BRIEFING PAPER

Electricity Privatisation, Budget Black Holes and Credit Ratings

OVERVIEW

A dummy-spit does not make for good financial management. But that is what we were subjected to by Mr Costa on his sacking as Treasurer, when he claimed the State was facing a financial crisis.

Mr Costa had the responsibility to oversee the State’s finances and infrastructure as Treasurer (for two and a half years) and as Minister for Infrastructure (for three years). He seems to have learnt very little, even though these were record terms of office for him. (Previously the longest period he had served in any ministry had been 1 year 9 months and 20 days.) By the end of his ministerial career, he still believed the 1980s notion that selling State-owned assets constituted ‘reform’.

His ignorance is no excuse for his wilful, self-indulgent baseless attack on the State’s finances apparently assisted by Treasury bureaucrats with an agenda to promote a sense of financial crisis.

To borrow from a prominent Danish economist, politicians and bureaucrats commonly push through major proposals by engaging in ‘strategic misrepresentation (i.e. lying)’.

It is time to examine some ‘strategic misrepresentations’ about State finances. This briefing paper assesses seven:

#1 NSW faces a financial crisis
#2 NSW faces a threat to its Triple A credit rating
#3 Downgrading of the credit rating would cost $500 million
#4 NSW needs to spend $15 billion to keep the lights on
#5 NSW has a $20 billion hole in its budget
#6 NSW needs to sell the electricity retailers
#7 Selling assets is a ‘reform’

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INTRODUCTION

The last few weeks have seen the highs and lows of Parliamentary democracy in NSW.

The lows included the production of a flimsy report from the Auditor-General which was trumpeted as supporting privatisation. It did no such thing. The Auditor-General was empowered to undertake a ‘performance audit’ in terms of section 38B of the Finance and Audit Act, but chose not to do so. The terms of reference established by the Auditor-General (Supplementary Powers) Bill empowered him to report on the ‘financial value for taxpayers’ and the potential sale price of the assets, but he chose to avoid that responsibility. Having found that Treasury had failed to establish a ‘reserve price’, he then offered the extraordinary suggestion that it was OK for the reserve price to be below ‘retention value’. In short, the Auditor-General should have provided information that would enable Parliamentarians to make informed decisions about whether to vote for the proposals, or against the proposals. He failed to do so.

Another low was the recall of Parliament (at the expense of taxpayers of some $500,000) to debate a bill for the privatisation (or ‘restructuring’) of the State-owned investments in electricity business. Unusually, the bill was introduced in the Legislative Council – apparently so that (now former) Premier Iemma could avoid the embarrassment of yet another loss (following the 7 to 1 vote against the Iemma/Costa privatisation proposals at the NSW State ALP Conference in May).

One of the highs was the realisation that the Legislative Council was prepared to reject the privatisation proposals (and Treasurer Costa faced another loss) so that government members moved to adjourn the debate (and, it appeared, to abandon the proposals altogether). The rejoicing of some was short-lived.

Then Iemma announced he would move to privatise the electricity retailers (and some land sites) using the artifice that government ministers nominally owned the share in the electricity retailers: Energy Australia, Integral Energy and Country Energy. And the expected price? According to Mr Iemma, $3 billion.

The Iemma Government’s stance on privatisation was obviously led by (now former) Treasurer Costa and bureaucrats in NSW Treasury. Costa’s departure would have been seen as a ‘high’ had he resigned after the State ALP Conference rejected his proposals. Instead he stayed on. His performance has been almost universally described as damaging the Government and the Labor Party.

But the greatest damage has been done to the quality of debate about public finance.
As Treasurer, Costa was responsible for the dissemination of a farrago of lies and misrepresentations about State finances. And he was supported in this by Treasury officials. Mr. Iemma used taxpayers' money to publicise the same falsities – many of which have been repeated by an uncritical media.

Mr. Costa is no longer Treasurer. Mr. Iemma is no longer Premier.

But there's a risk that, unless corrected, the lies and misrepresentations will continue to be accepted.

Mr. Costa saved his worst for last. After being tapped on the shoulder, Mr. Costa called a press conference to disseminate distorted and exaggerated propaganda about State finances. Perhaps trying to paint himself as a financial expert (if any business would risk hiring such a divisive character), Costa claimed that the rejection of the electricity privatisation proposals meant that that the State faced a financial crisis.

This briefing paper seeks to set the record straight.

MISREPRESENTATION #1: NSW FACES A FINANCIAL CRISIS

It was claimed by Mr. Costa that the failure of Parliament to pass the privatisation legislation (even though Parliament did not really get a chance to vote on it) has caused a 'financial crisis' for the State requiring a mini Budget to plan drastic actions to make up for the lost proceeds.

