Submission No 34

INQUIRY INTO LEASING OF ELECTRICITY INFRASTRUCTURE

Name: Emeritus Prof Bob Walker & Dr Betty Con Walker

Date received: 15/05/2015

Submission to
Legislative Council Select Committee
Inquiry into the leasing of
electricity infrastructure

Prepared
by
Emer Prof Bob Walker and Dr Betty Con Walker

May 2015

SUBMISSION TO
LEGISLATIVE COUNCIL SELECT COMMITTEE
INQUIRY INTO THE LEASING OF
ELECTRICITY INFRASTRUCTURE

1. INTRODUCTION

We welcome the opportunity provided by the Committee to make a submission on the NSW Government's electricity privatisation proposal.

2. OUR POSITION

The NSW Government's plan to privatise profitable electricity assets (in order to fund a claimed $20 billion worth of projects over the next ten years) is bad policy and bad financial management.

If two of the agencies slated for partial or full sale had prepared their financial statements on the same basis as listed public companies, they would have reported returns on shareholders' funds of 80% to 82% per annum - these can only be described as 'super profits'. Instead their reported returns have been understated, notably by recent upward asset revaluations of depreciable assets – including a $2.9 billion write-up by Ausgrid on the last day of the 2012-13 financial year.

These changes occurred when Premier Baird was the state's Treasurer – and saw NSW Treasury permit use of a valuation method that it had previously ruled unsuitable for specialised assets where there was no market evidence of 'fair value'. These changes were designed to 'prepare the ground' for privatisation but could also have been designed to avoid criticism from consumers bearing the burden of higher electricity prices

Obviously it is crazy to be selling assets that are producing such high rates of return – before getting any benefits from their just-completed five year program of capital works. Earnings from the retention of the distribution agencies could help pay for future investment in priority infrastructure projects, particularly schools, hospitals and public transport.

Without dividends and other payments from state electricity agencies (all other things being equal) the Coalition Government would have recorded deficits in each of its first four years in office – with further impacts in the forward years. For example, all other things being equal, the 2014-15 forecast surplus of $272 million would be a deficit of $922 million.

At present, State-Owned Corporations do not pay corporate income taxes to the Commonwealth – only notional taxes to the state Treasury. Last December the Baird Government announced it would be setting up a holding company to handle the ‘lease’ arrangements. If this entity is not wholly owned by the state, then we understand that it would be liable for Commonwealth taxes. This interpretation has been confirmed by a government document distributed to Coalition MPs and selected journalists which acknowledged that the ‘lease’ arrangement would see a loss to the state of both tax equivalents and loan guarantee fees. Further, a Senate Committee examining privatisation was told by a Treasury official that the Commonwealth may benefit from such an arrangement, and that the proposed one-off payment to the states of 15% of the sale proceeds of any privatisation was not intended to fully compensate for such a loss of revenues from tax equivalents.

Instead of selling these assets, the state would be better off borrowing at the current historically low interest rates - and keeping businesses providing basic services which in 2013-14 contributed $1.7 billion to the state Budget. And that figure does not take account of loan guarantee payments to the Treasury Corporation which in 2012-13 were estimated at $338 million – nor the retained earnings of the electricity agencies. Retention would enable the Government to reap the benefits from significant capital investments made by the electricity agencies from their own resources – some $28 billion spent over the ten years to 2013-14. All this has been at no cost to the budget.

These arguments are presented in a Briefing Paper (see Annexure 1) which we prepared at our own initiative and expense because of concern about the dissemination of incomplete and misleading information about the Baird Government’s plans for further electricity privatisations, and the likely impact on services and future prices for consumers.

While our paper is highly critical of the Baird Government proposals, it also criticises past Labor governments. For example, we refer to the Carr Government’s 1997 effort to sell electricity assets for a claimed $22 billion. Had it succeeded, the state would have missed out on dividends and tax equivalent payments to the Budget in the period up to 2014-15 of $20.2 billion – plus loan guarantee fees, and many billions of dollars in retained earnings. After enjoying these revenues from electricity assets, the state still owns most of them.

In relation to the Iemma-Costa Government’s failed 2008 attempt to sell assets based on claims that $15 billion was needed ‘to keep the lights on’ – the evidence indicates that just $2-$3 billion was needed but not until after 2023-24.

As for the part privatisations pushed through by former treasurer Eric Roozendaal in 2010: the loss of revenues from those sales is shown in the Budget Papers as having ‘a *net negative* impact on the Budget result from 2010-11 to 2014-15 of $347 million’.

Our position is that the Baird proposals for the funding of new infrastructure projects from sales are ‘bad financial management’, since selected projects could be funded by a combination of electricity revenues and borrowings. The Baird Government proposes a 10-year $20 billion project plan meaning an average annual requirement of $2 billion. At current 10 year bond rates, the cost of borrowing an annual $2 billion would be just $60 million in the first year – a fraction of the $1,700 million received in 2013-14 from the network agencies in direct payments to the Budget – let alone loan guarantee fees and retained earnings. Even with their 'curiously conservative reported profits' the three agencies slated for sale have retained earnings of $2.6 billion - an increase in only the past three financial years of $1.03 billion.

And further borrowings at an average of $2 billion per annum would be well within the state's capacity – NSW has an annual Budget of some $70 billion and general government net debt of less than $7 billion or 1.4% of Gross State Product.

We disagree with the Baird Government's claim that electricity prices will soon be much lower as a result of its efforts.

That is because the regulatory regime will still provide network agencies with an overly-generous rate of return on a 'regulatory asset base' that is based on current replacement prices, has been added to by major new investments, and is indexed annually for CPI increases. While the regulator has proposed reductions in the allowable rate of return, prices may fall marginally but will still be much higher than before the regulator's determinations came into effect. Moreover, to anyone with a basic understanding of corporate finance (and the 'capital asset pricing model') and who has taken the trouble to read the AER's draft determinations, it should be clear that the major reason for a reduction in the regulator's approved 'rate of return' is belated acceptance that the 'risk' faced by a public utility subject to price regulation is less than that of the stock market as a whole.

