Emeritus Prof Bob Walker & Dr Betty Con Walker
40 Lang Road Tel: 9360 4537
Centennial Park NSW 2021 Mob: 0411 237 672 or 0409 360 453 Fax: 9360 4538

**LEGISLATIVE COUNCIL SELECT COMMITTEE**
**INQUIRY INTO ELECTRICITY PRIVATISATION**

**RESPONSE TO SUPPLEMENTARY QUESTIONS**

***QUESTION 1***

*In your evidence you spoke of the possibility of a holding company being established, including the option of a share option. Can you please elaborate on the issue of structures that might be established, and associated lease conditions and their potential strengths and weaknesses?*[1]

**USE OF A HOLDING COMPANY AS LESSOR**

Members of the Committee will be aware that information about the structure to be established to enable 'leasing' of a claimed 49% of the network assets has not been provided in any detail by the proponents of these transactions. Direct questions about the vehicle(s) to be used to serve as 'lessor' of these assets have been evaded – or deflected with the advice that this will be disclosed in forthcoming legislation. When members of the Inquiry sought access to the legislation, they were told that it was still being drafted – yet when Premier Baird was asked 'when will we see the legislation that govern the transaction', he let slip that it was already prepared:

> *If you give me a tick today I will put it in this afternoon* (*Transcrip*t, 11 May, p. 21).

Government representatives have insisted that they are proposing to lease assets – and most would interpret this as referring to the lease of *physical* assets. This stance has been maintained by Premier Baird:

> *We own all the assets and that is the important point. We are just leasing the use of 49 per cent....* (*Transcript*, 11 May 2015).

Yet Treasurer Berejiklian, on the last day of formal hearings, contradicted this stance by referring to the lease of *businesses*:

> *What we will do is lease only 49 per cent of poles and wires* ***business*** *to the private sector*. (*Transcript*, 18 May, 2015, emphasis added).

As for how a lease of 'assets' in the form of a 'business' might be undertaken, in an opinion piece published in the Sydney Moring Herald in June 2014 we mentioned the possibility of use of a holding company that would act as 'owner' of the businesses,

[1] Neither our submission nor our oral reference included any reference to share options. It is possible that share options could be utilised to exercise the 'step in rights' alluded to by others.

leasing them to private operators, with a mix of government and private sector shareholders of the holding company as lessor.

This seemed to be confirmed when in a statement issued on 18 December 2014 the Government confirmed it planned to utilise a 'holding company' as the vehicle to hold shares in what are presently State-Owned Corporations.

> *The State's interests in the leased Network Businesses will be overseen by a special independently governed holding entity. The new holding entity will have a mandate to protect the value of taxpayers' interest in the leased assets through the exercise of reserved shareholder rights.*
>
> *Essential Energy will remain a State-Owned Corporation and will not be transferred to the holding entity. (Rebuilding NSW - Update on Electricity Networks, p.2)*

The same document revealed, for the first time, that the Baird Government intends to privatise 100% of TransGrid, and 50.4 per cent each of Ausgrid and Endeavour Energy.

We noted that the significance of privatising 100% of TransGrid and more than 50% of Ausgrid and Endeavour is that the government would have ***transferred control of all three agencies to the private sector***.

In the absence of more detailed information, our submission and our oral evidence alluded to the possibility of a holding company being established as a vehicle to serve as lessor of the 'assets' in question.

However more information has trickled out during the course of the Inquiry.

On 11 May 2015 Premier Baird told the Committee:

> *The Government will continue to hold 51 per cent across the overall businesses with an investment* in a statutory board *and an organisation that will be finalised.*

That did not add to anything said before (but later turned out to be misleading).

The following day (12 May 2015) a submission from the Government was lodged with the Inquiry (though in line with committee practice it would not have been placed on the Inquiry's website for some days thereafter). This submission now referred to ***holding entities (plural)***:

> *The government will also retain significant influence over the assets when they are leased.*
>
> *The Government is expecting to lease 50.4 per cent of Ausgrid and 50.4 per cent of Endeavour Energy. Final proportions will be calculated in accordance with the Government's commitment to maintain 51 per cent of the network businesses in public hands.*
>
> *The State's interests in the leased network businesses will be overseen by special independently governed holding entities. The new holding entities will*

*have a mandate to protect the value of taxpayers' interest and maximise returns from the leased assets through the exercise of shareholder rights. (p.3)*

