Submission No 9

INQUIRY INTO THE LEASING OF ELECTRICITY INFRASTRUCTURE

Name: Mr John Quiggin

Date received: 8/05/2015

No Magic Pudding: How the Baird government's asset lease strategy will weaken the fiscal position of the NSW State government

John Quiggin

Australian Research Council Laureate Fellow

School of Economics and School of Political Science and International Studies

University of Queensland

http://www.uq.edu.au/economics/johnquiggin

Table of Contents

No Magic Pudding: Key Points

* The NSW government proposes to issue a 99-year lease on 50.4 per cent of its interest in electricity distribution enterprises Ausgrid and Endeavor and 100 per cent of the transmission enterprise Transgrid. The sale proceeds have been notionally allocated to finance the expenditure of $20 billion on a variety of non-commercial public infrastructure assets and consumer subsidies for electricity users.

* This policy package will substantially reduce the net financial worth of the NSW public sector, and contribute $1-2 billion annually to the budget deficit

*In terms of fiscal impact, this proposal combines all the worst features of privatisations undertaken in Australis over the past two decades

- Partial sale;
- Lease rather than outright sale;
- Proceeds notionally allocated to new expenditure programs; and
- Sale at a time of high regulatory uncertainty

The fiscal loss to the public will therefore be at the upper end of the range observed in past privatisations.

No Magic Pudding: Summary

1. For most purposes a 99-year lease is equivalent to a sale. However, the proposed ownership structure is likely to reduce the value of the asset to a private buyer, relative to an outright sale of the whole enterprise or even to a partial sale without the complications of a lease

2. Past proposals for privatisation, had they gone ahead, would have resulted in a substantial net loss to the NSW public

3. The sale of income generating assets does not provide any additional capacity to undertake non-commercial public investments or to finance current expenditure. Such investments must be paid for either out of current revenues or through borrowing and debt service

4. The planned asset sales will weaken the fiscal position of the state

- Future dividends from the assets in question are uncertain, but this uncertainty will be reflected in the sale price.

- In general, governments are better placed to bear risk associated with changes in policy and regulation. Selling assets at a time of rapid regulatory change is likely to reduce the sale price.

- The sale of the assets involves the loss of the associated flow of dividends and tax equivalent payments. If the proceeds of asset sales are used to repay debt, the fiscal effect is broadly neutral. If the proceeds are spent, then the foregone revenue, if not replaced by additional taxation, will contribute permanently to the budget deficit and will imply continuously growing debt.

- The economic case for privatisation rests on the claim that private ownership will result in more efficient operations and superior investment decisions. Regardless of the merits or otherwise of this claim, it is irrelevant in the context of the current proposal, which involves the lease of a partial interest.

5. Proposed investments and public expenditures should be evaluated on their merits, rather on the basis of a notional source of funding such as asset sales

6. Electricity privatisation is unlikely to reduce prices faced by consumers

7. The electoral unpopularity of privatisation reflects a mature public judgement based on long experience. The exclusion of Essential Energy from the asset sale program reflects strong opposition in a core element of the government's support base.

No Magic Pudding: How the Baird government's asset lease strategy will weaken the fiscal position of the NSW State government

Public-private partnerships do not provide governments with an additional bucket of money for use on infrastructure projects, John Pierce (NSW State Treasury Secretary 1997-2008 and Ian Little, Secretary of the Victorian Department of Treasury and Finance from 1998–2006.

The central issue in the NSW state election, to be held on 28 March 2015, will be the government proposal for a partial lease of electricity transmission and distribution assets. The NSW government proposes to issue a 99-year lease for 50.4 per cent of its interest in monopoly electricity distribution enterprises Ausgrid and Endeavour (but not the rural distribution enterprise Essential energy) and 100 per cent of its interest in the transmission enterprise Transgrid.

The government also plans to spend $20 billion on a variety of non-commercial public infrastructure assets and consumer subsidies for electricity users, notionally financed by these partial leases. As economists (including the Secretaries of the NSW and Victorian Treasuries, quoted above) have pointed out many times, the link between asset sales and infrastructure investment is spurious. Nevertheless, politicians have continued to push the idea that asset sales represent a 'magic pudding' that can finance desirable public infrastructure at no cost the public.