Indeed, it is scandalous that a state government would dare to claim credit for this long overdue adjustment - or to suggest that an 'Electricity Price Commissioner' (Allan Fels) will have a meaningful role in ensuring that privatised electricity businesses do not overstep the AER's (still overly generous) rulings.

On the face of it, the only apparent explanation for privatisation of a highly profitable, natural monopoly that is delivering basic services to the community is an ideological commitment on the part of proponents simply to reduce the size of government.

If the transactions proceed, they will be both bad for the budget and bad for the state.

ANNEXURE 1

Briefing Paper

ELECTRICITY PRIVATISATION: BAD FINANCIAL MANAGEMENT

February 2015

Emeritus Prof Bob Walker & Dr Betty Con Walker
M: 0411 237 672 or 0409 360 453
walkerbob@bigpond.com

Contents

Dr Bob Walker is an Emeritus Professor of Accounting, University of Sydney
Dr Betty Con Walker is an economist and a former Treasury official

SUMMARY

1. INTRODUCTION

Privatisation of the NSW electricity network agencies would be ***bad policy*** and ***bad financial management.***

Proponents have disseminated ***statements that are either wrong in fact or misleading.***

This paper largely focuses on issues of financial management.

2. FURTHER ELECTRICITY PRIVATISATION WOULD DAMAGE STATE FINANCES

The prospect of selling the state's electricity assets has been tempting politicians for decades.

In 1997, Treasurer Egan tried to sell the assets for $22 billion. Had he succeeded, the state would have missed out on dividends and tax equivalent payments to the Budget in the period up to 2014-15 of $20.2 billion – plus loan guarantee fees, and many billions of dollars in retained earnings. At the same time, the agencies were able to fund tens of billions of dollars on renewing infrastructure.

In 2008, Premier Iemma and Treasurer Costa were next to embark on a failed attempt to sell assets based on claims that $15 billion was needed 'to keep the lights on'. Subsequent evidence indicates that just $2-$3 billion was needed but not until beyond 2023-24.

In 2010, Treasurer Roozendaal undertook a part-privatisation which according to the Budget Papers is expected to have a ***net negative*** impact on the Budget result from 2010-11 to 2014-15 of $347 million.

In 2014 the Baird Government proposed the privatisation of the network assets (excluding Essential Energy).

Electricity revenues prop up the Budget

Despite their use of curious accounting, the network agencies have managed to pay dividends and notional taxes to the Budget. Indeed, all other things being equal (see full report), ***without electricity payments to the Budget, the Coalition will have had deficits in each of its four years in office*** – with further impacts in the forward estimate years (even if payments are reduced in the event of the adoption of the Australian Energy Regulator draft determinations).

NSW Budget results 2011-12 to 2017-18: without electricity revenues

	2011-12 Actual $m	2012-13 Actual $m	2013-14 Actual $m	2014-15 Revised $m	2015-16 Estimate $m	2016-17 Estimate $m	2017-18 Estimate $m
Budget result with electricity revenues	660	(1,300)	1,247	272	402	1,096	1,038
Less electricity revenues	1,427	1,790	1,701	1,194	952	946	855
Budget result without electricity revenues	**(767)**	**(3,090)**	**(454)**	**(922)**	**(550)**	**150**	**183**

Notes:1. Electricity revenues are predominantly from network agencies with some small amounts from generation.
2. This table does not include loan guarantee fees paid to Treasury Corporation.

There is also scope for further dividend distributions in future. At 30 June 2014, Ausgrid, Endeavour and TransGrid had nearly $2.6 billion in retained earnings – an increase of $666 million on the previous year, or $1.35 billion in the past two years.

Plainly the loss of relatively stable revenues from the electricity distributors will make the state more reliant on volatile revenues from property taxes.

Electricity agencies have self-funded capital works

One of the arguments for sale (or lease) of the state's electricity assets has been that otherwise the state would face major outlays for system upgrades. In fact, these agencies have comfortably been funding infrastructure upgrades – from their strong and stable operating cash flows plus borrowings – with capital expenditure totaling over $31 billion over the eleven years to 2014-15.

Capital expenditure in the electricity sector: 2004-05 to 2014-15

	2004-05 to 2012-13 $m	2013-14 Revised $m	2014-15 Budget $m	2004-05 to 2014-15 $m
Total	**25,578**	**2,782**	**2,680**	**31,040**

Capital expenditure in the period 2008-13 amounted to $17.4 billion. This in itself thoroughly discredits the claims made in 2008 by Messrs Iemma and Costa that an investment of up to $15 billion was required 'to keep the lights on' (when it wasn't) and that such expenditure was unaffordable (when it was).

Network agencies are highly profitable

Network agencies were more profitable than their 2013-14 accounts show (relative to private sector benchmarks) due to the use of curious accounting. Major upward asset revaluations of depreciable assets have led to increased depreciation charges, which reduces reported profits (the numerator in rate of return calculations). The revaluations also affected 'total assets' and 'shareholders' equity' (the denominator in those calculations). Then in 2013 system assets were revalued upwards on a so-called 'income basis' (an approach that NSW Treasury had argued should not be used for specialised assets where there was no market evidence of 'fair value').

To indicate the effect of these curious accounting practices, their reported results were restated on a private-sector accounting basis. The major adjustment removed the effect of the upward revaluation of system assets. A second adjustment was to use pre-tax profits, since the agencies only pay a notional tax to Treasury.

