Submission
No 2

INQUIRY INTO GENTRADER TRANSACTIONS

Organisation:

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The Director
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Re: INQUIRY INTO THE GENTRADER TRANSACTIONS

Attached are documents we prepared on the issue of the NSW electricity privatisation which address the Committee's third and fourth Terms of Reference. They are also relevant to the second Term of Reference since it appears that eight directors of state-owned electricity agencies resigned their positions because they believed that the consideration offered in these transactions was inadequate.

These papers show that the State's electricity assets and businesses – apart from providing an essential service to the people of New South Wales – were highly profitable and generated significant annual returns to the State Budget. Moreover they indicate that publicly-owned electricity agencies were, if retained, capable of funding significant on-going investment in infrastructure from their operating cash flows.

The most recent paper, which was circulated to many members of Parliament including the Premier, was prepared just after the State Budget was brought down in June 2010. It should be noted that the analysis contained therein was:

- before a further improvement in the State's economy with its concomitant positive impact on the State's finances; and

- before the State could benefit fully from the huge electricity price increases which appear to have been imposed in order to 'fatten the cow before sale' – that is, in order to make the assets even more attractive to purchasers who will be the main beneficiaries of the increases. In this connection we note that IPART (while nominally an 'independent' agency) is required by sub-sections 15(1)(g) and 15(1)(h) of the IPART Act to have regard to the wishes of government.

At the very least, we urge the Committee to focus on what can be learned from recent experience with these transactions, so that mistakes are not repeated – and possibly, so that further transactions do not proceed without greater Parliamentary scrutiny.

In particular it is suggested that the Committee seeks evidence (from central agencies, those consultants contracted to negotiate the sale, and from directors of the electricity agencies concerned) regarding the sale price of these assets (or elements of government businesses) as compared with their ‘retention value’.

We note that the Premier has conceded that government agencies have calculated a ‘retention value’. However she has declined to release relevant documents before transactions were completed. As some transactions have now been completed it would be appropriate for the Committee to seek copies of relevant documentation, so that they can be subject to careful analysis and assessed as to their validity. If it is claimed that some transactions are still in process, then possibly documents can be provided that at least detail the matters that were considered in the analysis of sale versus retention values, and the choice of any discount rates used to assess the present value of alternative options.

In this connection, any analysis of ‘sale versus retention value’ (and ‘the value obtained for NSW taxpayers’) will have to consider such matters as:

- the financial impact of government subsidies for the ‘inputs’ to coal-fired power stations;

- the basis upon which transfer prices payable by private-sector retailers for access to ‘poles and wires’ were established;

- the prospective profitability of the retained ‘poles and wires’ businesses, and how that compares with the profitability of those business segments when operated by government agencies before the transactions;

- an analysis of what risks were transferred to the private sector and what risks will be borne by government as a consequence of the alleged ‘reform’.

The role of the Auditor-General

Much has been made of a forthcoming review of the sale transactions by the NSW Auditor-General. We believe that the Auditor-General has failed to ensure that the Parliament was adequately informed about the financial aspects of these transactions before they occurred.

Moreover, we have little confidence that the Auditor-General will provide a fully independent and comprehensive report on these transactions. That view is based on the fact that he is compromised by the stance he has previously taken on this issue. For example, despite on-going community concerns about proposals to sell off the electricity retailers and other businesses, and government responses that it proposed to retain Transgrid and other electricity distribution infrastructure, the Auditor-General has failed to ensure that government electricity businesses reported on the contributions of the ‘poles and wires’ segments of these businesses, or to provide commentary on this omission even though the information is highly relevant to any Parliamentary scrutiny of the merits of selling-off or retaining multi-billion dollar businesses. In contrast, listed public companies and other ‘reporting entities’ are required to report on the profitability of business segments.