The report is organised as follows.

Section 1 deals with the claim that the proposal involves a lease rather than a sale. The primary conclusion is that there is no practical difference, from the viewpoint of the public, between the proposed leases and an outright sale. However, the additional complexity of a lease in a partial interest is likely to reduce the sale price

Section 2 deals with previous proposals for privatisation in New South Wales, rejected by voters. Had they gone ahead, these proposals would have resulted in a substantial net loss to the NSW public. Section 3 responds to the idea that asset sales constitute a 'magic pudding'. As already indicated, this idea is rejected by economists, regardless of their views on privatisation. Section 4 deals with the fiscal impacts of privatisation. In general, the appropriate procedure is to compare the earnings foregone through privatisation with the interest savings from using sale proceeds to repay debt. In the present case, no debt repayment is planned, so this analysis is inappropriate. Section 5 deals with the infrastructure investment plan. In the absence of a revenue source, this plan will reduce public sector financial net worth and contribute up to $2 billion a year to deficits on an accrual basis. Section 6 deals with the claim that electricity prices are lower under privatisation. In fact, the highest retail prices are observed in the privatised South Australian system. The large increases in prices experienced in recent years reflect the failure of the National Electricity Market reforms, designed with the objective of a fully privatised system. Section 7 deals with public attitudes to privatisation. Repeated rejections of privatisation show that Australian voters understand, as the political class does not, the spurious nature of the magic pudding theory. Section 8 restates the unpalatable truth that the only way to provide public infrastructure is to pay for it with user charges or out of general revenue. An appendix contains a statement by 20 leading economists on the asset sale proposal put forward by the Queensland Labor government in 2009, and repudiated by voters in 2012. Apart from a change of date, state and governing party, this statement is fully applicable to the current proposal.

1. Lease or sale?

Before considering the economics of the issue, it is necessary to discuss the way the proposed transaction is being described. It is common for governments undertaking politically sensitive privatisations to dress them up as leases, and this is true of the current proposal for a 99-year lease

In practical terms, a 99-year lease is no different from a sale. Queensland LNP Treasurer, Tim Nicholls made the point well. Commenting on similar proposals from the Labor Party in 2010, he observed

> As anyone would know if they had observed the privatisation of assets, a 99-year lease is as good as giving away the farm

There is one arguable counterexample, that of the British lease of Hong Kong from China, which expired in 1997. However, there is a crucial difference in terms. Under the Hong Kong lease, Britain received no compensation for the transformation of Hong Kong from an obscure trading post to one of the world's great cities. By contrast, under the terms of the leases being proposed here, resumption of control will require that the lessees be fully compensated for their investments over the term of the lease, which far exceeds the life of most of the assets concerned.

In practical terms, the proposal is for a sale. The only result of the packaging as a lease will be to deter some potential buyers who prefer the security of outright ownership, and therefore to reduce the price received by the people of New South Wales.

The problem is exacerbated by the fact that the lease relates to a partial interest. The resulting situation, in which the government notionally owns 100 per cent of the asset, but has leased 50.4 per cent, is plagued with potential governance problems. Concern about such problems is likely to reduce the sale price received by the public.

2. Previous proposals for privatisation

Proposals for privatisation of the NSW electricity industry were first raised by the Carr government in the 1990s. The government commissioned reports from consultants (the Allen Group and Ord Minnett) and a committee chaired by former ALP National President Bob Hogg, all of which supported privatisation. The estimated sale price for the NSW electricity industry was around $20 billion. However, the proposal was rejected by the Labor Party conference, with the result that the industry remained in public ownership until 2010 when it was partially privatised.

In the first stage of privatisation, electricity retailers Country Energy and Integral Energy, and the output from power generator Eraring were sold to Origin Energy for $3.3 billion.

EnergyAustralia, the output from the Delta West generator, the Mount Piper Extension and two Marulan development sites, were all sold to the Hong Kong company TRUenergy for $2 billion.

These deals were highly controversial, with the majority of board members of Delta and Eraring resigning in protest, and allegations that the sale price was only half the true value.

In 2012, the O'Farrell LNP government announced the sale of the remaining generation assets, with an expected price of $3 billion.

