of the infrastructure assets currently held by the NSW Government.

<table>
<thead>
<tr>
<th></th>
<th>$m</th>
<th>% of Total</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>State of NSW</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Plant and equipment/infrastructure systems</td>
<td>92,433</td>
<td>100%</td>
</tr>
<tr>
<td><strong>NSW Power Assets</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(excluding Transgrid)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Plant and equipment/infrastructure systems</td>
<td>18,992</td>
<td>21%</td>
</tr>
</tbody>
</table>


The above shows the significance of NSW electricity generators and distributors as a proportion of the State’s total infrastructure assets - around 21% of the total legacy left to the State by past generations of taxpayers and the wider community.

Decisions to dispose of such a significant legacy should not be taken lightly, or in haste, or on the basis of ideological rhetoric.

Members of the Committee have been given a serious and weighty responsibility, requiring the exercise of informed judgment.
3. PROFITABILITY OF THE NSW POWER ASSETS & THEIR CONTRIBUTION TO THE STATE BUDGET

This section analyses the 2006-07 financial statements of the Government operators in the NSW electricity industry. It looks at a number of indicators in order to show their profitability and contribution to the State Budget.

3.1 PROFITS

The Table below shows the net profit figures (before tax) for the NSW electricity generators and distributors for the year ended 30 June 2007.

<table>
<thead>
<tr>
<th></th>
<th>Net Profit $m</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Generators</strong></td>
<td></td>
</tr>
<tr>
<td>Eraring</td>
<td>207.9</td>
</tr>
<tr>
<td>Macquarie</td>
<td>203.7</td>
</tr>
<tr>
<td>Delta</td>
<td>201.0</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>692.6</strong></td>
</tr>
<tr>
<td><strong>Distributors</strong></td>
<td></td>
</tr>
<tr>
<td>Energy Australia</td>
<td>374.1</td>
</tr>
<tr>
<td>Integral Energy</td>
<td>239.2</td>
</tr>
<tr>
<td>Country Energy</td>
<td>235.7</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>849.0</strong></td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>1,541.6</strong></td>
</tr>
</tbody>
</table>

*Source: Annual Reports of the nominated agencies for the year ended 30 June 2007.*

As the above Table shows, the NSW electricity industry reported net profits for the year ended 30 June 2007 of nearly $1,542 million, with about 45 per cent coming from the generators and 55 per cent from the distributors.
### 3.2 ASSETS AND EQUITY

The Table below summarises the reported value of assets and equity of the NSW electricity industry.

#### Table 3.2

**NSW Electricity Industry Assets and Equity**

<table>
<thead>
<tr>
<th></th>
<th>Assets 30 June 2006 $m</th>
<th>Equity 30 June 2006 $m</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Generators</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Eraring</td>
<td>1,571.4</td>
<td>991.8</td>
</tr>
<tr>
<td>Macquarie</td>
<td>2,972.1</td>
<td>1,003.5</td>
</tr>
<tr>
<td>Delta</td>
<td>2,148.4</td>
<td>730.0</td>
</tr>
<tr>
<td>Total</td>
<td>6,691.9</td>
<td>2,725.3</td>
</tr>
<tr>
<td><strong>Distributors</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Energy Australia</td>
<td>6,589.3</td>
<td>1,725.0</td>
</tr>
<tr>
<td>Integral Energy</td>
<td>3,179.4</td>
<td>883.4</td>
</tr>
<tr>
<td>Country Energy</td>
<td>3,727.4</td>
<td>790.9</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>13,496.1</td>
<td>3,399.4</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td>20,188.0</td>
<td>6,124.7</td>
</tr>
</tbody>
</table>

Note: The ‘assets’ and ‘equity’ figures are those at the beginning of the financial year 2006-07, whilst Table 2.1 shows data for the end of 2006-07.

Source: Annual Reports of the nominated agencies for the year ended 30 June 2007.

### 3.3 RETURN ON ASSETS AND EQUITY

Combining the financial indicators above shows that the NSW electricity industry yields very high returns on assets and equity as shown in the Table below.
Table 3.3
NSW Electricity Industry Returns on Assets and Equity 2007

<table>
<thead>
<tr>
<th></th>
<th>Assets 30 June 2006 $m</th>
<th>Equity 30 June 2006 $m</th>
<th>Net Profit Y/E June 2007 $m</th>
<th>Return on Assets %</th>
<th>Return on Equity %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Generators</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Eraring</td>
<td>1,571.4</td>
<td>991.8</td>
<td>207.9</td>
<td>13.2</td>
<td>21.0</td>
</tr>
<tr>
<td>Macquarie</td>
<td>2,972.1</td>
<td>1,003.5</td>
<td>203.7</td>
<td>9.5</td>
<td>28.3</td>
</tr>
<tr>
<td>Delta</td>
<td>2,148.4</td>
<td>730.0</td>
<td>201.0</td>
<td>9.4</td>
<td>27.5</td>
</tr>
<tr>
<td>Total</td>
<td>6,691.9</td>
<td>2,725.3</td>
<td>692.6</td>
<td>10.3</td>
<td>25.4</td>
</tr>
<tr>
<td>Distributors</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Energy Australia</td>
<td>6,589.3</td>
<td>1,725.0</td>
<td>374.1</td>
<td>5.7</td>
<td>21.7</td>
</tr>
<tr>
<td>Integral Energy</td>
<td>3,179.4</td>
<td>883.4</td>
<td>239.2</td>
<td>7.5</td>
<td>27.1</td>
</tr>
<tr>
<td>Country Energy</td>
<td>3,727.4</td>
<td>790.9</td>
<td>235.7</td>
<td>6.3</td>
<td>29.8</td>
</tr>
<tr>
<td>Total</td>
<td>13,496.1</td>
<td>3,399.4</td>
<td>849.0</td>
<td>6.3</td>
<td>25.0</td>
</tr>
<tr>
<td>TOTAL</td>
<td>20,188.0</td>
<td>6,124.7</td>
<td>1,541.6</td>
<td>7.6</td>
<td>25.2</td>
</tr>
</tbody>
</table>

Note: The ‘assets’ and ‘equity’ figures used in the calculations are those at the beginning of the financial year 2006-07, whilst Table 2.1 shows data for the end of the 2006-07.