Further, a year or so ago during an interview with Deborah Cameron on ABC Radio 702, before the Legislative Council was due to consider a bill dealing with the electricity privatisations, the Auditor-General announced that he proposed to restrict any review his office would undertake to a review only of the Government’s ‘strategy’ for selling these assets and not address whether or not the transactions were a good deal for the State – this was before Parliament had even considered legislation relating to the privatisation proposals. We also note that the Auditor-General’s 2010 report on the profitability of government-owned electricity agencies gave prominence to the ‘after tax’ profitability of these agencies when in fact such taxes (and other guarantee charges) are actually paid to the NSW Government. A more relevant indicator would have been the rate of return earned on these businesses, *before* NSW State taxes and charges. As the accompanying papers note, these returns have been of the order of 24% per annum (even after applying public sector accounting practices – private sector firms would have recorded an ever higher rate of return).

On the basis of the positions he has taken in the past on this matter, it may be that the Auditor-General will (wrongly) take the view that he is bound to avoid commenting on the adequacy of the sale consideration in the transactions being considered by the Committee, as acceptance of those prices was a matter of ‘government policy’.

However the Auditor-General has not shrunk from criticising certain activities (such as expenditure associated with the now postponed Metro project) as ‘waste’ – even though much of that expenditure could be regarded as reflecting government policy to secure a corridor for future public transport initiatives. Whatever the merits of his criticisms of the Metro project, the financial impact of the Gentrader Transactions seems likely to involve far greater financial costs to the taxpayer if publicly-owned assets were sold for a song. That is a more fundamental form of ‘waste’, and the sums involved are greater. Moreover, by failing to ensure that members of Parliament have been provided with relevant financial information the Auditor-General appears to have, by omission, endorsed the sale of businesses that have provided a basic service to citizens of NSW – as well as a very good financial return to the Budget. In that respect, arguably he has already ‘crossed the line’ by endorsing a contentious ‘policy’ that was unambiguously rejected by the 2008 State Conference of the political party currently in office in NSW (and which polling suggested was opposed by 80% or more of the community).

In that context, the Committee’s work is of great significance.

We are happy to appear as witnesses with or without the benefit of Parliamentary privilege. Indeed, our experience suggests that the Parliamentary privilege is likely to be of little interest to those who are prepared to comment on public sector financial issues on the basis of evidence and analysis. On the other hand, privilege may afford protection to those MPs who are so sensitive to criticism of their policies that they are prone to attack critics rather than engage in reasoned debate about financial issues.

Yours sincerely

Prof Bob Walker

Dr Betty Con Walker

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BRIEFING NOTE

2010-11 NSW Budget performance and outlook confirm Electricity Privatisation should be stopped

1. 2010-11 NSW Budget Results

According to the NSW Budget brought down on 8 June 2010, the NSW economy has 'recovered strongly in 2009-10' with better than expected increases in economic growth, employment growth, and business and consumer confidence (*2010-11 Budget Paper No. 2*, p. 2-1). These improvements have resulted in a turnaround in the projected 2009-10 Budget result from an estimated deficit of $990 million to a surplus of $101 million. The Government is forecasting continuing Budget surpluses in the next four years as shown below (p. 1-1).

Table 1

NSW Budget Results 2007-08 to 2013-14

2007-08 Actual $m	2008-09 Actual $m	2009-10 Revised $m	2010-11 Budget $m	2011-12 Estimate $m	2012-13 Estimate $m	2013-14 Estimate $m
935	(897)	101	773	885	863	628

Source: *2010-11 NSW Budget Paper No. 2*, p. 1-1.

2. Growth in NSW Budget Revenues

Questions have been raised about the likelihood of achieving the abovementioned Budget results because of low forecasts in expenses. However the forecast increase in general government revenues over the next four years of an annual average rate of 3.6 per cent (p. 1-5) appears conservative when compared with the increase in 2009-10 over 2008-09 at 11.7 per cent (see Table 2), and an annual average rate of 7.3 per cent in the five years since 2004-05 (p. 9-10) (see Table 3).