It is possible to compare the outcomes from the actual outcome with what would have occurred if the proposed sale had gone ahead in 1997, yielding $25 billion in net proceeds. Assuming (over-optimistically) that all the sale proceeds were used to repay public debt, and that the resulting interest savings were compounded at 6 per cent, the $20 billion would have a 2010 present value around of $50 billion.

By holding on to the assets, the government received dividend and tax equivalent payments averaging around $1 billion a year. In addition, a capital restructure yielded around $5 billion in equity repayments. Converting these flows to 2010 present values yields about $25 billion. So, if privatisation had been undertaken in 1997, the state's debt would be lower by around $25 billion in 2010. On the other hand, the state retained ownership of the generation and retail assets, which realised a sale price of $8 billion (including the estimated $3 billion for the sale of remaining assets. So, the reduction in debt, relative to the current situation, is around $17 billion.

Against that, the public has retained ownership of the transmission and distribution sector, by far the most profitable component of the industry. The value of transmission and distribution assets is estimated at $40 billion, implying that the decision not to sell has left the NSW public better off by more than $15 billion.

3. The magic pudding

For more than 20 years, Australian governments, both state and federal have attempted to justify privatisation on the basis that the proceeds can be used to finance investments in desirable, but non-commercial, assets such as schools and hospitals. Economists, regardless of their views on privatisation, have uniformly rejected this claim. In 2009, responding to the Queensland Labor government's claim that selling assets would permit additional expenditure on roads, schools and hospitals, a group of 20 leading economists issued a statement, saying in part

> This claim is economically unsound. Forgoing income generating investments, and borrowing an equal amount to fund investments that return no additional revenue, leaves the government with no flow of income to service the associated debt. The necessary income must be raised by increasing taxes or cutting expenditure.

The signatories included twelve professors of economics from four leading Queensland universities and nationally prominent academic and business economists including current and former members of the Board of the Reserve Bank of Australia.

As noted above, the same point was made by John Pierce (NSW State Treasury Secretary 1997-2008) and Ian Little, Secretary of the Victorian Department of Treasury and Finance from 1998-2006, commenting on the financing of public infrastructure through public-private partnerships *Public-private partnerships do not provide governments with an additional bucket of money for use on infrastructure projects*

Although the proposed partial lease is superficially different from a standard public–private partnership, the logic is exactly the same.

Despite repeated refutations of this idea by economists over more than 20 years, politicians continue to put forward the idea that asset sales constitute a 'magic pudding', which can be used to get something for nothing.

The Australian public does not share this delusion, and voters have repeatedly rejected proposals for privatisation.

4. Fiscal impacts

The most common reason governments in developed countries have privatised assets is because of the illusory belief that the money raised in this way will allow them to increase public spending, cut taxes or repay debt. This illusion is the basis of the NSW government's proposed infrastructure plan. Economists, regardless of their views on privatisation, have uniformly rejected the claim that it can be used as source of cash for governments or as a way of financing desired public investments without incurring public debt.

It is a basic principle of economics that the value of a capital asset is determined by the flow of earnings or services it generates. The cash gained from selling public assets comes with the cost of forgoing the earnings it would have generated in continued public ownership. In a world where both governments and markets were perfectly efficient the cost would be exactly equal to the benefit and privatisation would not change anything. privatisation will yield net fiscal benefits to governments only if the price for which the asset is sold exceeds its value in continued public ownership. This value depends on the flow of future earnings that the asset can be expected to generate, and on the discount rate used to evaluate those earnings.

Application of this analysis to Australian privatisations, including those in the electricity industry shows that, in general, they have worsened the fiscal position of the public sector. The main exceptions are cases, including Victorian electricity privatisation in the early 1990s. where private buyers overestimated future profits and paid too much, subsequently selling at a loss. Provided private investors accurately estimate the value of future earnings, and in the absence of large efficiency gains obtainable only through privatisation, the sale of government business enterprises will worsen the long-term fiscal position of government even when the proceeds are used to repay debt.

The current proposal

In the present case, none of the proceeds will be used to repay debt. Hence, there is no offset to the reduction in public sector net financial worth associated with the sale of an income-generating asset.