Network agencies' returns on equity 2013-14
– as reported & recalculated to be consistent with private sector accounting practices

	Reported Return on Equity %	Recalculated Return on Equity %
Ausgrid	**14.1**	**82.8**
Endeavour Energy	**18.2**	**80.8**
TransGrid	**Not reported**	**32.1**

The recalculations show that all of these agencies have been extremely profitable – with Ausgrid and Endeavour earning 'super profits', with returns on equity over 80% per annum.

Yet even those figures are understated, since another appropriate adjustment would have been to add-back the payment of loan guarantee fees to Treasury Corporation. A government document distributed to Coalition MPs and selected journalists identified these payments from the electricity businesses as amounting to $338 million in 2012-13 – or roughly around 20% of the adjusted earnings for all four agencies (including, for this purpose, Essential). The agencies' financial statements did not separately disclose loan guarantee fees but aggregated them with other expenses.

3. BAIRD GOVERNMENT PRIVATISATION PROPOSAL: FALSE AND MISLEADING INFORMATION

Preparing the ground with manipulated (and deficient) financial reports

While there may be merit in periodically revaluing assets held by public utilities, the practices adopted in NSW in 2013 are extraordinary, and do not convey relevant information to users of financial statements. For example, Ausgrid revalued system assets upwards by $2.9 billion on the last day of the 2012-13 financial year without explaining how those book entries had affected reported indicators of profitability.

The Australian Energy Regulator (AER) has advised that it pays no heed to the recent asset revaluations and uses its own (arguably, generous) calculations of a 'regulatory asset base'.

It can be safely concluded that *the 2013 upward asset revaluations were undertaken to disguise trends in the profitability of the state-owned network agencies.*

Claims the state would retain 51% interest when control of three agencies will be lost

The Baird Government announced on 10 June 2014 that it planned a 99-year lease of 49% of the state's total electricity network and distribution assets – with the $20 billion proceeds to be spent on a variety of projects.

This implied that the state would retain ownership and control of these public assets. But this statement was grossly misleading.

Indeed, using the book value of the network agency assets as an indicator of what was to be privatised (and adjusting for the retention of Essential) the state would retain less than a 38% interest in the other three agencies. This interpretation was mentioned to journalists in November and December 2014 (but did not lead to any media comment, at the time).

However the government later issued *Rebuilding NSW – update electricity networks* (18 December 2014) which revealed, for the first time, that the Baird Government intends to privatise 100% of TransGrid, and 50.4% each of Ausgrid and Endeavour Energy.

In other words, contrary to what is implied in announcements by reference to a 49% lease, the proposed privatisation involves disposition of a majority interest of both Ausgrid and Endeavour Energy, and 100 per cent of Transgrid.

Use of Future Fund shifts responsibility for future sales to trustees

The Government claimed that its 51% interest in the total network agency assets would be placed in a new NSW Future Fund. On the face of it, trustees of the Fund could dispose of all or part of those interests without Parliamentary or even government approval. This would enable the Government to insulate itself from responsibility for any future sales by claiming that those decisions were being made by 'independent' trustees.

Confusion: still no details on structure of lease arrangements

While it had claimed that a 51% interest in the total network agency assets would be placed in a new NSW Future Fund, there was no explanation of how the 49% lease would be implemented. Would only some assets be leased? If so, which parts of an integrated system?

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.

But this is speculation. The Baird Government has failed to explain how it will structure these transactions – or explain the consequences of setting up a holding company as lessor.

Exposure to 'real' not notional taxes.

Presently State-Owned Corporations do not pay corporate income taxes to the Commonwealth – only notional taxes to the state Treasury. If the proposed holding company is not wholly owned by the state, then it would be liable for Commonwealth taxes. Indeed, a government document distributed to Coalition MPs and selected journalists acknowledged that the 'lease' arrangement would see a loss to the state of both tax equivalents and loan guarantee fees. Further, in giving evidence before a Senate Committee, a Treasury official agreed the Commonwealth may benefit from such an arrangement – but that the proposed 15% one-off payment to the states was not intended to fully compensate for such a loss of revenues.

Proposal does not add up: the supposed proceeds

The Government's claimed potential proceeds from privatisation of $20 billion is made up of $13 billion of net sale proceeds plus an incentive payment of $2 billion from the Commonwealth plus $5 billion interest to be earned on the sale proceeds.

First, it is not clear what is meant by the reference to $13 billion 'net proceeds' – *net of what*? At 30 June 2014 the assets of the three agencies totalled $29.7 billion (at book value). 49% of that amounts to $14.6 billion. But there are also financial obligations e.g. at 30 June 2014 the three agencies had formal borrowings totalling $15.2 billion. Provisions for accrued employee benefits (including defined benefits superannuation obligations, annual leave, long service leave and workers' compensation liabilities) amount to nearly $1.4 billion.

Questions arise as to how these obligations will affect the sale price and what has been assumed by the Government in announcing $13 billion net sale proceeds. On the face of it, the claimed net proceeds could be after extinguishing the above-mentioned liabilities – implying a sale price (after transaction costs) of $29.6 billion.

Second, the $2 billion supposedly to be received from the Federal Government's asset recycling incentive program is based on 15 per cent of the proceeds of asset sales. According to the COAG *National Partnership on Asset Recycling Agreement* (May 2014) in order for a payment to be made, both the Commonwealth and the relevant state government have to identify the asset(s) to be sold and the project(s) to be funded by 30 June 2016; the sale of the asset(s) must be completed and construction of new infrastructure must commence on or before 30 June 2019. The future of this program is currently in the hands of the Senate.

Third, the $5 billion interest assumed from investing the sale proceeds over 10 years is unrealistic.

If the estimated net proceeds of $13 billion have to be at least partly invested in new infrastructure by 2019 to secure the Commonwealth's $2 billion incentive, then obviously some of those funds would only be earning interest for as little as one or two years. This alone would leave the hypothetical $20 billion bucket of money short by billions of dollars.

It should be noted that the Commonwealth payment will be made in two instalments of 50% – the first when sale processes have commenced and the state government has commenced obtaining planning approvals for the agreed projects. The second payment will only be made when the states have completed the asset sale and commenced construction.