THE FACTS:

The 2008-09 State Budget dated 3 June 2008 was not predicated on the privatisation of any electricity assets. We know that because Costa stated in his Budget Speech:

> But as has been the case with past major transactions, estimates of the proceeds of electricity sector transactions have not been included in the budget, with the impact on the balance sheet and our fiscal targets to be shown in future years (p. 5).

In fact, the Budget provided for capital expenditure in the electricity sector of $15.720 billion over the five years to 2011-12 as follows.

<table>
<thead>
<tr>
<th>Capital Expenditure in the Electricity Sector</th>
</tr>
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<tbody>
<tr>
<td>2007-08</td>
</tr>
<tr>
<td>Revised $m</td>
</tr>
<tr>
<td>2,709</td>
</tr>
</tbody>
</table>

Note: Figures for 2009-10 to 2011-12 are Forward Estimates. Source: 2008-09 Budget Paper No. 2, pp. 7-8 to 7-9.

According to the Budget Papers, the major driver for the above is the level of expenditure by the NSW electricity network businesses (transmission and distribution) necessary to meet significant asset replacement and renewal,
growth in demand, and regulatory requirements to enhance system reliability (p. 7-8).

The Budget Papers stated that the Owen Inquiry signalled the need for further significant expenditure over the next decade should the Government retain the retail and generation assets. They admitted that:

the (Owen) Inquiry indicated that the majority of this expenditure, including new investment for baseload generation and the retrofit of existing plant, will be required from 2013 onwards. Given the Government's response to the Owen Inquiry, and indicative time line for new baseload investment, no provision has been made in this Budget for new baseload investment by NSW generators (p. 7-9).

In short, less than two months after saying that there was no urgency in providing for new baseload investment, Iemma and Costa claimed that the State was in financial crisis if money for new baseload generators could not be found.

It appears that Treasury secretary John Pierce has contributed to this misconception. As The Daily Telegraph reported:

Sources revealed that [Pierce] warned that the Government's net debt would begin to rise sharply beyond the four-year forward estimates because of the need to factor in now $12 billion for future spending on new power generation (3 September 2008).

Plainly Pierce influenced Costa and Iemma to pursue this theme about a financial crisis.

Another element of Costa’s claim about a financial crisis was that there was a looming $1 billion revenue shortfall.

...facts, which [Costa] revealed in a document he sent to Mr. Iemma on Thursday [4 September] include the need for a statewide economic statement to be delivered within a month to tackle a looming $1 billion revenue shortfall in the 2009 budget and a $300 million blowout in the health budget this year (Simon Benson, The Daily Telegraph, 6 September 2008).

The document referred to a one and a half-page letter to Iemma proposing that the former Premier convene an urgent meeting of the Budget Committee of Cabinet – it made no mention of revenue shortfalls or budget blowouts, beyond a passing reference to 'the current weakness in revenues'. Other reports have subsequently referred to information provided by un-named 'Treasury sources'.

But exactly what are the facts? What is the evidence of that 'weakness'?

NSW Treasury publishes monthly financial reports on general government expenditure. However the latest monthly statement on the Treasury website was for May 2008 – nothing was reported for the month of June 2008, let alone the two months subsequently.

Figures for the 11 months ended May 2008 show a budget surplus of $2,188 million – well ahead of the budgeted figure for the full year of $376 million. No sign of a 'budget blowout' there. Further, capital expenditure of $3,820
million was more than a billion dollars less than the $4,937 million forecast in the budget for the full year. Plainly these numbers don't support Costa's claims about a 'budget blowout'.

As for a supposedly 'looming $1 billion revenue shortfall' for 2008-09, the best indicator of that might be the monthly results for July and August 2008. They have yet to appear.

Section 8 of the Public Finance and Audit Act (1983) states:

The Treasurer is to publicly release a statement for each month ("a monthly statement"), by the end of the following month, setting out the budget time projections and year-to-date balances for the major general government sector aggregates disclosed in the Budget.

The Act goes on to say that 'the Treasurer may delay the release of a monthly statement if, at or near the time at which the statement would otherwise be released, other key reporting documents are (or are to be) released, such as the Budget, the half-yearly review, the consolidated financial statements and the general government sector financial statements'. Mark the reference to withholding 'a' monthly statement. That might cover the month of June, but doesn't excuse the failure to publish the data for July and August. Possibly the figures for those months may contradict what Mr. Costa told the media in his last appearances as Treasurer.

However it would be hazardous to generalise from only one or two months data, since seasonal factors may be at work. For example, tax revenues for the month of August 2007 were $1,408 million, $56 million shy of what might be regarded as the target for that month (i.e. the annual budget of $17,562 million, divided by 12). Annualised, that suggests a tax revenue shortfall of $672 million. Yet by May 2008 tax revenues were actually running $883 million ahead of the eleven month target.