It might still be useful to undertake a standard analysis comparing the projected sale price with estimates of the earnings foregone through privatisation. Unfortunately, however, the proposed sale is taking place at a time of substantial uncertainty about the future earnings of electricity distribution enterprises, driven primarily by regulatory uncertainty. It is therefore difficult to project either the foregone earnings or the likely sale price.

It should not be supposed, however, that this uncertainty strengthens the case for privatisation. While it is possible that an over-optimistic buyer will pay too much for the assets, it is more likely that regulatory uncertainty will depress the price of the asset.

Summary

In terms of fiscal impact, this proposal combines all the worst features of privatisations undertaken in Australis over the past two decades

* Partial sale
* Lease rather than outright sale
* Proceeds notionally allocated to new expenditure programs
* Sale at a time of high regulatory uncertainty

The fiscal loss to the public will therefore be at the upper end of the range observed in past privatisations.

5. The infrastructure investment plan and public sector financial net worth

As argued above, the desirability or otherwise of the infrastructure investments proposed by the NSW government is independent of decisions regarding asset ownership. No benefit-cost evaluation appears to have been undertaken regarding this program. However, expenditure notionally financed from sources other than general revenue has typically been characterized by waste and pork-barrelling. This was evident in the recent Queensland election campaign, where expenditure proposals were targeted at particular electorates, and made conditional on the return of an LNP member.

The impact on public sector financial net worth is straightforward. On the optimistic assumption that the asset sales program yields a return equal to the value of the assets in continued public ownership, it will be financially neutral. The effect of the infrastructure program, therefore will be to reduce public sector net financial worth by the full $20 billion of expenditure. Assuming an interest rate of 5 per cent, the resulting addition to the deficit will be $1 billion a year. On an accrual basis, and assuming a depreciation rate of 5 per cent, this is equivalent to an annual flow of up to $2 billion. This outflow must be financed either by additional tax revenue or by (so far unannounced) cuts in other areas of public expenditure.

6. Interstate comparisons in prices

In the course of the debate over privatisation, considerable attention has been paid to claims by the Ernst and Young consultancy group (lobbying on behalf of governments advocating privatisation), to the effect that consumers have done better in states where privatisation has taken place. The typical procedure is to look at the change in distribution charges over a cherry-picked time interval during which prices have increased more in New Sout Wales and Queensland than in Victoria and Australia.

What matters to consumers, however, is the price actually paid, which is monitored regularly by the Australian Energy Market Commission. Its 2013 Residential Electricity Price Trends report showed the following average prices charged to households with medium levels of electricity use in the four states in question.

State	Average residential price (c/kwh)
Queensland	23.71
New South Wales	27.86 c/kwh
Victoria	27.66 c/kwh
South Australia	31.27 c/kwh

As can be seen, the lowest prices were in Queensland, under public ownership, and the highest in South Australia under privatisation.

It is important not to overstate the significance of these differences. The overwhelming factor driving higher electricity prices in Australia has not been privatisation *per se* but the failure of the National Electricity Market. However, the designers of the market relied heavily on the assumption that the process of ‘reform’ would eventually culminate in privatisation, and that competition between private firms would drive prices down. Of course the opposite has happened (see Figure 1).