After comments that the hypothetical $20 billion would not cover all of its proposed projects, in December 2014 the Baird Government explained that funds would be reinvested with ‘strong returns’ and not drawn down until needed up till ten years later. An obvious contradiction is that, as noted above, the Federal funds will not be forthcoming in one go and will not be forthcoming unless new infrastructure is commenced by 2019. So if the Government keeps all of the sale proceeds for 10 years to earn $5 billion, it will miss out on the $2 billion Commonwealth subsidy. They cannot spend the proceeds and keep all of them at the same time – any sale proceeds would not be a magic pudding.

Proposal does not add up: claimed cost of new projects

The Baird Government’s June 2014 *Fact Sheet* claimed that the proceeds from privatisation would be used to fund ‘investment in public transport, roads, water, hospitals, schools and other projects that improve services, increase opportunity and grow the economy’. Commentary suggested that these projects would cost around $31 billion – far more than the heralded $20 billion proceeds of the part privatisation (which include unrealistic assumptions about interest to be earned from investment of the proceeds).

Then a document issued last November, *Rebuilding NSW: State Infrastructure Strategy 2014,* included a detailed list that emphasised moneys to be spent on roadworks (e.g. $2.4 billion on urban roads, $3.7 billion on a rural freight corridor, and fixing country roads and bridges).

Perhaps inevitably, some commentary pointed out the folly of selling profitable assets to pay for infrastructure that did not produce a financial return – wouldn’t it be better to keep the electricity agencies and use their earnings to fund other projects? So in December 2014 a new version of proposed projects was issued with a different description of projects and costings. The June 2014 version had included Sydney Roads Renewal – major projects to key arterial routes across Sydney, including in Southern Sydney, the West and Northern Beaches. The November version had a different listing for urban roads. The December version, without any explanation, dropped direct reference to Sydney Roads Renewal. And, to further ‘vague it up’, in this December list sums that in June had been promised for several projects totalling $7.4 billion were now not to be spent but only ‘reserved’.

Given that the Baird Government has chosen to make the 2015 election virtually a referendum on the privatisation of the ‘poles and wires’, the community should be told exactly what projects are being proposed and what each is expected to cost, together with a realistic assessment of potential proceeds.

Claims about a ‘lease’ are misleading: ‘lease’ soon becomes a ‘sale’ and a partial sale turns into a full sale

The suggestion that assets would be ‘leased’ implies that the state will retain the risk and benefits of ownership. In practice, a long-term lease does no such thing (international accounting practice is to treat such an arrangement as a ‘sale’).

Experience has shown that long-term leases become outright sales when no-one is looking. One example is the Old Treasury Building, now part of the InterContinental

Hotel in Macquarie Street which was initially leased for 99 years, only to have the freehold transferred a few years later, when public interest had evaporated.

As for part sales, they can soon become full blown sales. One example is the purported part sale of Telstra by the Howard Government which soon became a full sale.

Claims that prices inevitably fall with privatisation are misleading

The Baird Government has cited a report from Ernst & Young as authority for its claim that network prices for typical customers in Victoria and South Australia have fallen in real terms since becoming privately owned – while NSW network prices have significantly increased over the past decade. This involved selective quotation and a disregard for the facts.

The E&Y report actually stated that 'various factors can and do contribute to the discrepancy (e.g. the starting position in respect of price levels, the age of the assets and therefore the need for investment, service standards etc.).' It noted that the networks in NSW and Queensland have invested particularly heavily in their networks, and added:

> In contrast, the businesses in Victoria are approaching a stage in their life cycle which may require substantial further investment. South Australia may also have recently entered a similar stage in their investment life cycle as is the case in Victoria.

In other words, Victoria and South Australia can expect to experience increased electricity prices once local operators undertake a necessary investment program.

Impact of price regulation

The Baird Government has claimed that

> electricity network prices and household bills are on their way down in NSW and will continue to fall as a result of the [Australian Energy Regulator] determination.

Pricing is regulated by the AER (previously by NSW's IPART). The AER determines the value of a defined 'regulatory asset base' (RAB) – and allows agencies to earn a rate of return on their RAB. Consequently substantial capital expenditure in NSW and Queensland has been reflected in increased electricity prices.

It is well recognised in the economic literature that firms subject to 'rate of return regulation' face incentives to over-invest in capital works. That is because the higher a firm's asset base, the higher the returns a regulator will allow that firm to enjoy by charging higher prices.

The AER has only recently indicated that it will restrict additions to the RAB to what is regarded as 'efficient' investment. This may be a case of closing the stable door after the horse has bolted. It also can be interpreted as an acknowledgement or admission that some past spending has been 'inefficient'.

This AER intervention would only affect the treatment of post-2014 capital expenditure. Balances of the RAB would remain in place and continue to be indexed from year to year in line with changes in the CPI, reduced by depreciation charges. Since system assets are being depreciated over long periods – apparently 50 to 60 years – annual depreciation charges would be maintained in ‘real’ terms at close to current levels. Those charges would translate into a component of the ongoing costs that the network agencies are allowed to recover, over the life of those assets.

What may have a greater effect is that the AER has lowered the rate of return that network agencies can enjoy after 1 July 2015. The AER’s draft determination for Ausgrid, for example, has lowered the return (supposedly based on Ausgrid’s ‘weighted average cost of capital’) from 10.02 per cent to 7.15 per cent.

It is a bit of a stretch to claim that ‘electricity network prices and household bills are on their way down in NSW and will continue to fall as a result of the AER determination’.

Electricity prices will continue to be determined by a regulatory regime that provides network agencies with a rate of return that arguably is overly generous. Hence the AER’s recent determination can be interpreted as ensuring that electricity prices will remain high (after increases of 80% or more). Prices may soon fall marginally but will still be much higher than before the AER’s determinations came into effect.

