Supplementary Submission No 34a

INQUIRY INTO LEASING OF ELECTRICITY INFRASTRUCTURE

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Date received: 20/05/2015

LEGISLATIVE COUNCIL SELECT COMMITTEE INQUIRY INTO ELECTRICITY PRIVATISATION

Supplementary submission
20 May 2015

1. The Rev the Hon Fred Nile asked about payments by the agencies slated for privatisation. Dr Con Walker advised that the dividends and tax equivalent payments o the Budget totalled $1.7 billion in each of the last two years – or a total of $3.4 billion over just two years. But adding the loan guarantee fees paid to TCorp and which totalled $338 million in just 2013-13 and which conservatively would add another $600 million to the $3.4 billion means that the agencies paid $4 billion to the government is just the last two years. Adding their retained earnings takes it up to $5 billion.

2. The Rev the Hon Fred Nile asked Prof Walker to put a dollar figure on his mention of a rate of return recently earned by two of the agencies slated for privatisation at between 80%-82% per annum. He believes he misunderstood the question, and so wishes to provide more details. The adjusted before tax 'profits' of these entities on a private sector accounting basis would total $1.7 billion

Profit and rates of return on a 'private sector' accounting basis

Y/E 30 June 2014	**Ausgrid** **$m**	**Endeavour Energy** **$m**	**TransGrid** **$m**
Pre-tax profit	904.6	422.0	373.9
Rate of return on shareholders' equity	82.8%	80.8%	31.4%

Source: data from financial statements for the year ended 30 June 2014.
Note: Profits are before tax (since 'tax equivalents' are received by general government) and are after adding back estimated depreciation on the quantum of upward revaluations of system assets. Returns on shareholders' equity relate adjusted earnings to the average of equity as at 30 June 2013 and 30 June 2014, after adjustments for accumulated upward revaluations of system assets as at those dates.

The 'recalculated' pre-tax profit on a private sector accounting basis for these three agencies totals $1.7 billion (not to be confused with the $1.7 billion payments of dividends and tax equivalents to the budget in 2013-14 from all state owned electricity agencies – i.e. including Essential and from the remaining generators).

3. Our submission noted that dividends were effectively 'managed' by the government of the day. It may be of interest to the Committee to note the following 'payout' ratios during 2013-14 by the three agencies, when expressed as a percentage of *reported after-tax profits*:

Y/E 30 June 2014	Ausgrid $m	Endeavour Energy $m	TransGrid $m	Average $m
After tax reported profit	607.5	301	226.9	
Dividends	381.7	178.1	178.5	
Dividends as % profit	62.8%	59.2%	78.7%	65%

After we provided our evidence on 18 May 2015, a Treasury official told the Committee that Treasury applies a 'metric' to establishing dividends on the basis of 80% of after-tax profits. Possibly that is the practice this financial year. But last year's dividend payouts as shown in the table above were an average of only 65% of after-tax profits. That in itself confirms our suggestions:

- that the government is in a position to 'manage' dividend flows form state-owned corporations;
- that claims about sharp reductions in dividends in future are overstated – and that there has always been room for the government to increase cash flows from dividends (rather than accumulating retained earnings at past levels).

And, of course, if the agencies used 'private sector' accounting methods, their reported profits would be much higher than those in the above table.

4. The Treasurer and Treasury officials provided information to the Committee which was 'new' and which confirmed matters outlined in our submission and in our evidence to the Committee. In particular, our submission noted at pages 22-23 that it was 'likely' that

> *the state will assume responsibility for the full amount of the formal borrowings at the time of the privatisation transactions (which were $15.2 billion at 30 June 2014). Past experience also suggests that the state will retain responsibility for the accrued employee benefits of $1.4 billion. Adjustments for trade creditors and receivables could be made after preparation of a settlement balance sheet.*

And, in that case

> *the net sale proceeds of $13 billion [would be] after repayment of $15.2 billion borrowings and assumption of employee benefits liabilities $1.4 billion – implying a sale price (after transaction costs) of $29.6 billion.*

We simply note that Treasury officials confirmed that the claimed net sale proceeds of $13 billion was after the State assumed those liabilities and mentioned that on this basis, the sale price may be around $30 billion

5. We note that the Treasury Secretary claimed that the 2013 upward asset revaluations (notably, Ausgrid's $29 billion upward asset revaluation on the last day of the 2012-13 financial year) was consistent with revised Treasury guidelines issued 'in anticipation' of a new accounting standard which allowed for the use of an 'income approach' to asset valuation (previously the network agencies had valued assets on the basis of 'depreciated replacement cost').

This explanation is both false and misleading because the existing standard AASB 116 'Property, Plant and Equipment' (2004) already provided for use of the ‘income approach’, in cases where there was ‘no market-based evidence of fair value because of the specialised nature of the item of property, plant and equipment...’. This has been interpreted as permitting use of this approach (which involves calculating the present value of forecast cash flows) as relevant where (say) a highly specialised property is leased, and the streams of cash flows were locked in by those contracts.