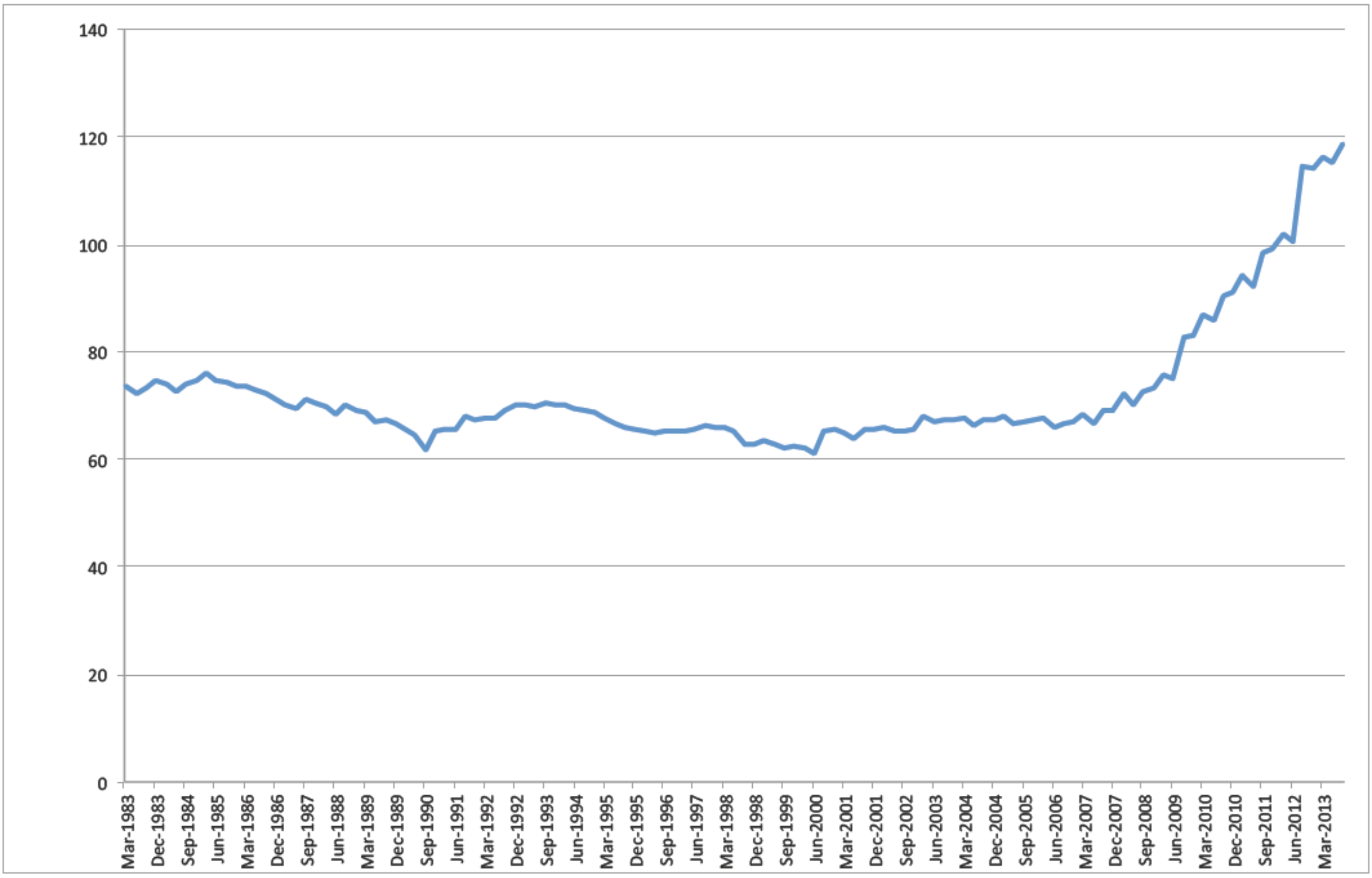

Figure 1: Electricity price index (National Electricity Market commenced at beginning of 1999)

7. Public attitudes

One reason for the persistence of privatisation proposals is the belief among the political class that the combination of asset sales and expenditure notionally financed by those sales is appealing to the general public. This view has been sustained in the face of overwhelming evidence to the contrary, both from opinion polls and electoral outcomes.

Unlike the political class, ordinary voters understand at an intuitive level that the ‘magic pudding’ theory of privatisation is nonsense. They correctly see it as analogous to ‘selling off the farm’ to pay the bills. Moreover the lived experience of 20 years of privatisation has dispelled the notion the private enterprises, particularly those in a monopoly or near-monopoly position, will necessarily provide better services or more competitive pricing than their public counterparts

Privatisation has been, from the start, an initiative of policy elites, with no popular groundswell of support. Nevertheless, in the 1980s, the majority of the general public did not have strong views on the subject one way or another. A study by Jonathan Kelly and Joanna Sikora (2002) showed that in 1986, views on the privatisation of Telstra were about evenly divided.

Advocates of privatisation assumed that the benefits of competition and private ownership would be obvious, and that what they saw as 'emotional' attachment to iconic assets would fade over time. In fact, the reverse has been the case. Public opinion against privatisation has hardened steadily over time, and with experience. By 2002, when the privatisation of Telstra was complete, Kelly and Sikora found that 70 per cent were opposed and only 16 per cent in favour. Similar views applied even to firms like the Commonwealth Bank and Qantas that had been privatised for years. Opposition was even stronger in the case of Australia Post, the only business in the study still in full public ownership.