4. BAIRD GOVERNMENT PRIVATISATION IS UNNECESSARY

Mr Baird has made the absurd claim that his 10 year $20 billion project plan

> is only possible with the proceeds generated by recycling capital locked up in the electricity networks (*Rebuilding NSW*, December 2014, page 1).

That is just not true. The state could borrow (or use a combination of borrowing and own-source revenues). In June 2014 NSW had general government net debt of $6.869 billion or just 1.4 per cent of Gross State Product (GSP). That level of state net debt is miniscule in comparison to those of many developed countries in the OECD with an average of net debt to Gross Domestic Product of over 70%.

NSW’s current level of debt is highly manageable on annual budget revenues of around $70 billion. Net debt is expected to be $9.3 billion in June 2015 and $10.7 billion by 2018 or just 1.8 per cent of GSP (which is forecast at $601 billion).

Adding an average $2 billion per annum borrowings would mean that the state’s debt levels would continue to be manageable.

According to TCorp, if the Government was to borrow funds right now, ***the 10-year bond rate is 2.90%.*** On this basis, the annual interest on $2 billion would be less than $60 million – a fraction of the revenues expected to be earned from the remaining electricity agencies.

5. ELECTRICITY PRIVATISATION IS NOT IN THE PUBLIC INTEREST

Developments since the 2010 part-privatisation of the state's electricity assets have confirmed the folly of privatising valuable and profitable assets that operate as natural monopolies.

Payments to the Budget, even after the part-privatisation of electricity assets, confirm that retention of the profitable network agencies is not only affordable but financially prudent. If the privatisation of Essential Energy is not a good deal for rural New South Wales then surely the privatisation of the other electricity assets cannot be good for the rest of the state.

Further electricity privatisations would not be in the best financial interests of the state. Nor would they be in the best interests of the NSW community with the potential for investors to try to cut costs, leading to poor reliability, while reducing services and increasing prices.

ELECTRICITY PRIVATISATION: BAD FINANCIAL MANAGEMENT

1. INTRODUCTION

Australian governments have long engaged in a diverse range of business activities – often because of ‘market failure’. Without government involvement, the country would not have developed systems for water harvesting, treatment and distribution; and it would not have developed systems for the distribution of electricity.

We have previously argued that there may no longer be a case for government involvement in some activities, and that funds released from privatisation could be re-invested to meet new needs.[1] But we did so by adopting a view about the ***role of government***. We expressed disappointment that political leaders have avoided articulating their vision about the role of government, but continue debating the merits or otherwise of privatising the latest target – without reference to overall objectives.

Our views about the role of Commonwealth or state governments were expressed as follows:

> ... the primary activities of government are to promote national security, public health and public safety; to ensure the maintenance of law and order, and the equitable treatment of citizens; to provide basic support for those unable to look after themselves; ***to provide basic infrastructure (for water, waste water, energy distribution and transport);*** to ensure equitable access to education; to ensure that markets work effectively and fairly (and to ensure that the community is not exploited by monopolies); and, in order to maintain and develop our democratic institutions, to ensure that information and diversity of opinion can be freely disseminated within the community (page 279, emphasis added).

From that perspective, the Baird Government’s June 2014 announcement of its intention to take to the next election a proposal for a 99-year lease of 49 per cent of the state’s total electricity network and distribution assets (hereafter, ‘network agencies’) – the so called ‘poles and wires’ – would seem to involve the abandonment of one of the state’s core responsibilities. The only rationale provided for the privatisation of a natural monopoly providing basic services to the community has been that the funds so released could be

---

[1] Walker and Con Walker, *Privatisation: sell off or sell out?*, ABC Books, 2000, and republished with a *New Introduction* by Sydney University Press, 2008.

spent on an (ever changing) list of projects that are, supposedly, electorally attractive.

If one adopts a view about the role of government similar to that outlined above, the Baird Government's proposals represent ***bad policy***.

However this paper has a different focus.

It points out that proponents of further electricity privatisation have disseminated ***statements that are either wrong in fact or misleading.***

It explains that privatisation of the NSW electricity network agencies would constitute bad ***financial management.***

2. FURTHER ELECTRICITY PRIVATISATION WOULD DAMAGE STATE FINANCES

2.1 The prospect of selling the state's valuable electricity assets has been tempting politicians for decades

Earlier privatisation attempts

Electricity privatisation was first mooted in May 1997 by Treasurer Egan when he proposed selling the assets for $22 billion. Had he succeeded, the state would have missed out on dividends and tax equivalent payments to the Budget in the period up to 2014-15 of $20.2 billion – plus loan guarantee fees, and many billions of dollars in retained earnings. At the same time, the agencies were able to fund tens of billions of dollars on renewing infrastructure.

In 2008 Premier Iemma and Treasurer Costa claimed that the state needed to invest almost immediately up to $15 billion on infrastructure 'to keep the lights on' – and claimed this was not affordable. The premise of that claim was simply wrong. First, it has become evident that any such investment would only be $2-$3 billion – a fraction of the $15 billion quoted – and it would not be necessary until beyond 2023-24.[2] Second, investment at that rate was already being made, and was mainly funded by the electricity industry's operating cash flows supplemented by its own borrowings – not from the state Budget. In fact, investments in electricity infrastructure have produced increased revenues since regulatory arrangements provide for the agencies to earn a prescribed rate of return on past spending on capital works ('the regulatory asset base').

Negative budget impact of December 2010 part-privatisation

Then on 14 December 2010, just months out of the state election, Treasurer Roozendaal undertook the first part-privatisation of public electricity assets as follows:

- the retailing arms of Country Energy and Integral Energy, along with the Generation Trading Agreement (Gentrader Agreement) for Eraring power station, were acquired by Origin Energy for an aggregate of $3,250 million;

---

[2] The Australian Energy Market Operator (AEMO) predicted that in NSW the Low Reserve Condition point - when additional investment in generation or demand-side response may be required to maintain electricity supply reliability – would now be beyond 2023-24 (*2014 Electricity Statement of Opportunities for the National Electricity Market,* August 2014, pp. 1, 6, 16-17).