The ‘new accounting standard’ was AASB 13 ‘Fair value measurement’ (September 2011) which explicitly stated that it applied to annual reporting periods beginning on or after 1 January 2013 (para. Aus4.2). The main thrust of AASB 113 was to emphasise that priority should be given to applying valuation techniques which maximised the use of ‘directly observable inputs’ in the form of market prices – and that entities should avoid use of ‘unobservable’ inputs (such as subjective forecasts of future events). This was entirely consistent with the previous Treasury Circular TPP 07/01 ‘Accounting Policy: Valuation of Physical Non-Current Assets at Fair Value’.

The effect of the revised Treasury Circular NSW TC 12/05 ‘Fair Value of Specialised Physical Assets’ was not to ‘anticipate’ AASB 113, as wrongly stated to the Committee by the Treasury Secretary. Rather, TC 12/05 encouraged contravention of that standard, by signalling that the agencies concerned could shift from using ‘observable inputs’ (such as current replacement prices) to unobservable inputs (such as management forecasts). In short, the 2012 Treasury Circular encouraged creative accounting that disguised the underlying profitability of the network agencies.

(In any event, Ausgrid’s financial statements for the year ended 30 June 2012 did not report that Ausgrid had applied AASB 13, as required by that standard. Nor did Ausgrid comply with any of the basic disclosure requirements of AASB 113 e.g. it failed to provide details of the valuation techniques and inputs used to develop those measurements – such as discount rates. It is regrettable that these failures were overlooked by the Auditor General or his delegate, given the materiality of the asset revaluations that followed this ‘creative accounting’.

6. Another matter that was revealed by a Treasury official to the Committee goes some way to explaining the Premier’s claim that the privatisation transactions would lead to a reduction in general government debt. That was that the holding entity would be ‘deconsolidated’ (i.e. not counted as a subsidiary of government in the State’s accounts). That is of course consistent with the speculation outlined on page 21 of our paper i.e.

> *The December 2014 announcement referred to the establishment of a holding entity as lessor of the network agencies’ assets, while adding that Essential Energy will remain a State-Owned Corporation and will not be transferred to the holding entity. Presumably both the government (via the Future Fund) and private sector investors will hold shares in this new entity.*

At the same time questions remain about how and when the existing debt of the network agencies will be repaid, and whether in the process this debt would be properly regarded as ‘general government’ debt since it would no longer be associated with the operations of a state-owned business and hence could not be treated as part of the Non-Financial Public Trading Enterprise sector.

7. At the conclusion of our appearance mention was made of the need to consider the detail of privatisation proposals ('the devil is in the detail'). But matters were somewhat confused by a 'point or order' and ensuing argument. It was our recollection that you ruled against the point of order but in the ensuing confusion Prof. Walker was unable to complete his reference to the losses incurred by the State after the 1995 privatisation of the State Bank of NSW. The following is a concise summary:

> We found out later that contractual conditions (whereby the State retained responsibility for most of the bad debts on a $13 billion loan book) reduced the headline sale price of $576 million to $80 million or less. Only later did we learn that the misleading advice to Parliament that the $576 million exceeded 'retention value' was calculated by discounting projected earnings at a Bankcard rate of interest of 18.9% - a device guaranteed to reduce retention value. And a few years later (when the purchaser CML on-sold the bank to CBA) we learnt that an expert valued the State Bank at between $2.5 to $2.7 billion. On that deal, NSW lost more than $2.5 billion.

8. We are offended that during our appearance before the Committee the Hon Catherine Cusack wrongly suggested that Bob Walker had served as a consultant to then Opposition leader Bob Carr and that he was subsequently 'rewarded' with a government job by the incoming Carr Government.

   We would like to place on record that Bob Walker has never been a consultant to the Opposition (though he has happily provided advice about public sector accounting and financial arrangements when asked by MPs from all sides of politics).

   Prior to his appointment as chair of the Council on the Cost of Government in 1995, his major involvement in the NSW public sector was as a contributor to the Public Accounts Committee's 1984 *Report on Superannuation Liabilities of Statutory Authorities* (which led NSW to lead other Australian governments in revealing the scale of their unfunded superannuation liabilities arising from sponsorship of defined benefit superannuation schemes). Subsequently he was invited to contribute to several Public Accounts Committee seminars on annual reporting and the application of accrual accounting to the public sector.

   As he noted at the hearing, his commentaries on government finances appear to have encouraged improvements in public sector accountability throughout Australia by the move towards standardised budget reporting encompassing the 'general government sector'.

9. Finally, it should be noted that the State has miniscule General Government debt at 1.7% of Gross State Product and, as TCorp has advised us, the State can currently borrow funds at 10 year bond rates of 3.3%.

   If the Government believes in the benefits of undertaking its proposed $20 billion of projects over the next 10 years, then it should fund them from State revenues including those from the electricity agencies and /or borrowings.

With such low debt and if the projected benefits are genuine then the small addition to debt spread over 10 years would not affect the State's triple A credit rating.

(It should also be noted that past statements of the impact of a downgrade have been grossly exaggerated. The fact is that a fall in the credit rating by one notch from AAA to AA+ is likely to result in an increase in interest rates of just 10 to 20 basis points or 0.1% to 0.2%. Of course, this would only apply to 'new' debt as old borrowings mature over many years ahead.)

With interest rates so low, and the profitability of the electricity agencies far greater than the cost of new loans, the possibility of funding new infrastructure from these sources is (to use Premier Baird's phrase), *a once in a generation opportunity.*