Commentators should be asking: why are the monthly reports for June 2008 and thereafter so overdue?

**MISREPRESENTATION #2: NSW FACES A THREAT TO ITS TRIPLE A CREDIT RATING**

As soon as he failed in his obsession to privatise the State’s power assets, Costa began briefing media that credit rating agencies had put the State on credit watch. The media duly reported this 'information'.

Within hours of Liberal leader Barry O'Farrell declaring he would oppose the power sale, international credit rating agencies put the state on credit watch for the first time in 20 years after claims the cost to taxpayers could be as high as $20 billion due to the need for the Government to now retrofit [power stations] instead of the private sector. A crisis Treasury meeting to prepare a mini-budget will be convened and will have 10 weeks to work out how to pay for the extra $15 billion required for new energy sources, which would otherwise have been paid for by the private sector under the dumped plan (Simon Benson, *The Daily Telegraph*, 29 August 2008).
NSW is faced with a downgrade to its AAA credit rating in the next few years, as it struggles with ailing infrastructure – and as it touts itself as the financial capital of Australia. Yet it will have a credit rating below that of all other mainland states, making it less competitive as it seeks to secure finance at interest rates higher than those offered to most other states (Brian Robins, *The Sydney Morning Herald*, 29 August 2008).

Standard and Poor's reacted to the news yesterday by immediately putting the state on credit watch (Editorial, *The Sydney Morning Herald*, 29 August 2008).

Standard & Poor's has put us on credit watch because of the Coalition's treachery. The last time this occurred was in 1991, under Nick Greiner (Morris Iemma, op ed column in a strike-breaking edition of the *The Sydney Morning Herald*, 30 August 2008).

To pay for new baseload generating capacity, the alternatives are borrowing and losing the state's triple AAA credit rating – which would put pressure on the economy and interest rates – or raising taxes and cutting infrastructure spending elsewhere (Editorial, *The Sunday Telegraph*, 31 August 2008).

THE FACTS:

The only ratings agency cited by Iemma and Costa was Standard and Poor's.

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).

Late last year, both rating agencies affirmed the State’s triple A credit rating. 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 as 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’s was repeating a political message rather than reflecting an independent view. Certainly S&P failed to provide any plausible analysis of ‘risks to the state’ – 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 a large-scale capital improvement program, however the state’s debt load should remain manageable. … (Moody’s Investors Service, Credit Opinion, 11 October 2007).

Moody’s added:

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 suggested 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 confirmed, credit ratings greatly depend on the rating of the Commonwealth Government:

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).
Not long after we highlighted the Moody's report in our 5 February 2008 submission to the Unsworth Review, the NSW Treasury link to the Moody's website was deleted. It appears that Costa (or NSW Treasury officials) did not want this information to be readily available, while the media were being encouraged to write stories about risks to NSW's AAA credit rating.

What did the credit ratings agencies say this month to lead Costa to tell all that the State was in a financial crisis? Well just one agency provided an 'assessment' and that was in the form of a five paragraph letter. This is what S&P actually said:

Melbourne, Sept. 19, 2007—Standard & Poor's Ratings Services today said it had affirmed its 'AAA/A-1+' issuer credit ratings on the state of New South Wales (NSW). The outlook is stable.

"New South Wales’ large capital program is a key feature of the state’s forecast financials," said Standard & Poor’s credit analyst Danielle Westwater. "However, regardless of the proposed debt increase over the forecast period, we expect the state’s balance sheet will remain moderately strong and consistent with the rating on the state."

New South Wales forecasts debt to increase in line with its intention to step up its capital spending. The state’s net debt to operating revenue, including public trading enterprises, is therefore expected to increase to nearly 63% in fiscal 2011, from 19% in fiscal 2006. However, there is a risk that the state will not be able to fully deliver its capital program given the potential for capacity constraints, which will mean the state’s forecast debt may be lower than budgeted.

We consider it a credit strength that the state continues to forecast accrual operating surpluses. While it is a negative that the state had previously forecast a deficit in fiscal 2007, the government has taken steps to shore up its operating position.

"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," said Ms. Westwater. "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" (emphasis added).

We don't know what qualifications and experience Ms. Westwater has in financial management - it appears she worked for a time in Tasmania's Treasury department. What we do know is that the privatisation of power businesses (which enjoy many of the features of a natural monopoly) would actually increase the State's risk profile. That is because it would involve the loss of a stable income stream (currently earning around 24% per annum on government equity). That would make the State's finances more reliant upon relatively volatile stamp duty and other revenues.