- the retailing arm of Energy Australia, the Gentrader Agreement for Delta Electricity's Mt Piper and Wallerawang power stations, and development sites at Mt Piper and Marulan were acquired by TRUenergy for an aggregate of $2,035 million (*2011-12 Budget Paper No. 2*, p. 8-9).

The Bamarang power station development site was sold to Infatil for $9 million in February 2011.

It will be recalled that there was a lack of clarity as to the financial costs and benefits to the state of the Roozendaal 2010 part-privatisation. The 2011-12 Budget outlined what it described as 'the revised impact of the transactions on the Budget result over the period from 2010-11 to 2014-15'. It concluded that – arising from the 2010 part-privatisation – in the period to 2014-15, there will be ***a negative impact on the Budget result of $347 million*** (see table below).

Table 1
NSW Budget results impact of 2010 part-privatisation of electricity assets

Budget result impact	2010-11 $m	2011-12 $m	2012-13 $m	2013-14 $m	2014-15 $m	Total 2010-11 to 2014-15 $m
Reduction in Interest Expenses @ 6%	75	233	244	259	273	1,084
Loss of Financial Distribution and Government Guarantee Fees	(51)	(317)	(252)	(106)	(106)	(832)
Availability Liquidated Damages, Separation Costs and Other Costs	(61)	(4)	(174)	(138)	(224)	(600)
Budget Impact	**(37)**	**(88)**	**(181)**	**15**	**(57)**	**(347)**

Source: *2011-12 NSW Budget Paper No. 2,* p.8-10.

The second and third lines in the table above show the loss of revenues to the general government sector arising from the privatisation transactions, totaling $1,432 million over five years. The first line reflects the consequences of another transaction – the returns supposedly to be received from re-investment of the proceeds to earn 6 per cent per annum (an earlier version of this table showed expected returns at the rate of 8.6 per cent, and was given the misleading description of 'reduction in superannuation expenses').

The NSW Budget Papers are presented in six volumes – plus a 'Budget Overview' – and it is no surprise that journalists and commentators working to meet deadlines don't always identify issues that are buried in the detail (especially when the Budget Overview focuses on the Government's chosen message of the day).

When the 2011-12 NSW Budget was brought down on 6 September 2011 neither Premier O'Farrell nor Treasurer Baird highlighted the fact that, in the period to 2014-15, the Roozendaal part-privatisation was expected to have a ***net negative*** impact on the Budget result of $347 million.

Other negative impacts of the part-privatisation on the state included the commitments related to the Cobbora Coal Mine. At the time of the 2011-12 Budget, brought down on 6 September 2011, the Budget Papers stated that the Cobbora Coal Mine commitments had 'a negative net present value to the state of approximately $300 million' (p. 8-12).

Coalition's privatisation proposal

The Coalition has shown that it has learnt nothing from the past as it has continued on the privatisation path. First, by completing (or is in the process of completing) the sale of the remaining generation assets. Second, by now trying to privatise the state's network agencies.

However, arguably the National's have recognised that privatisation of Essential Energy would be damaging and have insisted on its retention - only supporting Mr. Baird's proposals because of promises that part of the proceeds of the latest proposal would be diverted to benefit regional electorates.

Yet it will be recalled that when the Iemma and Keneally Governments proposed the sale of electricity assets they suggested that the funds would be reinvested in railway infrastructure (which doesn't make a profit for government). The Baird Government's plans are similar in that the aim is to replace electricity assets with non-profit making assets and, in the process, affect Budget outcomes as outlined below.

2.2 Electricity revenues prop up the Budget

The remaining state electricity businesses continue to support the Budget through dividends and tax equivalent payments. The 2014-15 Budget Papers show that ***in the period 2012-13 to 2017-18, the state Budget was expected to receive some $7.075 billion from electricity agencies, with most - $6.956 billion coming from network agencies.*** Following higher than expected payments of $1.701 billion in 2013-14, on the basis of the Budget data, the total would actually be ***$7.438 billion***.

Table 2
Dividends and tax equivalent payments from electricity agencies, 2012-13 to 2013-18

	2012-13 Actual $m	2013-14 Actual $m	2014-15 Budget $m	2015-16 Estimate $m	2016-17 Estimate $m	2017-18 Estimate $m	2013 to 2018 $m
Dividends							
Generation	30		27	11	8	41	
Distribution & transmission	1,098		848	635	629	469	
Total	**1,128**	**872**	**875**	**646**	**637**	**510**	**4,668**
Tax Equivalents							
Generation	43		(5)	(4)	2	48	
Distribution & transmission	619		324	310	307	297	
Total	**662**	**829**	**319**	**306**	**309**	**345**	**2,770**
Dividends & Tax Equivalents							
Generation	73	24	22	7	10	89	
Distribution & transmission	1,717	1,677	1,172	945	936	766	
TOTAL	**1,790**	**1,701**	**1,194**	**952**	**946**	**855**	**7,438**

Source: Based on data presented in *2014-15 Budget Paper No. 2*, p. 6-27, *Report on State Finances 2013-14*, p. 4-2, and Auditor-General's *Report to Parliament Volume Five 2014 focusing on Electricity and Water*, 11 November 2014.

According to the 2014-15 Budget Papers, the reduction in payments over the forward estimates were said to arise from 'a decline in network electricity revenues as rates of return decline, and more efficient cost management and reduced capital programs flow through to lower regulated prices and earnings' (p. 9-6).

As discussed below, in its *2014-15 Half-Yearly Review*, the Government reduced the forward estimates figures further on the presumption of the implementation of Australian Energy Regulator (AER) draft determinations released on 27 November 2014.