Opposition has only grown since then. Polls taken under the Bligh government in Queensland showed that 80 per cent of the public opposed asset sales. In regional Queensland, over 90 per cent of the public opposed the sale of the QR rail freight business.

Numerous Australian elections have been fought primarily on the issue of privatisation, with invariably catastrophic outcomes for supporters of the policy. A brief listing

* Queensland 2015, the Newman LNP government, elected with a majority of 67 seats in a Parliament of 89 campaigned on a policy of 99-year leases and lost office

* Queensland 2012: The Bligh Labor government, which undertook an asset sales program in defiance of its own 2009 election commitments was defeated, losing all but 7 seats in a Parliament of 89

* NSW 2010: The Keneally Labor government, which privatised electricity assets, was defeated, losing 32 of its 52 seats in Parliament

* NSW 1999: The Liberal Opposition, proposing privatisation of the electricity industry, was defeated in a landslide losing 13 of 46 seats and receiving only 33 per cent of the popular vote. The Liberals did not regain office until the 2010 election, when the parties had switched sides on this issue

* Tasmania 1998 The Rundle government, proposing privatisation of the state's electricity industry, was defeated. The Liberal Party was out of office until 2014.

* South Australia 2002 The Liberal government which had privatised the electricity industry was defeated. The Liberals have yet to regain office.

Other elections in which unpopular privatisation proposals played a role include the 1993 Federal election (in which, along with the GST, privatisation was a central element of the Coalition's policy platform) and the 2001 ACT election (where the Liberal government had sought to privatise the electricity and water provider ACTEW).

Australians are not unusual in their opposition to privatisation. Throughout the English-speaking world, privatisation has been imposed by policy elites on an unwilling public. In the United Kingdom, for example, 70 per cent of the public support renationalisation of electricity, gas and water services, and similar proportions support complete renationalisation of the railway industry (the rail track industry has been renationalised, and a public–private partnership arrangement for the London Underground abandoned).

Opposition to privatisation is similarly strong in Canada. Even in the United States, where public ownership of business enterprises is rare, proposals for the privatisation of the Social Security system were so politically toxic that they had to be rebranded as "choice" and still proved to be politically unsaleable.

The exclusion of the rural and regional distribution enterprise, Essential Energy, from the Baird government's proposed asset sale program reflects a recognition that voters in rural and regional New South Wales, most of whom are supporters of the government, are even more strongly opposed to privatisation than those in urban areas. It is poor governance, however, to exempt core elements the government's own support base from a policy that is being imposed on the electorate at large.

8. What is the alternative ?

Advocates of privatisation as a means of financing public expenditure have argued that none of the alternatives, such as increasing tax revenue, reducing public expenditure or tolerating higher levels of debt, is acceptable. In reality, however, asset sales and leases make little difference to the fiscal positions of governments that undertake them even when they are managed optimally. When the proceeds are dissipated on politically motivated projects, as in the present cases, privatisation makes governments worse off.

In the end, public expenditure, including the provision of non-commercial public infrastructure, must be financed primarily through taxation or user charges. Governments that evade this reality are exhibiting weakness not strength. Until this delusion is abandoned, we will experience financial difficulties whenever government revenue undergoes one of its regular cyclical declines, as is happening at present.

9. Concluding comments

In terms of fiscal impact, the Baird government's asset sale proposal combines all the worst features of privatisations undertaken in Australis over the past two decades

* Partial sale

* Lease rather than outright sale

* Proceeds notionally allocated to new expenditure programs

* Sale at a time of high regulatory uncertainty

The fiscal loss to the public will therefore be at the upper end of the range observed in past privatisations. The loss could be as high $1 billion per year on a cash basis or $2 billion a year on an accrual basis.

Appendix: Statement by 20 leading economists on asset sale proposal of Queensland Labor government 2009

Press Release: Queensland Government Case For Asset Sales 'Economically Unsound'; Informed Public Debate Needed

A group of prominent Australian academic and business economists has issued a statement describing the case presented by the Queensland government in support of its proposed asset sales as 'economically unsound' and 'based on spurious claims' The statement concludes that 'The people of Queensland deserve a robust and well-informed public debate over the costs and benefits of privatisation. So far they have not received it.'