Source: Annual Reports of the nominated agencies for the year ended 30 June 2007.

The rates of return being generated by the power industry while in government ownership – an average of 25.2% per annum for generators and distributors – is exceptional.

It indicates the capacity of the industry to generate sufficient profits for reinvestment and upgrading of its infrastructure to provide additional capacity.

The electricity industry has many of the characteristics of a natural monopoly. Despite rhetoric about 'competition' through the establishment of a national electricity market, the fact remains that electricity energy cannot be stored; nor can it be transmitted long distances without loss. Unlike the circumstances of North America or Europe, where output from base load generators can readily be 'wheeled' east to west to meet peak demands in changing time zones, the bulk of Australia's population is distributed north and south along the east coast, where time zones are broadly consistent (despite different policies on summer daylight saving).

Arguably, under private sector ownership, operators are likely to demand more from consumers in the form of increased prices (as can be expected in Victoria when prices are no longer regulated). Under government ownership, monopolistic pricing is subject to political constraints (e.g. IPART's terms of reference require it to have regard to the Government's demand for dividends). However one could expect private sector owners to seek higher returns – particularly if they are compelled to pay a premium to obtain long-term leases for the generating facilities. It is noted that the Government contemplates the maintenance of price regulation for a period of only five years (to 2013).
Note however that the above data reflect profits from operations, before allowances are made for losses on cash flow hedges as at 30 June 2007. The adoption in Australia of International Financial Reporting Standards has required agencies to ‘mark to market’ their hedging positions. The three generators collectively reported losses on these positions at 30 June 2007 of some $2,666.1 million – yet the audited financial statements treated these as adjustments to shareholders' equity.

This is not the occasion to debate the accounting treatments. A more fundamental concern is why agencies in public ownership have engaged in hedging activity when they are providing what is essentially a monopoly service to the community. One might have thought that lessons might have been learned from the losses incurred in 1995 by Pacific Power as the result of speculative dealings via forward sales of electricity (described at the time as ‘the sale of more electricity than Pacific Power could produce, at prices below what it cost to produce’).

The electricity generators Eraring, Macquarie and Delta are all State Owned Corporations, and as such have been required to prepare an annual 'statement of corporate intent', to be tabled in Parliament, and half-yearly reports on their operations. The following requirements are established by the State Owned Corporations Act 1989, section 21:

1. The board of a State owned corporation must prepare and submit to the voting shareholders a draft written statement of corporate intent not later than one month after the commencement of each financial year of the corporation.
2. The board must consider any comments on the draft statement of corporate intent that are made to it by the voting shareholders within 2 months after the commencement of the financial year of the corporation.
3. The board must consult in good faith with the voting shareholders following communication to it of the comments, make such changes to the statement as are agreed between the voting shareholders and the board and deliver the completed written statement to the voting shareholders within 3 months after the commencement of the financial year.
4. The statement may not, before it is laid before both Houses of Parliament, be published or made available to the public without the prior approval of the board and the voting shareholders.
5. The statement may be modified at any time by the board with the agreement of the voting shareholders.
6. If the board, by written notice to the voting shareholders, proposes a modification of the statement, the board may, within 14 days, make the modification unless the voting shareholders, by written notice to the board, direct the board not to make it.
7. The voting shareholders may, from time to time, by written notice to the board, direct the board to include in, or omit from, a statement of corporate intent any specified matters.
(8) Before giving a direction under this section, the voting shareholders are to consult with the board as to the matters to be referred to in the notice.
(9) The corporation is required to comply with any such direction.
(10) At any particular time, the statement of corporate intent for the corporation is the completed statement, with any modifications or deletions made in accordance with this Part.

Section 22 deals with the contents of the Statement of Corporate Intent:

Each statement of corporate intent is required to specify for the group comprising a State owned corporation and its subsidiaries, in respect of the financial year to which it relates and each of the 2 following financial years, the following information:
(a) the objectives of the corporation and of its subsidiaries,
(b) the main undertakings of the corporation and of its subsidiaries,
(c) the nature and scope of the activities to be undertaken,
(d) the accounting policies to be applied in the financial reports of the corporation and of its subsidiaries,
(e) the performance targets and other measures by which the performance of the corporation and of its subsidiaries may be judged in relation to their stated objectives,
(f) the kind of information to be provided to the voting shareholders by the corporation during the course of those financial years, including the information to be included in each half-yearly report,
(g) such other matters as may be agreed on by the voting shareholders and the board from time to time.

In practice, State Owned Corporations have been required to include in their statement of corporate intent a schedule of identified risks, and what steps have been taken to manage or remediate those risks. The agreed statement of corporate intent is then signed by the shareholding Ministers (who, in the case of the three State owned generators, have been the Treasurer and Minister for Finance).

Accordingly, the Committee is invited to consider how State Owned Corporations could have incurred such major losses as a result of their engagement in 'cash flow hedging'. The use of such financial instruments may be justified in certain circumstances (e.g. if a business has undertaken major capital investments and relies on a minimum stream of cash flows to meet its repayment obligations). In other circumstances, the exercise could only be categorised as involving speculative dealing (gambling).

Two additional observations:

- the past exposures to losses from hedging should not be regarded as affecting the prospective earnings of the underlying businesses if retained in State ownership. Rather the Government needs to establish more effective
governance arrangements to avoid yet another repetition of such losses by operators in the electricity industry;

- on the other hand, the Government’s decision to sell these generators so soon after the publication of their 2007 annual reports may reflect efforts by the shareholding ministers to avoid accountability for those losses, since the presence of hedging arrangements would previously have been disclosed in the statement of corporate intent that the shareholding ministers had agreed and signed.

3.4 CONTRIBUTIONS TO THE STATE BUDGET

The Table below shows that in 2006-07, the state-owned electricity industry contributed around $1.1 billion to the NSW Budget through dividends and tax equivalent payments; with an additional $184 million coming from a return of capital, making a total of nearly $1.3 billion.