Table 2

NSW General Government Revenues 2008-09 to 2013-14

2008-09 Actual $m	2009-10 Revised $m	2010-11 Budget $m	2011-12 Estimate $m	2012-13 Estimate $m	2013-14 Estimate $m
49,663	55,492	57,669	59,962	62,196	64,025
Increase on previous year	11.7%	3.9%	4.0%	3.7%	2.9%

Source: *2010-11 NSW Budget Paper No. 2*, p. 1-1.

Professor Bob Walker is a Professor of Accounting, University of Sydney and former chairman of the NSW Council on the Cost of Government. Dr Betty Con Walker is an economist, principal of Centennial Consultancy, and a former Treasury official. They are co-authors of 'Privatisation: sell off or sell out' published by ABC Books in 2000, reprinted in 2006, and reissued in 2008 with a New Introduction published by Sydney University Press.

Table 3
NSW General Government Revenues 2008-09 to 2013-14

	2004-05 Actual $m	2005-06 Actual $m	2006-07 Budget $m	2007-08 Estimate $m	2008-09 Estimate $m	2009-10 Estimate $m	Average Annual Increase
	39,081	42,629	44,694	47,431	49,663	55,492	
Increase on previous year		9.1%	4.8%	6.1%	4.7%	11.7%	7.3%

Source: *2010-11 NSW Budget Paper No. 2*, p. 9-10.

Even the conservative 2010-11 Budget forecasts provide a total increase in revenues in the years 2008-09 to 2012-13 of ***$18.7 billion more than that forecast in the 2008-09 Budget*** (see below). This is made up of an increase in revenues of $7.3 billion presented in the 2009-10 Budget over the 2008-09 Budget; and $11.35 billion presented in the 2010-11 Budget over the 2009-10 Budget. It will be recalled that in 2008 it was alleged that NSW had a $20 billion 'hole in its budget' over the next four years. That hole has vanished.

Table 4
NSW General Government Revenues 2008-09 to 2013-14

	2008-09 Actual $m	2009-10 Revised $m	2010-11 Budget $m	2011-12 Estimate $m	2012-13 Estimate $m	Total $m
2008-09 Budget	47,882	50,665	53,223	55,186	na	
2009-10 Budget	48,818	52,958	55,322	57,170	59,365	
2010-11 Budget	49,663	55,492	57,669	59,962	62,196	
2009-10/2008-09	936	2,293	2,099	1,984	na	7,312
2010-11/2009-10	845	2,534	2,347	2,792	2,831	11,349
2010-11/2008-09	**1,781**	**4,827**	**4,446**	**4,776**	**2,831**	**18,661**

Source: *2008-09 NSW Budget Paper No. 2*, p. 4-7, *2009-10 NSW Budget No. 2*, p. 5-5, *2010-11 NSW Budget Paper No. 2*, p. 5-8.

3. NSW Government Debt

NSW general government sector net debt as a percentage of Gross State Product is expected to increase slightly from 2.5 per cent in June 2010 to 2.7 per cent in June 2011, before falling back to 2.5 per cent by June 2014 (p. 7-10) (see Table 5).

Table 5
NSW General Government Net Debt

	June 2007 Actual $m	June 2008 Actual $m	June 2009 Actual $m	June 2010 Budget $m	June 2011 Revised $m	June 2012 Estimates	June 2013 Estimates	June 2014 Estimates
Net Debt	3,645	5,663	8,108	10,375	12,228	12,574	13,113	13,485
% of GSP	**1.0**	**1.5**	**2.0**	**2.5**	**2.7**	**2.6**	**2.6**	**2.5**

Source: *2010-11 NSW Budget Paper No. 2*, p. 7-10.

These levels are miniscule in comparison to those of many developed countries in the OECD with an average of net debt to GDP of more than 62%. The latest general government net debt figures for some OECD countries are shown in the table below.

Table 6
OECD General Government Net Financial Liabilities
% of GDP

	2007	2008	2009	2010	2011
Australia	-7.3	-7.6	-3.8	0.2	2.8
Germany	42.9	45.0	48.3	52.7	55.8
Japan	81.5	94.9	108.3	114.9	121.5
United Kingdom	28.8	32.8	43.5	53.5	61.9
United States	42.2	47.0	58.2	66.6	72.6
Euro Area	42.6	47.0	53.8	59.5	63.6
Total OECD	**38.4**	**43.3**	**51.5**	**57.7**	**62.4**

Source: *OECD Economic Outlook 87 database, May 2010*.