The group encompasses a broad range of views on the merits of privatisation —some might favour it in particular cases whilst others would be less likely to. However, all are agreed that such important decisions should be made on the basis of well-informed discussion. Important issues include whether the private or public sector would be the most efficient managers, which would be the best bearers of the business risk and the best ways for the enterprise to meet social as well as financial objectives.

The group includes twelve professors of economics from four leading Queensland universities and nationally prominent academic and business economists including current and former members of the Board of the Reserve Bank of Australia.

23 November 2009,

Statement by academic and business economists on the Queensland government's case for asset sales

Decisions on the sale or retention of public assets have important implications for competition and public policy, as well as for the fiscal position of governments. These decisions cannot be resolved on the basis of general ideological arguments for or against public ownership, and require informed public debate in each case. The normal lines of economic debate include whether a given business is more efficiently operated in the private or public sector, the appropriate allocation of risk and the extent to which the enterprise is required to pursue social as well as financial objectives.

The signatories of this statement have a range of views on the appropriate balance between the public and private sectors and on the merits of privatisation in particular cases. However, we share the view that these questions should be resolved on the basis of well-informed discussion of the economic and social costs and benefits of privatisation, and not on the basis of spurious claims that asset sales represent a costless source of income to governments.

The arguments put forward by the Queensland government in its booklet 'Facts and Myths on Asset Sales' do nothing to promote a well-informed debate. Two central claims are particularly, and sadly, noteworthy. In relation to five public assets proposed for sale, the "Facts and Myths" booklet states

Keeping these businesses would cost the Government $12 billion over the next five years. That's $12 billion spent on new coal trains and new wharves that can't be spent on roads, schools or hospitals.

This claim is economically unsound. Forgoing income generating investments, and borrowing an equal amount to fund investments that return no additional revenue, leaves the government with no flow of income to service the associated debt. The necessary income must be raised by increasing taxes or cutting expenditure.

Selling public assets will improve the public sector's fiscal position only if the price realised for the assets exceeds the value of the income stream that the asset would otherwise generate for the public sector. In this respect, the 'Facts and Myths' booklet states

The total return from all five businesses in 2008-09 was approximately $320 million

When the sale process is completed, it is anticipated the Government will save $1.8 billion every year in interest payments.

This is an invalid, apples-and-oranges comparison. The $320 million figure consists solely of dividend payouts, excluding retained earnings, tax-equivalent payments and the interest paid by the government business enterprises to service their debts.

The $1.8 billion represent the interests that would be saved, at a rate of about 6 per cent, if the state realised $15 billion from the asset sale and avoided $12 billion in new investment. Most of this interest would be serviced out of the revenues of the GBEs, and can therefore not be compared with dividends derived from earnings after the payment of interest and tax.

The people of Queensland deserve a robust and well-informed public debate over the costs and benefits of privatisation. So far they have not received it.

Signatories

Harry Campbell, Professor of Economics, University of Queensland

Tim Coelli, Adjunct Professor of Economics, University of Queensland

Henry Ergas, Economic Consultant, Canberra

John Foster, Professor of Economics, and former Head of School, University of Queensland

Paul Frijters, Professor of Economics, QUT

Ross Guest.Professor of Economics, Griffith University,

Nicholas Gruen, CEO, Lateral Economics

Christopher Joye, Managing Director, Rismark International

Andrew McLennan, Australian Professorial Fellow in Economics, University of Queensland

Flavio Menezes, Professor and Head of School of Economics, University of Queensland

Christopher O'Donnell, Professor and Deputy Head of School of Economics, University of Queensland

Andrew Leigh, Professor of Economics, ANU

Adrian Pagan, Professor of Economics, QUT, former member RBA Board

Rohan Pitchford, Australian Professorial Fellow in Economics, University of Queensland

John Quiggin, Federation Fellow in Economics, University of Queensland

John Rolfe, Professor of Economics, Central Queensland University

Prasada Rao, Australian Professorial Fellow in Economics, University of Queensland

Rabee Tourky, Professor of Economics, University of Queensland

Warwick McKibbin, Professor of Economics, ANU, current member RBA Board