<table>
<thead>
<tr>
<th></th>
<th>Dividends Paid $m</th>
<th>Tax Paid $m</th>
<th>Capital Return $m</th>
<th>TOTAL $m</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Generators</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Eraring</td>
<td>41.3</td>
<td>43.6</td>
<td>184.0</td>
<td></td>
</tr>
<tr>
<td>Macquarie</td>
<td>130.0</td>
<td>28.4</td>
<td>0.0</td>
<td></td>
</tr>
<tr>
<td>Delta</td>
<td>131.6</td>
<td>47.4</td>
<td>0.0</td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>303.0</td>
<td>119.4</td>
<td>184.0</td>
<td>606.4</td>
</tr>
<tr>
<td><strong>Distributors</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Energy Australia</td>
<td>205.2</td>
<td>175.0</td>
<td>0.0</td>
<td></td>
</tr>
<tr>
<td>Integral Energy</td>
<td>103.9</td>
<td>61.6</td>
<td>0.0</td>
<td></td>
</tr>
<tr>
<td>Country Energy</td>
<td>76.8</td>
<td>34.2</td>
<td>0.0</td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>385.8</td>
<td>271.3</td>
<td>0.0</td>
<td>657.1</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td>688.8</td>
<td>390.7</td>
<td>184.0</td>
<td>1,263.5</td>
</tr>
</tbody>
</table>

*Source: Annual Reports of the nominated agencies for the year ended 30 June 2007.*

These contributions would be lost if the generators were leased and the business of the distributors sold to private sector operators. Offsetting those losses would be lease payments and possible returns from the reinvestment of the proceeds. However it is difficult to contemplate that the financial returns from reinvestment in other forms of infrastructure would exceed those currently being earned from the electricity industry.
4. ANALYSIS OF THE NSW GOVERNMENT’S JUSTIFICATION FOR THE PROPOSED SALE OF ITS POWER ASSETS

This section analyses a number of the claims made by Mr. Iemma and Mr. Costa in trying to justify their decision to privatise the State’s power assets.

4.1 CLAIM: ALL INFRASTRUCTURE ASSETS WILL STAY IN PUBLIC OWNERSHIP

The Government claims that 'all infrastructure assets will stay in public ownership such as power stations, the poles, the wires and the country depots' (Newspaper Advertisement, 'Securing NSW’s future energy needs', The Daily Telegraph, 23 January 2008, p. 6). However, it is playing word games. The fact is that the proposed leasing of electricity generators is proposed to be for a very long time. On the basis of public statements made by Government representatives, such an arrangement will transfer the majority of the risks and benefits of ownership to the lessee. The international accounting profession has long taken the view that such arrangements should be regarded as being, in substance, a sale, and requires that such transactions to be recorded accordingly as ‘finance leases’.

Moreover, claims that the State will retain the ‘poles and wires’ assets of the distributors simply means that the Government will retain responsibility for the maintenance of this infrastructure while the money making elements, that is the business of electricity distributors, will move to private operators. Possibly distributors will be charged for use of these elements of the infrastructure system. No public statements have been made as to the basis for those charges.

It is submitted that the Committee can not sensibly report without addressing this issue, and its impact on prices to consumers.

---

1 According to the Owen Inquiry Report: ‘In the event that the Government does not wish to sell generation, then it should implement an appropriately structured long-term leasing of current generation assets’ (p. 10).
4.2 CLAIM: PROPOSAL WILL BE SECURED AT 'NO COST TO TAXPAYERS'

On 10 December 2007, the NSW Premier announced that:

… the future needs of the State's businesses and families will be secured at no cost to taxpayers … (Premier of NSW News Release, 'NSW acts to secure state's energy supply', 10 December 2007).

This claim was repeated by Mr Costa who said:

But the fundamentals are clear – it simply does not make sense for NSW taxpayers to pay up to $15 billion for electricity investment when the private sector can do it at no cost to the taxpayer (Premier of NSW News Release, 10 December 2007).

Acceptance of this spurious rationale would actually impose substantial costs on taxpayers. Some of the costs to the State, and in turn, to taxpayers include:

- loss of or loss of control of assets valued at some $20 billion;
- loss of net profits in excess of $1.5 billion per annum;
- loss of contributions to the Budget of around $1.3 billion per annum.

There will also be the on-going cost to the taxpayer for:

- the maintenance of the 'wires and poles'; and
- site remediation.

In relation to maintenance of 'wires and poles', it is noted that the Morgan Stanley report to the Owen Inquiry referred to

The considerable funding already required for the transmission and distribution poles and wires over the next four years of around $9Bn (p. iv).

As for site remediation: it is curious that the latest financial statements of the State-owned electricity generators do not include substantial provisions for this obligation. The recently-issued Australian Accounting Standard AASB 137 'Provisions, contingent liabilities and contingent assets' (2004) introduced rules requiring the establishment of provisions for site remediation. In particular, the Standard encompassed obligations for site remediation or restoration arising from contracts, legislation or other operation of law, and 'constructive obligations'.
It has long been suggested that the State's electricity generators - along with chemical factories and petroleum refiners and distributors - may be facing significant bills for site remediation work. Private sector firms in the extractive industries (such as BHP Billiton, Santos, Woodside) have established substantial provisions for site restoration, as have petroleum distributors (e.g. Caltex). The NSW Total State Sector consolidated statements report a 'Provision for Land Remediation and Other Restoration Costs' of $267 million at 30 June 2007. Yet the 2007 accounts of the state-owned electricity generators report very little on this score. Macquarie Generation discloses a provision for only $6.36 million, while Eraring and Delta Electricity did not report any provision for site restoration.

It appears likely that any bidder for a lease of the electricity generators would seek either to require the lessor (the State Government) to assume responsibility for site remediation or restoration work, or to indemnify the lessee for any claims arising from the need to remediate sites, or compensate others for losses incurred from contamination.