But Premier Baird provided written answers to several questions from the Committee – but apparently after hearings had concluded – and these answers included information that had been withheld during earlier questioning of the Premier. Those responses to questions on notice included the following:

***35. Who will the new government holding company report to?***
*The State's two Retained Interest Corporation (sic) will be managed by separate Boards of Governors with a mandate to protect the value of the State's retained interest. The governance for the State's retained interests will be established by legislation.*

***36. Will the trustees be able to act independently of government? Will the government or the parliament be required to approve any decision deemed not to be an operational decision including those such as future ownership levels, sell downs or buy backs?***
*The Boards of Governors will be able to act independently.*
*Any sell down of the retained interests would require legislation.*

***37. As the major shareholder in Ausgrid, Endeavour Energy and TransGrid will the lease holder have full managerial control?***
*Under the proposed governance structure for the long-term lease of the Ausgrid and Endeavour Energy networks the private sector will control the operation of the businesses previously conducted by Ausgrid and Endeavour Energy. The Boards of Governors will maintain a range of rights to protect the long term value of the State's retained interest in the businesses, such as in relation to capital structure and dividend policy.*
*TransGrid will be 100 per cent leased and the private sector investors will have full managerial control.*
*The lessees will be subject to strict conditions imposed by legislation and license and lease conditions. These include safety, reliability and performance requirements, and an obligation to operate and maintain the network in accordance with the regulatory regime.*
*The Independent Pricing and Regulatory Tribunal will be appointed to ensure compliance with licence conditions and safety and reliability standards. The Energy Minister will also be able to trigger new 'step in rights' should a breach of licence or electricity regulatory obligation threaten the safe, secure or reliable supply of electricity.*

**Interpretation:** The information that has trickled out during the course of the Inquiry confirms that claims by the Baird Government to be 'only leasing 49% of the assets' were deceptive and misleading. Indeed, Premier Baird told the Inquiry on 11 May 2015:

*The legislation will reflect that we retain 51 per cent and we are leasing 49 per cent, and only 49 per cent.*

The Government has now admitted that it is ***proposing to 'lease' 100% of all three businesses*** - TransGrid, Ausgrid and Endeavour. In December 2014 it conceded that it was proposing to lease 100% of TransGrid, but maintained that it was only proposing to lease 50.4% each of Ausgrid and Endeavour. But the acknowledgment that the proposal means that the '*the private sector will control the operation of the businesses'* indicates that private sector bidders will operate and control the businesses in terms of the lease, with the State ***only having a minority shareholding in the holding company to be established as lessor***.

## USING A HOLDING COMPANY TO MOVE DEBT OFF BALANCE SHEET

Arguably the most startling 'new information' to emerge during the Inquiry's hearings came from one of the UBS 'research analysts' during the following exchange on 11 May 2015:

> **The Hon. Scott Farlow:** Mr Leitch, one of the things that you said in the Australian *Financial Review* that you wanted to highlight was actually how much debt we would be wiping off with this transaction as well—$15 billion worth of debt.
> **Mr Leitch:** Thank you, I was surprised actually that the *Financial Review* picked up on that because they seemed to be so interested in the low politics of it all and not in analysing the proper finances of what is one of the most important decisions, in my opinion, in recent history. Where I think this transaction is particularly clever, and a point that virtually no commentators seem to be picking up on, is, in my opinion and I hope I am correct in saying this, that when you lease 51 per cent of an asset you will essentially move 100 per cent of the debt of that asset off the balance sheet. Essentially the State's—and Andrew can explain this better than me—borrowing powers goes up by an amount of 100 per cent of the debt even though you have only sold 51 per cent of the equity.
>
> This is a very great advantage for the State that I think has been completely missed. In fact, that was the single most dominant rationale in writing the report in the first place. That is a point—and I am so glad you have asked a question on that, I know I am not allowed to say that because it is an essential point that I think deserves a lot more commentary than it has actually achieved so far.

Mark the reference to ***moving debt off the balance sheet***.

Mr Leitch's broad comments about the effect of leasing an asset are plainly wrong. The accounting rules for 'finance leases' are set out in Australian Accounting Standard AASB 117 'Leases'. For accounting purposes such leases would be treated as 'sales' and the accounting entries undertaken by a lessor to record such transactions would not affect reported liabilities.

The only way Mr Leitch's interpretation makes sense is if he was assuming that a separate holding entity (or entities) was to be set up to 'own' Ausgrid and Endeavour (and then lease the 'business' of those entities) with the majority of the shares in the holding entity being held by private sector investors. That implied interpretation by UBS conflicted with Premier Baird's statement earlier that day that the Government

would hold '51 per cent across the overall businesses with an investment in a [single] statutory board'.