4. Electricity privatisation confirmed unnecessary

While the 2010-11 NSW Budget claimed that the State's financial circumstances are better than previously claimed by ex-Treasurer Costa, it also confirms that there is no fiscal need to privatise the NSW electricity industry.

The positive turnaround in general government revenues outlined above should be seen in the context of the Costa-Iemma rationale for privatisation. It will be recalled that in 2008, the then Premier, Morris Iemma and then Treasurer Michael Costa were determined to sell these assets. They claimed that unless the State sold the electricity assets it needed to find $15 billion ‘to keep the lights on’. As was noted in our November 2008 Briefing Paper this was a significant overstatement on many fronts. Suffice it to say that the $15 billion was for a shopping list of projects. and that just one power station may be needed by 2015 at a cost of around $3 billion – not $15 billion. We also noted that the electricity assets were highly profitable, producing a rate of return of around 24% per annum. That figure would be even higher if state agencies applied private sector accounting methods.

According to the latest Budget, ***the State's electricity assets are now expected to provide $7.6 billion in dividends and tax equivalents to the consolidated fund over the five years to 2013-14*** (see Table 7). This is not unexpected, given recent increases in electricity prices approved by IPART (whose terms of reference include having regard to the impact on pricing policies of the dividend requirements of the government agency concerned – see section 15(1)(g) of the IPART Act). Possibly prices were increased to make the sale of state-owned businesses more attractive to prospective purchasers (IPART is directed to have regard to 'any arrangements that a government agency has entered into for the exercise of its functions by some other person or body' – section 15(1)h)).

An alternative view is that the State's taxpayers (not private sector purchasers) should benefit from the flow-through of higher electricity prices to higher profits.

Table 7
Dividends and Tax Equivalent Payments from the Electricity Sector

	2009-10 Revised $m	2010-11 Budget $m	2011-12 Estimate $m	2012-13 Estimate $m	2013-14 Estimate $m	Total 2009-10 to 2013-14 $m
Generation	501	380	378	389	436	**2,084**
Distribution & Transmission	724	712	1,136	1,536	1,367	**5,475**
Total	**1,225**	**1,092**	**1,514**	**1,925**	**1,803**	**7,559**

Source: *2010-11 Budget Paper No. 2*, p. 5-17.

Strong and stable cash flows from operations comfortably enable capital expenditure in the electricity sector of some $20.8 billion over the five years to 2013-14 – more than the exaggerated $15 billion that Costa-Iemma claimed necessitated a sell-off of these highly profitable assets.

Table 8
Capital Expenditure in the Electricity Sector

	2009-10 Revised $m	2010-11 Budget $m	2011-12 Estimate $m	2012-13 Estimate $m	2013-14 Estimate $m	Total 2009-10 to 2013-14 $m
Total	**3,355**	**3,912**	**4,717**	**4,673**	**4,169**	**20,826**

Source: *2010-11 Budget Paper No. 2*, p. 8-8.

According to the Budget Papers, the key drivers for this capital expenditure are customer growth, increasing summer peak demand and the replacement and renewal of assets when they reach the end of their useful lives (p. 8-11). Plainly much of this expenditure will further enhance the revenue raising capacity of the public electricity sector in future years.

In 2008, the Costa-Iemma privatisation proposals were resoundingly defeated by a 7 to 1 vote at the ALP State Conference, and were about to be rejected by the Legislative Council when they were withdrawn.