Returning to the broader claim – that the future needs of the State's businesses and families will be secured 'at no cost to taxpayers', in context such statements reflect the misuse of financial concepts. The term 'cost' is associated with expenses, whereas any expenditure undertaken by the State Government in new generation facilities would constitute an investment, not a 'cost'. To date, the operation of those assets has been very profitable.

4.3 CLAIM: PROPOSAL WILL SAVE TAXPAYERS UP TO $15 BILLION

The Premier also said that:

The decision is expected to save NSW taxpayers pay up to $15 billion over the next 10 to 15 years … (Premier of NSW News Release, 'NSW acts to secure State’s energy supply', 10 December 2007).

The alleged $15 billion 'saving' is apparently the estimated investment required over 10 to 15 years by the State Owned Corporations to enable them to provide the required additional baseload. The $15 billion is made up as follow:

- $7 to $8 billion investment in new generation equipment;
- $2 to $3 billion to maintain the viability of retail businesses; and
- $3 to $4 billion to retrofit existing power stations with carbon reduction technologies.
It is emphasised that this expenditure on new generation equipment would not be a 'cost' but an 'investment'. If the State were to buy additional power assets, this expenditure will be transformed into an equivalent addition to the value of the State's asset holdings. As for retrofitting existing power stations with carbon reduction technologies, this must be regarded as a basic responsibility of government, given Australia's commitments to address its contribution to global warming. This is one area where the community is likely to accept the need to pay increases prices for electricity, if indeed that investment was undertaken with demonstrable effect. Many consumers are currently paying a premium for 'green' electricity in the belief that the energy is coming from solar or wind power.

So the required expenditure is estimated at $10 to $15 billion over 10 to 15 years. This means that, even at the higher end, the estimated expenditure for the State would average $1 to $1.5 billion per annum – an amount within the financial capability of the State even with its other commitments and even if it had to borrow. Currently the State's total liabilities, as recorded in the NSW Total State Sector consolidated balance sheet at 30 June 2007, total $76.75 billion. An extra $1.5 billion would amount to 1.9 per cent of the total.

Moreover, as already shown above, six of the power agencies themselves currently make a net profit of over $1.5 billion per annum and contribute some $1.3 billion to the State Budget. Nothing has been presented by the Treasurer or the Premier to suggest that the recent profitability of the investment in this infrastructure will not continue in the future. On the face of it, this means that any additional investment required to 'secure' the State’s energy needs could virtually be self-funded by the existing generators themselves.

On the other hand, there is nothing in Mr. Costa's announcements to indicate that the sale or long term lease of generating assets will secure new investment by the private sector in base load generating capacity. Nor has there been any suggestion that those bidding to acquire the existing generating businesses will be obliged to make such investments.

It seems that Mr. Costa is taking the ideological position that 'the market' will solve the need to expand capacity by undertaking new investment. Given the challenges facing new entrants to conform to new and higher standards of greenhouse emissions, it seems unlikely that such an outcome will occur without the benefit of major economic incentives from Government. Those incentives should be identified and costed – and taken into account when assessing the claim that 'future needs of the State’s businesses and families will be secured at no cost to taxpayers'.
4.4 CLAIM: INVESTMENT OF PROCEEDS WILL YIELD REVENUE AT LEAST EQUAL TO CURRENT ENERGY DIVIDENDS

According to Mr Costa:

… the Government will invest the proceeds in a new NSW Intergenerational Fund to provide revenue at least equal to that currently provided by dividends from energy businesses (as quoted in Premier of NSW News Release, ‘Energy savings to fund major infrastructure projects’, 10 December 2007).

Firstly, Mr Costa ignores that fact that energy businesses not only pay dividends but also make other contributions to the Government in the form of tax equivalents and capital repayments. In 2006-07, tax equivalents and capital repayments contributed $575 million of the total paid to the State Budget of $1,264 million. But focusing on cash payments to the general government sector may be misleading, since the wholly-owned State Owned Corporations in the electricity industry is also retaining profits for reinvestment. A better indicator of their contribution is their rate of return on equity – around 25% per annum.

In order for the sale proceeds to earn sufficient revenue to replace energy contributions to the State, they will need be invested so as to generate earnings in excess of that being produced by the State's current investment in electricity assets, in what (if one excludes the impact of speculative trading activities) is essentially a business with many of the characteristics of a natural monopoly, that provides a basic service to the community.

Secondly, Mr Costa seems to have discovered a 'magic pudding'. Not only will the revenue from the proceeds replace current dividends, but he says that the proceeds in the proposed Fund ‘will underpin the expected growth in infrastructure spending for generations to come’ and that they will also be used:

… to provide significant additional funding in the areas of Health and Education – funding more trade schools and cutting hospital emergency waiting times.

The proceeds would also support funding of the Government's priorities, including a new vision for:

- Urban transport including Euro-style metro rail and the extension of the M4;
- Improving regional and rural water outcomes;
- Rural and regional road transport improvements;
- Developing cost-effective energy efficiency measures; and

The extravagance of this claim speaks for itself – even disregarding the inconsistencies. We are told that sale of the generators will avoid the need for the
Government to spend $3 to $4 billion on carbon reduction equipment, but then we are told that the proceeds of any sale will be spent on 'clean coal technologies'.

4.5 CLAIM: RATINGS AGENCIES HAVE INDICATED THERE IS LITTLE ROOM TO FURTHER INCREASE INFRASTRUCTURE SPENDING WITHOUT JEOPARDISING OUR TRIPLE A CREDIT RATING

According to the Government 'the ratings agencies have indicated there is little room to further increase infrastructure spending without jeopardising our triple A credit rating' (Premier of NSW News Release, 'NSW acts to secure State’s energy supply', 10 December 2007).

Well that is not quite what the ratings agencies have said – despite what are assumed to be the best efforts of the Treasury/Treasurer in briefing those agencies.

The State of New South Wales is rated by two ratings agencies, namely, Moody's Investors Service Limited and Standard & Poor's. Those ratings are highly dependent on the rating of the Commonwealth of Australia (for example, a State’s credit rating cannot be higher than the Commonwealth’s).