Actually, the last time S&P put NSW on 'credit watch' was in response to an article published by Bob Walker in 1991, which noted that while then-Premier Greiner had been critical of budget deficits being recorded in Victoria, NSW would have recorded even larger deficits if its budget was prepared on a similar basis as Victoria's (i.e. encompassing what are now called 'general government' agencies, rather than being limited to the 'consolidated fund'). The evidence presented to support this analysis came from publications of the Australian Bureau of Statistics, and had been on the public record for some time. The local ratings agencies either hadn't noticed, or hadn't understood.
Possibly the quality of the work of credit rating agencies has improved since that time, though the AAA ratings they assigned to collateralised debt obligations (CDOs) has raised questions.

The following shows the current ratings of debt securities issued by Australian governments.

<table>
<thead>
<tr>
<th>State</th>
<th>Credit Rating</th>
</tr>
</thead>
<tbody>
<tr>
<td>NSW</td>
<td>AAA</td>
</tr>
<tr>
<td>Victoria</td>
<td>AAA</td>
</tr>
<tr>
<td>Queensland</td>
<td>AAA</td>
</tr>
<tr>
<td>South Australia</td>
<td>AAA</td>
</tr>
<tr>
<td>Western Australia</td>
<td>AAA</td>
</tr>
<tr>
<td>Tasmania</td>
<td>AA+</td>
</tr>
<tr>
<td>ACT</td>
<td>AAA</td>
</tr>
</tbody>
</table>

Note: The Northern Territory is not rated.
Source: Standard & Poor's, Submission to Senate Select Committee on State Government Financial Management, 19 March 2008.

Standard & Poor's claims that it 'rates about 190 sub-sovereign governments in the developed world outside the United States and only 16% are rated AAA'. Moreover, according to Standard & Poor's an analysis of its database of 13,162 companies that it first rated as at 31 December 1980 or that were first rated between that date and 31 December 2007, found the following default rates:

- 0.5% of entities rated AAA had defaulted within seven years;
- 0.6% of entities rated AA;
- 1.3% of entities rated A;
- 4.2% of entities rated BBB;
- 15.4% of entities rated BB;
- 29.9% of entities rated B; and
- 50.2% of entities rated CCC/C.

One would expect that the risk of default for sovereign governments would be far less than for companies – given the capacity of governments to repair their finances through taxes and charges.

In any case what does it mean when a government's credit rating is downgraded?

MISREPRESENTATION #3: DOWNGRADING OF THE CREDIT RATING WOULD COST $500 MILLION

After Costa sought to create the illusion of a financial crisis, it was not long before the media regaled us with the cost of a downgrading of the State’s credit rating.

Yesterday the state was issued with a threat that its interest payments on debt will blow-out by another $500 million if ratings agencies downgrade its credit rating, making borrowings more costly (Simon Benson, The Daily Telegraph, 30 August 2008)
NSW Treasury has estimates (sic) that a cut in the state’s credit rating by one notch from AAA would cost $500 million in higher interest payments alone [lemma] said. (Brian Robins and Alexandra Smith, The Sydney Morning Herald, 2 September 2008).

The failure to privatise the power assets … has prompted ratings agencies to reconsider the state's AAA credit rating; a downgrade would add hundreds of millions of dollars to the cost of borrowing (Editorial, The Sydney Morning Herald, 6 September 2008).

"The main priority was to avoid losing NSW's AAA credit rating, which would mean an interest payment blowout of $500 million a year', Mr. Rees said (Claire Harvey, The Sunday Telegraph, 7 September 2008).

Mr Rees said he was committed to maintaining the top credit rating, saying a downgrade would mean $500 million a year in additional interest payments that would be better spent on hospitals, schools and public transport.

"I’m committed to that AAA rating, and all the benefits that delivers for us for the future," he said. (James Madden, The Australian, 10 September 2008)

THE FACTS:

Downgrading of the credit rating – should it occur (and that is doubtful, given the State’s strong financial position) – would cost nowhere near the claimed $500 million a year.

It is not clear why NSW Treasury has allowed such scary misinformation to continue to be reported to the community. One can also wonder about the quality of the briefing provided by senior public servants to the incoming Premier. Premier Rees may only have echoed media reports by referring to an 'interest payment blowout of $500 million a year' on 7 September. But a key responsibility of the public service is to keep Ministers informed. Plainly, senior Treasury officials failed to brief the Premier about this overstatement, so that he was allowed to repeat the error on 10 September.

The difference between credit ratings at the top end of the scale is minimal. Even Standard & Poor's, in referring to Tasmania's one notch lower AA+ rating, states:

Tasmania is rated 'AA+', a rating which differs from 'AAA' only to a small degree and represents a very strong ability to meet a financial commitment (Standard & Poor's, Submission to Senate Select Committee on State Government Financial Management, 19 March 2008).