Mr. Costa is no longer Treasurer. Mr. Iemma is no longer Premier. But before being forced to resign Iemma announced amended privatisation proposals, in defiance of the Labor Party's decision. It is that version which is proceeding purportedly with the objective 'to optimise conditions that ensure private sector investment in generation capacity in New South Wales is adequate, economic and timely' (p. 8-11). The Treasury-prepared Budget Papers claims that it will create such an environment by implementing a strategy that:

- maintains public ownership of the existing power stations
- contracts the electricity trading rights of the Government-owned power stations to the private sector
- sells the retail arms of EnergyAustralia, Integral Energy and Country Energy
- sells the power station development sites around the state, and
- maintains public ownership of the transmission network of Transgrid and the distribution networks (poles and wires) of EnergyAustralia, Integral Energy and Country Energy (p. 8-11).

Yet the fact that a number of private electricity generating projects are already underway, shows the pointlessness of this objective and the privatisation itself.

Regard should also be given to the dangers of selling the retail arms of distributors as planned by the Government. 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 that 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 suggested 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’.

In 2008, Costa-Iemma engaged in 'strategic misrepresentations' about State finances, including the following claims:

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

Developments since talk of electricity privatisation began in 2008 have confirmed the folly of proposals to privatise any part of the State electricity assets or businesses.

#1 NSW does not face a financial crisis (and in reality, it never did).
#2 The State's Triple A credit rating has been retained.
#3 It is now widely recognised – even by the Opposition – that a downgrading of a Triple A credit rating would have a miniscule effect on State finances.
#4 NSW is now planning to spend nearly $21 billion on electricity infrastructure by 2014 – and these investments will be self-financed 'through a mix of operating surpluses and debt' (p. 8-12).

#5 The claimed 'hole in the budget' of $20 billion over four years will be filled by a turnaround in revenues.

#6 Sale of the electricity retailers would only lead to a loss of revenue to the State and higher prices to consumers. New investment is likely to generate increased returns to the State – as reflected in the Budget Paper estimates of an increase in dividends and tax equivalents of $7.6 billion over the five years to 2013-14 to support government spending in other areas. The adjusted annual net operating surplus of the electricity sector is expected to increase by 10 per cent per annum, growing from $3.8 billion in 2009-10 to $5.5 billion in 2013-14 (p. 8-12).

#7 Selling highly profitable assets that provide basic services is not a 'reform' – it is foolish. Cash flows from the State's electricity businesses are relatively stable (and increasing) – in contrast to the volatility of the State's revenues from property taxes – and hence actually enhance the State's capacity to borrow for new investment in infrastructure.

The 2010-11 Budget has confirmed that retention of the profitable electricity assets is not only affordable but financially prudent.

It is time for Premier Kristina Keneally to show real leadership, and to demonstrate that she is prepared to make the ***really*** tough and hard decisions, and

- stand up to public servants in NSW Treasury who don't see that the role of government is to deliver essential services, and who are ideologically committed to selling valuable assets to the private sector;

- accept that the ALP State Conference and more than 80% of voters in the State don’t want their electricity assets privatised;

- formally abandon the Iemma-Costa proposals for electricity privatisation, in the best interests of the State and its citizens.

(Then again, since Iemma's defiance of public opinion was the point when NSW Labor started to lose the electorate's trust, starting afresh wouldn't really be ***too*** tough …)

June 2010

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

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 pre-determined 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 2.1
NSW Infrastructure Assets

	$m	% of Total
State of NSW		
Plant and equipment/infrastructure systems	92,433	100%
NSW Power Assets (excluding Transgrid)		
Plant and equipment/infrastructure systems	18,992	21%

Source: NSW Report on State Finances 2006-07 and 2006-07 Annual Reports of six agencies.