In a short, six paragraph Press Release issued on 19 September 2007, Standard & Poor’s, after affirming the State's AAA credit rating and describing the 'outlook is stable', stated in part:

New South Wales’ large capital program is a key feature of the state’s forecast financials. … However, regardless of the debt increase over the forecast period, we expect the state’s balance sheet will remain moderately strong and consistent with rating on the state.

New South Wales forecasts debt to increase in line with its intention to step up its capital spending. …

We consider it a credit strength that the state continues to forecast accrual operating surpluses … (Standard & Poor’s Press Release, New South Wales Ratings Affirmed; Forecast Debt Increase Consistent With ‘AAA’ Rating, 19 September 2007).

Standard & Poor’s went on to make the following statement:

Over the longer term, there are some risks to the rating as the state considers options for its base-load generation. In the event that the state funds this additional generation, there may be pressure on the rating over the longer term … On the
other hand, if the state decides to sell its retail and generation businesses, we would expect this to significantly reduce risk to the state … (Standard & Poor’s Press Release, New South Wales Ratings Affirmed; Forecast Debt Increase Consistent With ‘AAA’ Rating, 19 September 2007).

Any sceptic with some knowledge of the process by which ratings are undertaken might say that this was the point where Standard & Poor was repeating a political message rather than reflecting an independent view. Certainly S&P failed to provide any plausible analysis of those risks – and how they would be avoided by sale of retail and generation businesses.

On the other hand, Moody’s Investors Service on 11 October 2007 in confirming its Aaa credit rating of the State and describing the outlook as ‘stable’ stated:

The debt burden is expected to rise over the medium term as NSW embarks on large-scale capital improvement program, however the state’s debt load should remain manageable. … (Moody's Investors Service, Credit Opinion, 11 October 2007).

And:

The state’s moderate debt burden provides solid support to the rating with debt ratios comparable to Aaa-rated counterparts in Australia and internationally. In line with Moody’s internationally comparable debt ratios, ‘net debt’ excludes the debt of self-supporting public corporations. Debt is estimated to be a moderate 48% of revenues and 7% of GSP. The positive performance of water and electric utilities eases the state’s debt burden as these corporations’ debt is self-supporting through user charges under a regulated pricing structure. Substantial financial assets held in liquid investments provide an ample cushion for debt obligations … [emphasis added].

The debt burden is projected to rise significantly with 40% of the state’s $50 billion capital improvement program to be financed with debt-resulting in the stock of debt more than doubling – however, the moderate starting-point provides the state with room to take on a heavier debt load … [emphasis added].

The strong financial support provided by the Commonwealth government through fiscal transfers to all states is also a key factor in New South Wales’ ratings. … (Moody’s Investors Service, Credit Opinion, 11 October 2007).

It seems that Moody’s showed greater independence. No intrusion here into internal policy and politics. In fact, Moody’s suggests that the State has the capacity to take on more debt, and that the State Owned Corporations are capable of funding new infrastructure investment since their debt is self-supporting.

In any case, as Moody’s confirms, credit ratings greatly depend on the rating of the Commonwealth Government. As Moody’s has stated:
Moody’s rating of Aaa reflects the BCA [Baseline Credit Assessment] of 1 and very high likelihood that the commonwealth government would act to prevent a default by New South Wales. The very high likelihood of extraordinary support reflects Moody’s assessment of the incentive provided by the risk to the commonwealth government’s reputation if New South Wales were to default, as well as indications of support stemming from the strong system of commonwealth-state transfers (Moody’s Investors Service, *Credit Opinion*, 11 October 2007).
ARGUMENTS FOR THE SALE OF PUBLIC ASSETS ARE NOT NEW: SELLING GOVERNMENT ASSETS TO AVOID DEBT

There is a general consensus that governments need to ensure investment in infrastructure. However, there are varying opinions as to the process of financing such investment.

It has long been recognised that governments cannot do everything and so the need for commercial relationships between the public and private sectors is not new.

Private businesses have long provided to government agencies:

- goods and materials;
- services;
- buildings on leases;

and private businesses have been engaged as:

- contractors to government in the construction of physical infrastructure – schools, hospitals, roads, and other public works.

These investments in infrastructure were normally funded from government revenues and/or government borrowings.

Decades later, much of NSW's legacy infrastructure is older, and the population has increased, so that there are greater demands on that legacy infrastructure.

Changing demography, technology and community expectations have collectively established demands for further investment in infrastructure.

But what are the priorities? In the absence of a systematic review of the current condition of the State's infrastructure, as well as an assessment of emerging
needs. the NSW community does not have a good sense of what should, rationally, be the State's priorities for infrastructure investment.

Parliamentarians have a great responsibility in identifying the long term infrastructure needs of the community. However, this responsibility is hampered by the political cycle and the many temptations to focus spending on short term and obvious projects, issues and achievements.

Moreover, a coalition of politicians, bureaucrats, merchant bankers and others have convinced each other, the media and the community about the evils of public sector debt or the so-called catastrophic effects of a down-graded credit rating. Meantime, the business community has engineered ways of earning high fees for themselves.

The public service, for its part, has been inappropriately politicised. Public servants may fear to provide appropriate advice. There are also concerns that many in senior positions lack the financial skills to adequately analyse proposals put to them by a self-interested private sector.

These developments have given rise to various forms of privatising the public sector and the proposed sale of the NSW electricity industry is just the latest example. But why?

Undoubtedly the main driver for private sector involvement in capital projects has been financial – the concern by governments to avoid increasing (reported) government ‘debtp. The political theme of advocating debt reduction by government appears to have been imported from Britain, where public sector debt was high, relative to GDP. The Maastricht Treaty (1992) had established targets for government borrowings by members of the European Union, on an annual and cumulative basis. A Protocol on the ‘excessive deficit procedure’ called for alarm bells to be rung when a planned or actual government deficit exceeds 3 per cent of gross domestic product, or when government debt exceeds 60 per cent of gross domestic product, at market prices.