The impact of a downgrading of a credit rating was discussed at length in our book, Privatisation: Sell Off or Sell Out? We cited a NSW Treasury publication (D. Nicholls, Managing State Finance, 1991) which suggested that a downgrading of NSW’s credit rating by one notch (to AA+) would only increase borrowing costs by 15 to 20 basis points, equivalent to an extra interest bill of $30 to $40 million per annum. The 1999-2000 NSW Budget papers claimed that retaining the Triple A credit rating saves NSW up to $30 million per annum (at a time when Gross State Debt was reported to be almost $31 billion).
However these estimates appear to assume that all debt would be ‘rolled over’ at once and interest charged on new borrowings at the higher rate. As we wrote previously:

In the event of a downgrading, existing borrowings would be unaffected and the financial impact of any re-rating would only be incurred as existing debt was rolled over. A government's debt can never be rolled over in a single year.

In fact, according to the *NSW Report on State Finances 2006-07*, the State's domestic and foreign borrowings as at 2007 were as follows:

<table>
<thead>
<tr>
<th>NSW Government Domestic and Foreign Borrowings 2007</th>
<th>1 year or less $m</th>
<th>1 to 5 years $m</th>
<th>Over 5 years $m</th>
<th>Total $m</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>6,755</td>
<td>13,378</td>
<td>11,137</td>
<td>31,270</td>
</tr>
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These borrowings are at a fixed weighted average effective interest rate of 6%.

This means that in the event of a downgrading of the State's credit rating, the additional cost due to increased interest rates would only apply in the short term to around $7 billion of borrowings that are due to be rolled over in the next few years. An increase of 10 to 20 basis points would only increase interest expense by around $7 to $14 million per annum. *Mark: not $500 million per annum, only $7 to $14 million per annum*

In the context of a State budget of around $48 billion, that would only increase expenditure by around 0.014% to 0.029% per annum - a relatively trivial amount.

Of course, increases would also apply to other debt as it was rolled over – and to any new borrowings undertaken to fund much-needed new infrastructure. But conversely, if that infrastructure generated revenues in excess of (say) 6.1% to 6.2% per annum – as seems probable in the case of investment in electricity infrastructure - the State's finances would actually be strengthened.

**MISREPRESENTATION #4: NSW NEEDS TO SPEND $15 BILLION TO KEEP THE LIGHTS ON**

In an 'open letter to the People of NSW' from the then-Premier Iemma, published at considerable expense in daily newspapers, it was claimed:

An expert report by Professor Tony Owen last year found the State needed to start building new electricity generation or face a supply shortage within a few years. The cost of essential new investment – more than $15 billion – would drain the State's resources and take money away from schools, hospitals, roads and transport (*The Sydney Morning Herald, 27 August 2008*).
Note that Owen’s $12 billion to $15 billion wish list was misrepresented by Iemma as a $15 billion immediate and essential necessity.

On 5 September 2008 outgoing Treasurer Costa, in his intentionally destructive letter to Iemma after he had been sacked, finally conceded that his much-publicised claim was a gross exaggeration. The ‘essential new investment’ to keep the lights on was not an immediate $15 billion, but only ‘up to $15 billion over the next 10-15 years’.

(To place that in context, in 2006-07, the State’s six agencies managed to invest $1.8 billion in new infrastructure from their own cash flows – while still contributing around $1.3 billion in dividends, tax equivalents and capital returns to the State budget.)

And Iemma claimed that:

We have developed an alternate strategy to keep the lights on … (Morris Iemma, op ed column in a strike-breaking edition of The Sydney Morning Herald, 30 August 2008).

The prize for the most ill-informed and misleading press ‘report’ must surely go to an earlier statement in The Sydney Morning Herald:

Last September, Professor Anthony Owen recommended the NSW Government look at privatising the electricity industry in order to have the private sector build a new baseload generator. The generator is needed by 2015, and the only other option was for the State Government to build it at a cost to taxpayers of about $15 billion (Nick Ralston, The Sydney Morning Herald, 29 August 2008).

THE FACTS:

In those few lines in The Sydney Morning Herald, the author uncritically repeated four myths or misrepresentations. First was the Costa/Owen claim that the private sector would not be prepared to invest in electricity unless the government sold out of the industry. Ironically on the same page of the SMH there was a paid advertisement from British Gas, then bidding to acquire control of locally-listed Origin Energy, an electricity generator and distributor in its own right. In the ad, British Gas announced ‘If we’re successful, we plan to invest in all of Origin’s Australian businesses’. Plainly, the private sector sees the profit potential of investment in electricity and is prepared to invest regardless of the on-going involvement of State-owned agencies.