Electricity agency payments have been important to the Budget for many years. As noted above, in May 1997, then Treasurer Michael Egan proposed the privatisation of the state's electricity assets for estimated proceeds of $22 billion. That proposal failed and from that time until 2013-14, electricity dividends and tax equivalent payments made to the state Budget totaled $19 billion. Adding payments expected in the current budget year, means that ***since electricity privatisation was first mooted in 1997 payments to the Budget from 1997-98 to 2014-15 will total $20.2 billion*** and that is after the part-privatisations undertaken since 2010. To these payments should be added loan guarantee fees paid to the Government's Treasury Corporation. Moreover, all these payments are in addition to the earnings retained by the agencies.

Table 3
Dividends and tax equivalent payments from electricity agencies, 1997-98 to 2014-15

	1997-98 to 2011-12 $m	2012-13 Actual $m	2013-14 Actual $m	2014-15 Budget $m	1997-98 to 2014-15 $m
Dividends					
Generation		30		27	
Distribution & transmission		1,098		848	
Total	**9,565**	**1,128**	**872**	**875**	**12,440**
Tax Equivalents					
Generation		43		(5)	
Distribution & transmission		619		324	
Total	**5,945**	**662**	**829**	**319**	**7,755**
Dividends & Tax Equivalents					
Generation		73	24	22	
Distribution & transmission		1,717	1,677	1,172	
TOTAL	**15,510**	**1,790**	**1,701**	**1,194**	**20,195**

Source: Based on data presented in various Budget Papers for 1997-98 to 2011-12, *2014-15 Budget Paper No. 2*, p. 6-27, *Report on State Finances 2013-14*, p. 4-2, and Auditor-General's *Report to Parliament Volume Five 2014 focusing on Electricity and Water*, 11 November 2014.

Importantly, while the state has benefitted from the payments from these agencies, it had retained all these valuable assets in public hands – until 2010 when the part- privatisation process began.

2.3 Budget results without electricity payments

All other things remaining equal, if the state was not receiving revenues from the electricity agencies, then the Budget results would have been as shown in the table below. ***Without the electricity contributions to the Budget, the Coalition will have recorded deficits in each of its four years in office*** – with further impacts in the forward estimate years.

Table 4
NSW Budget results 2011-12 to 2017-18: Impact of loss of electricity revenues

	2011-12 Actual $m	2012-13 Actual $m	2013-14 Actual $m	2014-15 Revised $m	2015-16 Estimate $m	2016-17 Estimate $m	2017-18 Estimate $m
Budget result with electricity revenues	660	(1,300)	1,247	272	402	1,096	1,038
Less electricity revenues	1,427	1,790	1,701	1,194	952	946	855
Budget result without electricity revenues	**(767)**	**(3,090)**	**(454)**	**(922)**	**(550)**	**150**	**183**

Note: Electricity revenues are predominantly from network agencies with some small amounts from generation. This table does not incorporate any hypothetical revenues (or savings in expenses) associated with the proceeds of *future* privatisations being reinvested or used to repay debt – though such returns would be modest.
Source: Based on data presented in *2013-14 NSW Budget Paper No. 2,* p. 1-3, *2014-15 NSW Budget Paper No. 2, Report on State Finances 2013-14*, p. 4-2, Auditor-General's *Report to Parliament Volume Five 2014 focusing on Electricity and Water*, 11 November 2014, and the *2014-15 Half-Yearly Review*, 18 December 2014, p. 11.

Perhaps in an attempt to downplay the revenues received from the electricity agencies, in its *2014-15 Half-Yearly Review*, the Government referred to a downward revision of dividends and cash equivalent payments primarily reflecting 'the impact of the Australian Energy Regulator (AER) draft determinations released on 27 November 2014' and stating that the 'draft determinations propose a lower Weighted Average Cost of Capital (WACC) allowance and reductions in network operating and capital costs that can be charged to customers'. Yet, as discussed below, the AER will continue to allow the network agencies to earn a prescribed rate of return (albeit somewhat reduced) on the major investments undertaken by those agencies as part of a substantially-completed five-year capital program

Using the 'potential' changes in the regulatory WACC, the Government revised the 2014-15 Budget Paper figures on dividends and tax equivalents expected from the electricity agencies in the forward estimates.

However, even taking account of these 'possible' changes the loss of these assumed lower electricity revenues would still be missed from the Budget bottom line as shown below.

Table 5
NSW Budget results 2011-12 to 2017-18: Impact of loss of electricity revenues

	2011-12 Actual $m	2012-13 Actual $m	2013-14 Actual $m	2014-15 Revised $m	2015-16 Estimate $m	2016-17 Estimate $m	2017-18 Estimate $m
Budget result with electricity revenues	660	(1,300)	1,247	272	402	1,096	1,038
Less Electricity revenues	1,427	1,790	1,701	1,194	736	642	407
Budget Result without electricity revenues	**(767)**	**(3,090)**	**(454)**	**(922)**	**(334)**	**454**	**631**

Note: Electricity revenues are predominantly from network agencies with some small amounts from generation.
Source: Based on data presented in *2013-14 NSW Budget Paper No. 2,* p. 1-3, *2014-15 NSW Budget Paper No. 2, Report on State Finances 2013-14*, p. 4-2, Auditor-General's *Report to Parliament Volume Five 2014 focusing on Electricity and Water*, 11 November 2014, and the *2014-15 Half-Yearly Review*, 18 December 2014, p. 11.

Obviously on the basis of the 49 per cent Baird privatisation proposal the Budget impact would be less than shown above after any future privatisations.

However, details on the proportion of dividends (or revenues from 'leasing') that would be retained by the state are still unclear.