It is no surprise that these arrangements also created incentives for the British Government to sell many public assets and to enter into off-balance sheet financing arrangements.

Obviously there are occasions when privatisation through the sale of government trading enterprises may make good sense. Private sector businesses have benefited from selling-off non-performing or non-core assets to meet financial obligations or to fund promising new ventures. But those occasions depend on a careful balancing of the financial and non-financial costs and benefits of a range of options.
In contrast, the arguments disseminated about how privatisation could repair or avert a crisis in government finances have been crude, and often quite misleading.

Indeed, the very idea that there is a crisis in government finances has often been deliberately manufactured to suit the interests of individual governments.

It is on the record that the Coalition Government which first advocated debt reduction in the 1980s had deliberately set out to 'manufacture a sense of crisis' in State finances.

A key element has been the establishment of short-term enquiries into government finances to report on a government’s financial position (and to dump on predecessors). Gary Sturgess, who was a pre-election political strategist to incoming NSW Premier Greiner (and later appointed head of the NSW Cabinet Office) later conceded that it was mainly a 'marketing exercise' to create 'a popular demand for that kind of reform'. He has explained the formation of the 1988 ‘Curran’ Commission of Audit as follows:

... it was a marketing exercise... In March 1988 there was no great feeling that New South Wales’s finances were in drastic shape, so why would you need a government shake up? ... at that point in time people just did not see the need for it, people couldn’t see the point of user pays. The whole idea of downsizing and putting these things on a commercial basis, there was just no basis for that. Nobody had done it. So we had to create a popular demand for that kind of reform (Interview, December 1994, as reported in Laffin and Painter, p. 9).

The Curran Commission duly reported that

New South Wales has been living beyond its means!


The facts are that government debt is not a problem in Australia or New South Wales.

Judging from some political rhetoric, all debt is dangerous. It cannot be emphasised too strongly that such claims would be regarded as nonsense in the private sector, where debt-financing is seen as a fact of life, and the choices about a firm’s capital structure can improve returns to shareholders.

International comparisons of debt levels are regularly undertaken as an indicator of the financial standing of governments. The focus of these reports is generally on ‘debt’ rather than ‘liabilities’, for the simple reason that data about public
sector ‘liabilities’ has been unavailable for most countries. It has to be acknowledged that, in some jurisdictions, the difference between the two figures may not be significant.

For the purpose of international comparisons, levels of debt are commonly related to the benchmark of Gross Domestic Product – to provide a crude index of ‘affordability’. At state level, levels of debt are related to Gross State Product.

It is clear from published international comparisons that Australian public sector debt levels are very low by international standards.

According to the 2007-08 Commonwealth Budget papers, Australia’s net debt position compares favourably to other industrialised countries and is among the lowest levels in the OECD [Organisation for Economic Co-operation and Development]. The average net debt to GDP ratio in the OECD is around 45 per cent while for Australia it is below zero. It states that:

Due to continuing strong economic and fiscal management net debt is expected to remain below zero in 2007-08 and over the forward years (Commonwealth of Australia, Budget Paper No 1, 2007-08).

The OECD survey, based on figures provided by the various member countries, shows an estimated net debt figure for Australia as a percentage of GDP at -4.7 for 2007 (and a projected -6.1 per cent and -7.1 per cent for 2008 and 2009 respectively). This compares with 44.2 per cent (2008: 45.9 per cent and 2009: 47.6 per cent) for the United States; 39.3 per cent (2008: 40.9 per cent and 2009: 41.8 per cent) for the United Kingdom; and an average of 42.6 per cent (2008: 43.2 per cent and 2009: 43.5 per cent) for the OECD. Some details are shown in the Table below.

Table 5.1  
GENERAL GOVERNMENT NET FINANCIAL LIABILITIES  
AS A PERCENTAGE OF NOMINAL GDP  
Estimates and projections

<table>
<thead>
<tr>
<th></th>
<th>2001</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>6.4</td>
<td>-0.9</td>
<td>-4.1</td>
<td>-4.7</td>
<td>-6.1</td>
<td>-7.1</td>
</tr>
<tr>
<td>France</td>
<td>36.7</td>
<td>43.5</td>
<td>38.2</td>
<td>39.2</td>
<td>40.3</td>
<td>41.3</td>
</tr>
<tr>
<td>Germany</td>
<td>37.2</td>
<td>50.0</td>
<td>48.8</td>
<td>46.7</td>
<td>45.0</td>
<td>43.1</td>
</tr>
<tr>
<td>Japan</td>
<td>66.3</td>
<td>84.0</td>
<td>85.9</td>
<td>88.1</td>
<td>90.8</td>
<td>92.4</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>32.9</td>
<td>39.3</td>
<td>38.7</td>
<td>39.3</td>
<td>40.9</td>
<td>41.8</td>
</tr>
<tr>
<td>United States</td>
<td>35.3</td>
<td>44.0</td>
<td>43.9</td>
<td>44.2</td>
<td>45.9</td>
<td>47.6</td>
</tr>
<tr>
<td>Euro area</td>
<td>48.0</td>
<td>51.2</td>
<td>48.5</td>
<td>46.1</td>
<td>44.8</td>
<td>43.5</td>
</tr>
<tr>
<td>Total OECD</td>
<td>38.7</td>
<td>44.2</td>
<td>43.1</td>
<td>42.6</td>
<td>43.2</td>
<td>43.5</td>
</tr>
</tbody>
</table>

Note: This OECD publication does not include a definition of ‘net financial liabilities’. However, according to the 1999-2000 Commonwealth Budget Paper No 1, ‘net financial liabilities’ data are for the total general government sector (i.e. the aggregate of all levels of government, including the social security sector but excluding public trading enterprises).
The above comparisons show that Australian governments are not in a public sector debt crisis. The emphasis placed by some politicians in 'reducing debt' is overblown and exaggerated.

The question might be asked:

**Does it make sense to base government policies on financial targets rather than on targets for the provision of services to the community?**

The fact is there is nothing wrong with governments borrowing to finance infrastructure that will be of benefit to current and future generations. This argument is strengthened if the project is also a profit maker.
6. PRIVATISATION IN PERSPECTIVE

In the last 20 years, gross proceeds from total Australian privatisations have totalled around $120 billion.