Second was the claim that privatisation was recommended by Professor Owen. In fact, he reported that he had been advised this was the Iemma Government’s preferred position. Third, the Owen Inquiry did not say that a new baseload power station would cost $15 billion. Rather, Owen presented a wish list of potential electricity infrastructure projects to cost $12 billion to 15 billion, comprising:
- $7 billion to $8 billion for power stations (2 coal fired, 2 open-cycle, 2 close-cycle gas fired)
- $3 billion to $4 billion to retrofit existing power stations with carbon reduction technology
- $2 billion to $3 billion to assist retailers - $1 billion for a 'portfolio of generating assets' (peaking, intermediate, 'potentially baseload') plus $1 billion to $2 billion ‘to develop an upstream gas position’

In short, this was a wish-list of possible investments, not a summary of critical expenditure required 'to keep the lights on'.

Fourth was the claim that there are limited options. This ignores the possibility of introducing California-style demand management.

**MISREPRESENTATION #5: NSW HAS A $20 BILLION HOLE IN ITS BUDGET**

The 'hole' started small, but grew quickly:

*This week's power privatisation decision left an $8 billion hole in the pockets of NSW taxpayers (Simon Benson, The Daily Telegraph, 30 August 2008).*

*lemma and Costa* announced there would be a mini budget to reshape NSW finances, in light of the fact that there would be no $8 billion windfall from the sale of the generators, and up to $12 billion investment required in new generation capacity and a retrofit of existing generators to reduce their carbon emissions (*Imre Salusinszky, The Australian, 30-31 August 2008).*

*The defeat of the original proposal by a combination of unions, rebel Labor MPs and NSW Opposition Leader Barry O'Farrell has punched a $20 billion hole in the state's medium term capital spending program* (*Imre Salusinszky, The Australian, 30-31 August 2008)*.

So within days the 'black hole' had grown to $20 billion. This journalist also peddled the line that the defeat of electricity privatisation was the fault of unions, and had nothing to do with the fact that 84% of NSW population had opposed the sell off: The same journalist then spectacularly contradicted himself by (correctly) noting that

*Costa has assured us on budget day in June that nothing in the recurrent or capital spending numbers depended on the power sell-off.*

Never mind that fact, the claim about a 'budget hole' was then repeated by lemma, reading from a NSW Treasury script:

*Treasury has already estimated the value of the Coalition bastardy at $20 billion. This is made up of as much of $8 billion in forgone transaction proceeds and in the absence of private investment, up to $12 billion in funding that NSW taxpayers will now need to spend on baseload generation* (*lemma, op ed column in a strike-breaking edition of the SMH, 30 August 2008)*.

Much commentary reflected an ignorance of accrual accounting and accrual budgeting e.g. this front page report from *The Daily Telegraph*:
Up for sale now will be the $3 billion retail business. The power plants, as demanded by unions, will remain in public ownership…. Scuttling of the Government’s original plan will cost taxpayers $7 billion in lost revenue, from what was originally a $10 billion model to privatise the lot (Simon Benson, The Daily Telegraph, 29 August 2008).

THE FACTS:

Government budgets are prepared on an ‘accrual’ basis. The proceeds of the sale of assets would not be recorded as ‘revenues’.

If electricity assets are sold, the transaction would only substitute one asset (the electricity businesses) for another asset (cash). A one-off ‘revenue’ would only be recorded to the extent that the sale price exceeded book value. In any case, the NSW Government’s 2008-09 budget did not incorporate any revenues from the sale of the electricity assets.

When media commentators have referred to a ‘hole’ in the budget for capital expenditure, they fail to spell out what that means. At best, it means that there is a need to adjust the amount and timing of projected spending on planned projects or those already under construction.

For example, recent media stories headed

Why we can't afford the $12b Metro

have referred to figures for projected capital expenditure as if they were newly-discovered estimates that exceeded the numbers previously announced:

Debate is raging in the new administration on whether it should be cancelled, postponed or replaced with another project.
There is $106 million allocated in this financial year for the project, but between 2010, when the civil engineering and tunnelling contracts are scheduled to be let, and about 2014, annual costs are likely to exceed $500 million (Linton Besser, The Sydney Morning Herald, 18 September 2008)

Such commentaries have failed to acknowledge that the 2008-09 State Budget included the following (far greater) estimates of capital expenditure for the North West Metro and South West Rail Link:

Corridor acquisition: $212.5 million (2008-09) $94.5 million (2009-10) $60 million (2010-11)

The suggestion that there is new information – that ‘annual costs are likely to exceed $500 million’ - is misleading and reflects poorly on the quality of political commentary – particularly from journalists working in offices only a few metres away from the Parliamentary library.
For that matter, the Iemma Government reported in July 2007 that it would be spending more than $50 billion on new infrastructure projects over four years. The figures in the 2008-09 capital budget only confirmed this – it was hardly news.