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 3.1
NSW Electricity Industry Net Profit Before Tax 2006-07

	Net Profit $m
Generators	
Eraring	207.9
Macquarie	203.7
Delta	201.0
Total	**692.6**
Distributors	
Energy Australia	374.1
Integral Energy	239.2
Country Energy	235.7
Total	**849.0**
TOTAL	**1,541.6**

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

	Assets 30 June 2006 $m	**Equity 30 June 2006 $m**
Generators		
Eraring	1,571.4	991.8
Macquarie	2,972.1	1,003.5
Delta	2,148.4	730.0
Total	**6,691.9**	**2,725.3**
Distributors		
Energy Australia	6,589.3	1,725.0
Integral Energy	3,179.4	883.4
Country Energy	3,727.4	790.9
Total	**13,496.1**	**3,399.4**
TOTAL	**20,188.0**	**6,124.7**

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

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

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 rein-investment 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 3.4
NSW Electricity Industry Contributions to the State Budget 2006-07

	Dividends Paid $m	Tax Paid $m	Capital Return $m	TOTAL $m
Generators				
Eraring	41.3	43.6	184.0	
Macquarie	130.0	28.4	0.0	
Delta	131.6	47.4	0.0	
Total	**303.0**	**119.4**	**184.0**	**606.4**
Distributors				
Energy Australia	205.2	175.0	0.0	
Integral Energy	103.9	61.6	0.0	
Country Energy	76.8	34.2	0.0	
Total	**385.8**	**271.3**	**0.0**	**657.1**
TOTAL	**688.8**	**390.7**	**184.0**	**1,263.5**

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[1]. 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
> - Supporting clean energy including clean coal renewable technologies (Premier of NSW News Release, *'Energy savings to fund major infrastructure projects'*, 10 December 2007).

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).

5. 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 'debt'. 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!

and the device of having a short-term 'Commission of Audit' talk about a crisis in government finances became a model for incoming governments thereafter – leading to reports in this genre being produced in Tasmania (1992), South Australia (1993), Western Australia (1993), Victoria (1994), Queensland (1996) and the Commonwealth (1996).

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

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

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).

Source: Organisation for Economic Co-operation and Development, *OECD Economic Outlook 82*, December 2007.

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 intersector 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.

The NSW Government has issued several documents outlining its approach to the assessment of future capital project, and the choice of discount rates. The latest is a 'Technical Paper*': Determination of Appropriate Discount Rates for the Evaluation of Private Financing Proposals (2007).*

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 revenue*s (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 report were withheld as 'commercial in confidence'. The then Auditor-General later advised that this condition was attached to the report by consultants he had engaged. As he had a deadline to deliver the report to Parliament, he was unable to argue the point.

Several years later, after the same Auditor-General was critical of the withholding of claims that documents were 'commercial in confidence', Centennial Consultancy wrote to the Auditor-General asking if he would now release the unpublished elements of his report on the proposed sale of the SBNSW. He did so in his last report to Parliament before his term of office ended.

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.

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Prof Bob Walker & Betty Con Walker

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'

Professor Bob Walker is a Professor of Accounting, University of Sydney and former chairman of the Council on the Cost of Government. Betty Con Walker is an economist, principal of Centennial Consultancy, and a former Treasury official. They are co-authors of 'Privatisation: sell off or sell out' published by ABC Books in 2000, reprinted in 2006, and reissued in 2008 with a New Introduction published by Sydney University Press.

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.

Capital Expenditure in the Electricity Sector

2007-08 Revised $m	2008-09 Budget $m	2009-10 $m	2010-11 $m	2011-12 $m	Total Budget Estimates $m
2,709	3,533	3,897	3,920	4,370	15,720

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.

State Credit Ratings

State	Credit Rating
NSW	AAA
Victoria	AAA
Queensland	AAA
South Australia	AAA
Western Australia	AAA
Tasmania	AA+
ACT	AAA

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 [Iemma] 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.

NSW Government Domestic and Foreign Borrowings 2007

1 year or less $m	1 to 5 years $m	Over 5 years $m	Total $m
6,755	13,378	11,137	31,270

Source: *NSW Report on State Finances 2006-07,* p. 3-79.

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).*
>
> *[Iemma 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 Iemma, 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 (Iemma, 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 (20010-11)
Other expenditure: $170 million (2008-09) $409 million (2009-10) $1,445 million (2010-11) $2,112 million (2011-12) (*Budget Overview, Budget Papers 2008-09*, p. 7).

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 Iemma/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.

20 September 2008.