The Commonwealth accounted for $68 billion of these sales – including such items of physical or social infrastructure as

- Australian Airlines
- Australian Industries Development Corporation
- Australian National Railways Corporation
- Sydney Airport (and other major city airports)
- Commonwealth Bank
- Commonwealth Serum Laboratories
- Housing Loans Insurance Commission
- Moomba Sydney Pipeline System
- Qantas
- Telstra

These were the legacy of past generations of tax payers - but were sold-off for short term spending purposes rather than for re-investment in major infrastructure projects.

During the 2007 Federal election campaign, the Coalition’s election promises were costed at $64 billion. Much of that went in tax cuts that favoured high income earners. A Commonwealth Government publication (Tax Expenditures Statement 2007) has been reported (Sydney Morning Herald, 26 January 2008) to have costed tax concessions and handouts for the 2006-07 financial year at $50 billion, of which the largest element was $25 billion in concessions for people putting money into superannuation.

In other words, the Coalition, in just one election campaign, spent or gave away funds that were roughly equal to the proceeds of two decades of asset sales. Which makes one wonder – what was the point?

New South Wales, apart from a small number of privatisations – with one major disaster, namely the sale of the State Bank (which is discussed below) - has been able to survive without the sale of its essential assets. It should take pride in this fact.
7. **DETERMINING RETENTION v. SALE VALUE**

One of the tasks assigned to the Committee is to assess ‘the retention value of the enterprise measured against its sale value’ – with the calculation of retention value to 'incorporate both commercial and non-commercial functions'.

We doubt that members of the Committee will attempt this exercise alone – but will presumably receive submissions from NSW Treasury.

7.1 **CALCULATION OF RETENTION VALUE**

It is believed the terminology - 'sale or retention value' – may have been first used in a 1995 paper by one of the authors of this submission ('Privatisation - a reassessment'). The major points made in that paper were that the exercise of examining the financial case for or against privatisations could proceed by examining the cash flows that would be received from sale or retention, and that these cash flows should be compared after undertaking discounted cash flow analysis. The paper was published at a time when political commentary referred to the minimal dividends received from some agencies, and the point was made that the cash flows derived from retention of a government agency encompassed not only dividends but receipts from:

- income tax equivalents, and other taxes; and
- loan guarantee fees.

This point has now been widely accepted (e.g. reports from the NSW Auditor General refer to cash flows from dividends and tax equivalents).

However this approach is largely a matter of convenience. In practice this may understate the real returns to government, as some proceeds from the activities of public trading enterprises may be retained within the agency and re-invested, thus enhancing the value of the government owned business (and those enhancements in value are also financial returns to government). Strictly any assessment of retention value should be based on the projected cash flows to be earned by the wholly-owned agency, not simply the cash flows arising from inter-
sector transfers (e.g. dividends paid from agencies in the non-financial public trading sector to the general government sector).

However arguably the most critical element in the determination of 'retention value' is the **choice of discount rate** to use in discounted cash flow analysis.


It might be explained that the higher the discount rate selected, the lower the net present value (NPV) of estimates of future cash flows.

In the private sector, the use of discounted cash flow calculations have been advocated with the overall objective of increasing returns to shareholders. Accordingly it has been argued that in order to increase shareholder value, firms should only select new projects that would be **as or more profitable** than those the firm was already undertaking (give or take some allowance for differences in risk). That approach led to the proposition that the discount rate should reflect the **opportunity cost of capital** – the rate of return that could be earned from other available investments. Another claim was that the discount rate should reflect a firm's **expected cost of capital**, based on the expected rate of return 'demanded' by investors in debt and equity securities. Whatever the stated rationale for the choice of discount rates, the underlying objective was to select a hurdle rate to identify those projects that would increase the value of the firm.

But the goal of the public sector is not to increase the value of 'government' but to provide services to the community. Governments can take a longer view than private investors, and are also in the position to spread risks across an entire community. Accordingly, it has been suggested that the social discount rate should be based on a social rate of time preference – which measures the value society places on forgoing present consumption for the benefit of current and future generations. This is often very low (one text suggests using a rate of 2% with sensitivity analysis at 0% and 4%) (Boardman *et al.*, 2001, p. 248). Indeed, many governments have used a relatively low discount rate to evaluate capital projects. The discount rates specified by central government agencies in the US and Canada have been only slightly above the rate at which governments can borrow to finance those projects (Boardman *et al.*, 2001, p. 250). In the UK the risk-free rate has been recommended for use in the evaluation of projects involving the private financing of public infrastructure (HM Treasury, 2003).

Yet in NSW various publications have advocated the use of private sector discount rates to evaluate the value of public sector delivery of infrastructure projects, and (presumably) the retention value of government businesses when considering privatisation. For example a 2001 'Green Paper', *Private Financing*
of Infrastructure Projects, acknowledged that the public sector can generally raise debt at a lower cost than the private sector, but asserted that ‘to ensure efficient use of resources, the same cost of capital should be used for both sectors for assets of the same risk characteristics when investment decisions are made about public sector projects (pp. 28-29). This position ignores the point that government investments in public infrastructure have typically been made because of market failure – the failure of private sector firms to invest in certain industries because of their lack of prospective profitability. This seems to have been the case with electricity distribution, and government investment was an important contribution to economic development in the State.

A 2007 NSW Treasury Technical Paper has similarly taken an extreme view about the choice of discount rates. It proposed an approach that ensured an extreme bias against government procurement. It presented alternative discount rates for use in calculations of the Public Sector Comparator (PSC), on the basis of a distinction between projects that were likely to generate a net cost to the public sector, and those likely to produce net revenues (such as tollways). It claimed that it was appropriate to use a discount rate that reflected the systematic risk transferred to the private sector in a Public Private Partnership (PPP). For net cost projects, the paper advocated use of the risk-free discount rate (p. 10). For net revenue projects, the paper advocated use of a higher discount rate in the PSC, reflecting market evaluations of the cost of capital in projects of equivalent risk (p. 62).