There may well be a good case for reassessing priorities on capital expenditure over the next few years. Arguably the pre-election NSW budget may have promised too many capital projects to be constructed over too short a time period. Possibly the Iemma/Costa Government had watched the Howard Government splurge some $64 billion in spending and tax concessions in a bid to get re-elected. That figure is close to the total proceeds of $68 billion (in nominal dollars) received by the Commonwealth from two decades of privatisation – including Telstra, CBA, Qantas, CSL, Pipeline Authority, ANL, and the Housing Loans Insurance Commission. All spent in one election.

But so-called 'budget holes' can be repaired by paperwork and desk analysis – simply by adjusting assumptions and policy settings.

One can only speculate why recent commentary on 'holes' in budgets for capital expenditure over the coming four years has (until recently) failed to mention the likelihood of the Rudd Government's proposed Commonwealth grants to the states to fund infrastructure projects.

But use of loose language like 'budget holes' encourages the view that the State's finances are in a poor shape.

**MISREPRESENTATION #6: NSW NEEDS TO SELL THE RETAILERS**

After the Iemma/Costa privatisation proposals failed, there were suggestions that the NSW Government would proceed to sell the retail arms of distributors – in order to plug holes in the State's (capital) budget. This was announced in a media release:

The Premier said a new investment package (sic) in the energy sector would comprise:

- Withdrawal of the Government from the electricity retail market (where three publicly-owned companies already compete against 20 private vendors);
- Sale of potential power station development sites to private operators, to encourage them to build new power stations to meet NSW's growth;
- Retaining the Government-owned power generation companies.

"These changes will help spur private investment in new baseload generation capacity for NSW," Mr Iemma said.

"That's priority one - keeping the lights on into the future.

(Media release, 'Update on Electricity Reforms - Premier Iemma taking action to secure NSW's energy and economic future', 29 August 2008).
THE FACTS:

Separate sale of the retail segments of government businesses would contradict the Owen report's claim that it would be desirable to have some degree of integration between generators and retailing activities – as once was the case in NSW, before Pacific Power was broken up after disastrous losses on speculative dealings in the electricity market.

Back in the 1990s, the argument for the disaggregation of State agencies was that having several 'pure' retailers and generators would encourage competition. Yet overseas experience should have warned that the market could be manipulated, and prices spike when some generators experience 'maintenance' difficulties and go off-line during times of peak demand.

Hence the 2007 Owen report recommended that retailers have some generating capacity – to protect retailers against the risks associated with volatility of energy prices. Accordingly a large proportion of the wish-list of $12 - 15 billion new investment in electricity assets dutifully listed by Owen was $2 - $3 billion to assist retailers - $1 billion for a 'portfolio of generating assets' (peaking, intermediate, 'potentially baseload') plus $1 - $2 billion ‘to develop an upstream gas position’.

The Owen Inquiry report was a political document intended to support the case for privatisation. It totally failed to address financial management issues e.g. it did not present schedules of the amounts and timing of cash flows associated with investment in new infrastructure, and it ignored the projected cash returns from those investments. As noted previously, the State's existing electricity industry assets are currently highly profitable, generating returns on the government's investment of around 24% per annum.

Forecasts of the proceeds of sale are entirely speculative. Premier Iemma forecast that the retailers (and some potential sites for generators) could be sold for around $3 billion. It is not known how this figure was calculated – but one can only wonder why a government would want to sell-off a business that is so profitable? Nowhere in the various reports on the proposed electricity privatisation was any information presented about the profitability of the 'poles and wires' businesses and the 'retail' segments of what are currently integrated electricity distributors.

The 2007 annual reports of Energy Australia, Integral Energy and Country Energy all failed to disclose the profit contributions and assets devoted to those business 'segments' – claiming that the state-owned corporations were operating in a single business segment, the electricity industry. Arguably that was a breach of Australian Accounting Standards, since the accounting standard AASB 114 'Segment Reporting' requires that information is to be reported 'based on the segments of the entity for which information is reported to the chief executive officer and the governing body'. Given that the restructuring proposals for the electricity industry contemplated retention of the 'poles and wires' businesses of the three distributors, then their CEOs and governing bodies must have been given reports on the profitability of
those segments. Hence that information should have been disclosed in annual accounts, and reported to Parliament – if for no other reason than to assist Parliamentarians to make decisions about whether to vote for or to vote against the recent privatisation proposals. The Auditor General should have secured compliance with AASB 114 or issued a qualified audit report.