According to Mr Leith's interpretation, as the State would then only have a minority shareholding, this holding entity would then not be 'controlled' by the State. Hence it would not be included in the State's total sector consolidated balance sheet. Ausgrid and Endeavour would be subsidiaries of this holding entity, and hence would no longer be encompassed by the state's consolidated balance sheet. The liabilities of Ausgrid and Endeavour would be 'deconsolidated'.

(On 18 May 2915 the Secretary of Treasury Mr. Gaetjens later referred to 'debt that is deconsolidated from the balance sheet' – though without elaborating on how that would be achieved.)

**Comment:**

1. Mr. Leitch did not couch his observations as speculations – he was confident that the government would reduce its ***reported debt***. But information about the use of a 'retained interest' corporation was only confirmed by Premier Baird on 19 May 2015, in answer to Committee questions on notice, the day after the Inquiry's public hearings concluded.

   On the face of it, the research analysts at UBS had access to information about the proposed transaction that was not otherwise in the public domain – and certainly had not been presented to the Committee by the Premier on 11 May 2015.

   That conflicts with statements by the CEO of UBS in Australia, Mr. Mathew Grounds, who on 11 May told the Inquiry that 'the research team publishes its own views, which are not those of our advisory team and are formed without the benefit of the information that our advisory team has'. Obviously the UBS research team had access to information not publicly available nor available to the Committee

2. Government representatives repeatedly referred to 'retiring debt' as if it was being 'paid out'. It was also acknowledged by the Treasurer and a Treasury official that the 'government debt' would remain 'government debt', but would be 'retired' (see questions from the Hon. Robert Borsak to Mr. Spencer and responses from Mr Spencer and the Treasurer, *Transcript* 18 May 2015).

   But on the face of it, the immediate effect of the transactions would be that some of the debt would simply be moved off balance sheet, through 'financial engineering', and not immediately paid out.

**USE OF A 100% OWNED ENTITY TO AVOID COMMONWEALTH TAXES**

Members of the Committee sought information about the basis of the Premier's claims that the State would continue to receive 'tax equivalent' payments from its residual interest in Ausgrid and Endeavour rather than be exposed to

Commonwealth income taxes. Responses were hardly illuminating. For example, Treasury Secretary Gaetjens stated:

> *The transaction team have engaged with the tax office and tax advisers. Without going into the absolute details of the transaction, we are seeking to form a structure that still maintains within the tax laws of Australia that the State's holding in the lease entity is still subject to State tax equivalent payments.*

More information was forthcoming in Premier Baird's response to questions (which, as noted above, were only received by the Inquiry after the conclusion of public hearings):

> *The State has had an ongoing dialogue with the Australian Taxation Office (ATO) on the key taxation implications. To date, the ATO has not raised any concerns regarding the preferred structures presented by the State.*
> *ActewAGL is an example of a partnership which is 50 per cent owned by the private sector (ASX listed AGL) and 50 per cent owned by the public sector (the ACT Government). The ACT Government holds its 50 per cent stake in the partnership through a 100 per cent Government owned corporation. This 100 per cent owned entity is exempt from Commonwealth income tax and is subject to tax equivalent payments under the National Tax Equivalent Regime. Accordingly, the ACT Government continues to receive tax equivalent payments from its 50 per cent stake in ActewAGL.*

That explanation suggests that if the ATO agrees, the State may indeed be able to continue to receive proportionate tax equivalent payments – if a new 100% owned entity is to hold the residual 'investment' in the new 'holding entity' that in turn is to own a minority shareholding in Ausgrid and Endeavour.

## THE REV THE HON FRED NILE'S QUESTIONS ON 18 MAY 2015

A puzzling feature of the Inquiry were some questions asked by the Chair, the Rev the Hon Fred Nile, to Treasury Secretary Gaetjens.

> **Chair:** On the management of the companies, we basically split the company in half so there will then be two boards, a government-appointed board for administration and the new owner will have their own board?
> **Mr Gaetjens:** Yes.
> Chair: How does the actual management fit in? Is the Treasurer still a shareholder in the government-owned ones?
> **Ms Gladys Berejiklian:** I will let Tim finish, but a lot of those issues you raised will be in the legislation because they will demonstrate to the public how we will protect the State's retained assets or interests. I will ask Tim to elaborate on that.
> **Mr Spencer:** Yes, that is correct. For TransGrid, which is going to be a 100 per cent lease, there will not be a government board going beyond the transaction. That will be replaced by a private sector board.
> **Chair:** I understand.