Use of the risk-free rate for net cost projects would almost inevitably make the conventional government delivery less attractive than a PPP, while use of a private sector discount rate for net revenue projects would have the same effect. These biases are compounded by the fact that the private sector discount rate would be applied not to 'best estimates' of cash flows, but to estimates adjusted (i.e. inflated) by project risks – even though those supposed 'risks' typically arise from changes in government specifications for the project.

The NSW Treasury paper was presented without reference to decades of technical literature discussing the ‘social discount rate’. It has been well recognised that individuals may seek some form of return from investments within their lifetimes. On the other hand, governments act on behalf of the entire community, not just those with surplus cash to invest, and can afford to be more patient with their investments (not seeking an immediate return in the form of cash flows or social benefits). Governments may consciously seek to develop infrastructure for the benefit of future generations, as prior generations have done for the present generation. Governments are also in the position to bear risks on behalf of the entire community, and can rely on taxation to finance projects if things don’t turn out as planned. For all these reasons, there is an accumulation of literature that suggests that government projects should be evaluated using a public sector discount rate. There may not be a consensus as to how that public sector discount rate may be measured. For example, some economists have argued for the use of the government bond rate (Arrow and
Kurz, 1970) or the private market rate for long-term debentures or bonds (Groenewegen, 1984), or some rate between the before and after tax rates of return in the private sector (Rosen, 1995), or simply somewhat above the government bond rate, but below the average cost of capital to private firms (Quiggin, 1997, Spackman, 2004). But, as the above citations indicate, it is widely accepted that the public sector discount rate should be lower than that used by private sector firms to screen or rank prospective investments.

The NSW Treasury stance is out of step with the weight of academic opinion, and the practices of experts from major western governments. To compound matters, the current NSW Treasury guidelines on other issues (e.g. the assessment of whether projects should be provided via government agencies or via public private partnerships) propose that estimates of projected cash flows from government procurement should be 'risk adjusted' - and then subject to discounted cash flow analysis using a private sector 'cost of capital' as the discount rate. This involves blatant double counting of risk.

The Committee may not have the time or inclination to explore these issues in depth. But it should note that higher the discount rate, the lower the calculation of retention value.

It is suggested that any Treasury submissions analyzing sale versus retention value should be published in full, and open to public scrutiny, of for no other reason than to avoid past mistakes.

7.2 LESSONS FROM PAST EXPERIENCE IN USE OF PRIVATE SECTOR COST OF CAPITAL (SALE OF SBNSW)

The Committee should take heed of the damage done to State finances by past reliance on the 'private sector cost of capital' in investment evaluations.

Early in 1995 the State Bank of NSW was sold by the Fahey Government for a headline price of $576 million to Colonial Mutual, after the major trading banks were excluded from bidding, supposedly to promote increased competition in the banking sector. One of the conditions of the sale was that the NSW Government would assume most of the risks of bad debts on a $13 billion loan book. After the first $60 million in bad debts, prospective purchasers were to be reimbursed for 90% of any further losses.

Parliament did not agree to the sale proceeding, prior to receipt of a report from the Auditor-General on the merits or otherwise of the sale. The report (costing close to $1 million), when received, recommended that the sale proceed, and independents announced they would vote for the sale. However sections of the
The reports that had been withheld included details of the discount rate that had been used to evaluate the options of 'sell' or 'retain' the Bank. It was argued that the relevant discount rate was the private sector cost of capital for the banking industry. It was claimed that this was 'high risk' (a claim that ignored the fact that the NSW Government was itself underwriting most of those risks).

As detailed previously (Walker and Con Walker, 2000), the discount rate selected to calculate the net present value of maintainable earnings from the Bank was equivalent to a rate of return of **18.9 per cent per annum after tax**. But Government agencies do not pay corporate tax to the Commonwealth (only notional taxes to the consolidated fund). Accordingly, given that the 1995-96 corporate tax rate was 36 cents in the dollar, this was equivalent to using a **discount rate of 29.5 per cent per annum before tax**.

Arguably, had there not been claims that elements of the report were 'commercial in confidence', this discount rate would have been disclosed, and been the subject of widespread ridicule.

Had the full report been provided at the time, and had it contained a meaningful assessment of 'sale value and 'retention value', the extent of potential bad debts on projected cash flows would have been obvious. Possibly media scrutiny would have dissuaded members of Parliament from voting for the sale to proceed under those terms.

The outcome was a financial disaster for the State of NSW:

- NSW had to reimburse the purchaser for hundreds of millions of dollars worth of bad debts. By 2001 the net proceeds from the sale had fallen from the headline price of $576 million to around $80 million.

- The net sale proceeds were less than one year’s profits: in its first year of private ownership, the bank reported a pre-tax profit of $146.9 million.

- Before Colonial merged with the Commonwealth Bank in 2000, an Independent Expert’s Report included a valuation of Colonial's banking
business – which, (apart from very minor investments in Tasmania and Fiji), was for all intents and purposes the old State Bank of NSW. The valuation, only four years after the State Government’s sale of the bank for a net $80 million, was in the range $2.5 billion - $2.75 billion.

In other words, the State of NSW lost around $2.5 billion from the premature sale of SBNSW – it was sold at the wrong time, for the wrong reasons (to get rid of it before the story of bad debts and maladministration came to light) and on the wrong terms.

The exercise deserves to be regarded as one of Australia’s worst financial scandals of the last century – along with the failure of Reid Murray and HG Palmers in the 1960s, and the failure of Bond Corporation in the 1990s.

The major mistake was to evaluate the 'sell' or 'retain' options using a discount rate based on market-determined estimates of the private sector cost of capital.

Arguably, NSW Treasury’s continued advocacy of use of that methodology has led to similar losses – including loss of profits from tollways such as the M2, because they were constructed as a Public Private Partnership.
REFERENCES


____ *(2007), Technical Paper: Determination of Appropriate Discount Rates for the Evaluation of Private Financing Proposals*