There is no real need to sell the retailers (let alone when the securities markets are in such turmoil). Now that the lemma/Costa proposals have been rejected, the NSW Government should be focusing on what the Owen Inquiry should have done: undertaking a hard-nosed analysis of priorities for capital expenditure.

As argued in our book Privatisation, Sell Off or Sell Out?, the case for privatisations is stronger for labour-intensive businesses than for capital intensive businesses such as electricity generation and distribution (given that governments have a lower cost of capital and can afford to be patient investors). But each privatisation proposal needs to be examined on its merits. The provision of electricity to industry is an important input, but to householders it is a basic service.

There are two main objections to the sale of the retail elements of the state-owned electricity industry. First, it could be seen as weakening the state-owned generation businesses, leading to arguments down the track that now, they should be sold as well.

Second, there are strong arguments to retain agencies that provide basic services in the hands of government. Energy retailers deal directly with the community. No doubt some managers of retail business would prefer to deal with a few hundred large business customers rather than millions of potentially troublesome individual consumers of services. Such arguments should be resisted. It would be better to retain control of basic services in government hands rather than rely entirely on regulatory intervention to protect consumers. Recall that in 1995 the Industry Commission then saw 'the winding back of cross-subsidies that favour residential users' (p. 7) as a significant 'reform' of pricing practices. In effect, the Industry Commission's idea of 'reform' was dismissive of the notion that a fundamental role of government was to provide basic services to the community.

Government involvement in the provision of basic services should be efficient, but need not disregard concerns about equity of access and pricing. After all, the community owns those business, and paid for them – and surveys show that 84% of the NSW community is opposed to their sale.

MISREPRESENTATION #7: SELLING ASSETS IS A 'REFORM'

A number of times Costa has referred to the sale of power assets as a 'reform'. This notion had been picked up by some journalists:

There is no point in being Treasurer of NSW if people aren't prepared to make the difficult decisions around public sector reform (M. Costa, as reported in The Australian, 30 August 2008).
... O'Farrell’s decision to sabotage a piece of reform (Imre Salusinszky, The Australian, 30 August 2008).

But what was the sum likely to be received?

$10 billion or so (Terry McCrann, The Daily Telegraph, 29 August 2008)

... the billions the state would not have to spend across electricity infrastructure (Terry McCrann, The Daily Telegraph, 29 August 2008)

THE FACTS:

Arguably in discussions of public administration, the most over-used word in the English language is 'reform'. Virtually every bureaucrat’s latest 'good idea' is presented as a 'reform' – even if it reverses the last good idea (or 'reform') that didn’t work.

Let’s look at two examples:

First, in 1995 an Industry Commission report, Does Pacific Power have Market Power?, claimed that 'reform of the electricity supply industry' included

the separation of responsibility for generation, transmission and distribution functions and, in some jurisdictions, disaggregation of generation and distribution activities

The report noted that

New South Wales recently announced a further program of reform, including a reduction in the number of distributors through a process of mergers, and their subsequent corporatisation into ‘wires’ and ‘retailing’ agencies.

So in 1995, separating ‘retailing’ from generation and distribution was a reform. By 2007 the Owen Inquiry saw that 'reform' would involve combining retailing with generation – presumably, to shield operators from Enron-style manipulation of the electricity market.

Second example. In 1995 the Industry Commission referred disparagingly to 'overinvestment' in generation capacity as ‘a major problem in many jurisdictions in Australia’ (notably in NSW). The establishment of the national electricity market was a reform designed to 'pool' excess capacity to avoid inefficient allocation of resources.

Did that work? In 2007, the Owen Inquiry claimed there was a major problem because demand was outstripping available capacity. The Iemma Government did not want to undertake further investment. Hence the next 'reform' was to sell off electricity assets.
As with all privatisation proposals, the devil is in the detail. There is a need to relate potential sale proceeds to retention value – a step that was either ignored or actively resisted by the authors of the Owen report, the Unsworth report, and by the Auditor-General. Without careful analysis, selling profitable and self-sustaining businesses is not a reform. To describe it as such is simply terminology abuse.

**FINAL COMMENT**

The State-owned electricity agencies are currently producing profits of around $1.5 billion per annum, a rate of return on taxpayers’ funds of around 24% per annum. If those assets were sold, the financial returns would be far less. Parliament's 'scuttling' the sell-off, rather than creating a financial crisis, has actually been in the public interest.

The State is facing enough problems with a slowing economy and does not need them to be exacerbated by the misrepresentations of self-interested politicians, and corporate lobbyists. In fact, falling revenues mean that, more than ever, the State needs to retain stable revenues such as the profits produced annually by its electricity assets.