> **Mr Spencer:** For the leased entities, there will be an arrangement in place whereby the State's interest in the two leased entities will be overseen by appropriate boards.

The content of those questions indicated that the Chair was either prescient or was well-informed about the proposed use of multiple company structures that had not been provided to other Committee members until Mr. Baird's written answers arrived on 19 May 2015.

## POSSIBLE CONDITIONS OF THE PROPOSED 'LEASE'

Members of the Committee did not receive meaningful responses to questions regarding the manner in which the retained government debt would be 'retired' over time. They were variously told that this would be evident when legislation was introduced, and that details would be worked out by TCorp.

There may be a precedent in some lease arrangements that have been used to keep new borrowings off-balance sheet. The following illustrates one of those arrangements:

> Public housing assets are assigned by long-term leases to special purpose entities in the form of NGOs. The NGOs are then to rent the properties to persons on low incomes. A condition of this arrangement is that the NGOs borrow to construct additional public housing. If they fail to do so, the government retains 'step in rights' to assume control of the housing assets, and to reassign the leases to another operator.

Possibly the proposed lease arrangements incorporate similar conditions for the lessee to pay out the borrowings of Ausgrid and Endeavour (possibly by replacing TCorp borrowings over time as they mature) and to fund ongoing maintenance of the network – with the government retaining 'step in rights'. Indeed, as shown below, Premier Baird's written responses to questions referred to 'step in rights' as relating to licence or regulatory obligations, but then implied that these rights also related to elimination of General Government net debt and the reduction of Total State Sector net debt:

> ***10. Step in Rights.*** *The Energy Minister will be able to trigger new 'step in rights' should a breach of licence or electricity regulatory obligation threaten the safe, secure or reliable supply of electricity. Under this power, IPART will become the network administrator and will appoint a 'step in operator' until the Minister determines that it is no longer required. (p.5)*
>
> *The transaction is expected to lead to a significant improvement in the State's financial position over the forward estimates period including the elimination of the General Government Sector's Net Debt position and a reduction in Total State Sector net debt of around $30 billion*

Again, it is emphasised that the Inquiry will be unable to make an informed recommendation to the Parliament unless it has access to the full details of the proposed leases.

***QUESTION 2***

*In your evidence you described examples from previous privatisations of the State [Bank] needing to meet bad debt[s]. Can you please elaborate what lessons have been learned that should be applied to the current proposal to privatise the electricity network?*

In 1993, when the Coalition Government proposed sale of the State Bank of NSW, Parliament was not prepared to agree without receiving advice on the merits of the transaction from the Auditor-General.

It is understood from discussions with the then Auditor-General that he did not believe that his office had the capacity to provide a report within the short time frame nominated by Parliament. Hence he engaged consultants to undertake elements of that evaluation. Based on advice from those consultants, he subsequently reported that the proposed sale should go ahead,. However several key elements of the consultants' advice did not accompany his report and were treated as 'commercial in confidence' – apparently on the (last minute) insistence of some of the consultants. The Auditor-General was facing pressure to report to Parliament in a timely fashion because the government had incorporated a 'poison pill' in the tender process: substantial financial penalties were payable if the sale transaction to the highest bidder was not concluded by an imminent date. Hence to avoid those penalties the Auditor-General felt compelled to provide his report with some of the consultants' reports omitted.

Some years later, after the Auditor-General criticised the manner in which the Carr Government was treating certain documents as 'commercial in confidence', we wrote to him asking if, given his current views, he would now release the full report on the proposed sale of the State Bank of NSW. To his credit, he did so in a report to Parliament just before his term of office concluded.

The most striking element of the belatedly-release 'full' report was the very defective advice that 'retention value' of SBNSW should be assessed using a discount rate of 18.9%, based on an academic's advice that bank share prices had been volatile and hence investment in bank shares was relatively risky – the 18.9% was calculated using the 'capital asset pricing model'. However the fact was that the purchaser of the SBNSW faced minimal risk because the tender documents provided that all but the first $60 million of bad debts on a $13 billion loan book were to be met by the State as vendor. Details of subsequent payouts to the purchaser were reported in official Budget papers.

As summarised in our supplementary submission dated 20 May 2015,

> We found out later that contractual conditions (whereby the State retained responsibility for most of the bad debts on a $13 billion loan book) reduced the headline sale price of $576 million to $80 million or less. Only later did we learn that the misleading advice to Parliament that the $576 million exceeded 'retention value' was calculated by discounting projected earnings at a Bankcard rate of interest of 18.9% - a device guaranteed to reduce retention value. And a few years later (when the purchaser CML

> on-sold the bank to CBA) we learnt that an expert valued the State Bank at between $2.5 to $2.7 billion. On that deal, NSW lost more than $2.5 billion.

Which leads to the 'lessons to be learned'. In 1995, members of Parliament were well-intentioned when they insisted on obtaining technical advice about the merits of that transaction before they voted. But in retrospect, they failed to ask the right questions, and were unaware of (a) the existence of penalty clauses in contracts already entered into by the government of the day, and (b) details of the conditions which the State incorporated in tender documents.

The proposed 99 year 'leases' of the electricity networks represent the biggest privatisations in the State's history, yet the current Legislative Council Inquiry seems likely to repeat the errors of the 1993 Parliament if it gives the 'tick' to the proposed transactions on the basis of a combination of incomplete and misleading information.

As noted in our final remarks,

> this Committee will not be fulfilling its responsibilities unless it gets clear and precise information from the Government about the structure to be used and the conditions of the lease.

## INVITATION TO COMMENT ON OTHER MATTERS

We add a few comments on several issues.

### Selling TransGrid through a trade sale

Government representatives have maintained that TransGrid will be the first to be sold through a trade sale, rather than through an IPO.

We are concerned that the Baird Government is intent on a 'sale at any price'. An IPO would quickly demonstrate that the Baird Government's repeated claims about a supposed collapse in the earnings of the network agencies has damaged the state's financial interests. We note with some amusement the inconsistency between those claims and the Government's submission to the Inquiry contained in an (undated) letter from the Premier received 12 May 2015 included the following statement about the attractions of the potential 'lease' to investors:

> *The stable and predictable returns from regulated utility businesses are highly attractive in the current low interest rate environment* (p. 13)

Despite some lack of business confidence, the ASX index is currently at levels not seen since before the global financial crisis. There have been several major share issues lately (with others in prospect), notably by the banking sector. It is difficult to understand claims that market conditions are not conducive to an IPO for TransGrid. It is feared that the government may have a number of international investors already 'lined up'.

In our opinion, it is likely that if an IPO was used, the market would price TransGrid at well above issue price. That may lead to adverse perceptions about the Government's financial management practices – i.e. that it is unwisely selling highly profitable assets . A 'trade sale' would avoid that political risk.

### Retention value and discount rates

Government representatives and Treasury officials have confirmed that they will undertake a calculation of 'retention value ' – when a tender process is nearing conclusion. For example:

> **Chair:** Is there a retention value what you must get, or a reserve price, or would that be kept confidential?
> **Mr Gaetjens:** There will be, as we do for all transactions. There will be a retention value calculated at the very end of the process, but before final bids, and probably even indicative bids, are submitted to the Government.
> **Chair:** and that would be kept confidential so it does not affect other bidders and so on?
> **Mr Gaetjens:** Correct.

One of the lessons what should be learned from the sale of the SBNSW is that assessments of 'retention value' can be manipulated by the choice of discount rates.

It is submitted that, before completing its Report, the Committee should seek information from Treasury as to the manner in which it will calculate that discount rate, whether that approach is consistent with approaches used by (say, the UK Treasury and the Canadian and US governments) and give an indicative range of percentages to be used in that calculation.

It could not be claimed that this information is 'commercial in confidence'.

**Credit ratings and interest costs**

Representatives of Infrastructure Partnerships Australia (a lobbying firm funded by corporations and with strong connections with the current government) provided the Committee with exaggerated claims about the cost of government borrowings and the hypothetical loss of the triple-A credit rating.

This was yet another example of exaggerations of the significance of a potential downgrade in credit ratings. As explained in our book, historical evidence indicates that any such downgrade might only affect the State by around 10 to 20 basis points (i.e. 0.1% to 0.2%). Moreover, that would only impact on the State's borrowings when tranches of borrowings were rolled over (TCorp's 2014 annual report discloses that the maturity date of government bond issues extends from 2015 to 2030, with coupon rates varying from 3.5% to 6.0% per annum.)

Moreover, as previously stated, NSW has miniscule net debt relative to Gross State Product, and even if $20 billion was added over 10 years, there would be little danger to the State's triple-A credit rating.

25 May 2015