The above suggests that the state cannot afford to sell its remaining electricity assets and depend on volatile sources of revenue such as property taxes. One year of good property stamp duties cannot be relied upon to continue – with commentators already indicating that the mini-property boom recently experienced in the Sydney region is not expected to continue for much longer.

Revenues from the electricity agencies have become even more crucial to the state following recently announced Federal Government cuts in health and education funding.

Note that the above figures ignore the possibility of returns from re-investment of proceeds in other projects (though as noted above, they may not be contributing revenues to the Budget), or the financial effect of reducing borrowings (though the network sale is proposed to fund other assets – not reduce debt). But any interest revenues are likely to be far less than the returns that could be received by the Budget from dividends and tax equivalents. Moreover, 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 assets. In any event, Tables 4 and 5 only reflect the financial impact of privatisation on the general government sector bottom line, and ignore undistributed profits retained within electricity agencies to sustain on-going investment (as discussed below).

2.4 Electricity agencies' retained earnings

The payments to the Budget by the electricity agencies do not tell the whole story about their profitability since they also retain part of their earnings. In the case of the network agencies, as shown in the table below, ***as at 30 June 2014, these agencies had nearly $2.6 billion in retained earnings – an increase of $666 million on the previous year, or $1.35 billion in the past two financial years.***

Table 6
Network agencies' retained earnings 2012 to 2014

	30 June 2012 $m	30 June 2013 $m	30 June 2014 $m	Increase 2012-14 $m
Distribution Networks				
Ausgrid	500.8	799.2	1,087.3	**586.5**
Endeavour Energy	199.1	322.9	457.9	**258.8**
Essential Energy	515.6	656.7	832.0	**316.4**
Total	**1,215.5**	**1,778.8**	**2,377.2**	**1,161.7**
Transmission Network				
TransGrid	-	119.5	187.6	**187.6**
TOTAL	**1,215.5**	**1,898.3**	**2,564.8**	**1,349.3**

Note: In 2011-12, TransGrid extinguished its retained earnings by declaring a dividend of $146 million.
Source: Annual Reports of the nominated agencies.

Adjusting for the retention of Essential Energy, that means that the retained earnings of the three agencies slated for privatisation increased in the past three financial years by $1.03 billion. Those are *reported* retained earnings:

as noted later in this paper, the accounting methods used by these state agencies significantly understated their reported profits (principally via writing up depreciable assets) relative to what might be expected of listed public companies.

It is of interest that the 2014-15 Budget Papers refer to retained profits in the following terms:

> Over the last few years, several government businesses with regulated prices and revenues have built up retained profits as a result of lower capital requirements and operating efficiencies, causing several businesses to have inefficient balance sheets (*2014-15 Budget Paper No 2*, p. 9-6).

Accordingly, the Government 'has moved to improve the capital structures of these businesses' and stating that this 'will assist to move the capital structures of TransGrid, Sydney Water and Sydney Catchment Authority closer to regulatory expectations and private sector practice … This will result in additional dividends in 2014-15' (p. 9-7).

Some of the electricity businesses (notably Ausgrid) are already highly-geared. But it is curious that while some politicians refer to a 'debt crisis' and suggest that 'debt is bad', the Baird Government's own Budget Papers suggest that higher levels of debt by government businesses can produce a 'more efficient' balance sheet.

2.5 Electricity agencies have self-funded capital works

Strong and stable cash flows from electricity operations have comfortably enabled capital expenditure in the electricity sector of nearly $26 billion over the nine years to 2012-13 as shown below.

Table 7
Capital expenditure in the electricity sector: 2004-05 to 2012-13

	2004-05 $m	2005-06 $m	2006-07 $m	2007-08 $m	2008-09 $m	2009-10 $m	2010-11 $m	2011-12 $m	2012-13 $m	2004-05 to 2012-13 $m
Total	**1,408**	**1,762**	**2,314**	**2,709**	**3,768**	**3,355**	**3,363**	**3,605**	**3,294**	**25,578**

Source: Various *Budget Papers*.

The electricity sector had managed to spend $17.4 billion in the period 2008-13 – a fact discrediting the claims made in 2008 by then Premier Iemma and then Treasurer Costa that an investment of up to $15 billion was required 'to keep the lights on' (when it wasn't) and that it was unaffordable (when it was).

As noted in previous Budget Papers, funding of any new capital expenditure is through 'a mix of operating surpluses and net debt' (*Budget Paper No. 2, 2011-12*, p. 8-12, p. 8-14) and has no impact on the Budget.

According to the 2014-15 Budget Papers, electricity sector capital expenditure from 2013-14 to 2017-18 is expected to total nearly $13 billion as shown in the table below. It is unclear as to whether this expenditure will proceed in the event that the part privatisation of 49 per cent of the network assets occurs – or who will be responsible for it.

Table 8
Capital expenditure in the electricity sector: 2013-14 to 2017-18

	2013-14 $m	2014-15 Budget $m	2015-16 Estimate $m	2016-17 Estimate $m	2017-18 Estimate $m	2013-14 to 2017-18 $m
Total	**2,782**	**2,680**	**2,608**	**2,376**	**2,340**	**12,786**

Source: *2014-15 Budget Paper No 2*.

In any case, the state's taxpayers (not private sector or overseas government purchasers) should be the beneficiaries of improved infrastructure resulting from such significant expenditure – past and future.

Typically, electrical infrastructure has an operating life of about 40 to 50 years so much of that equipment has needed to be replaced (*2012-13 Ausgrid Annual Report*).

The network and distribution agencies are currently in their final year of a five-year investment program to upgrade or renew infrastructure due for replacement. For example, in the case of Ausgrid which supplies electricity to more than 1.64 million customers in Sydney, the Central coast and the Hunter Region, major zone substations were built in the 1960s and 1970s and another 20 per cent were built in the 1950s or earlier. According to its *2012-13 Annual Report*, it expected that, by the end 2014, it will have largely completed major network investments that were needed to cater for electricity use, in particular peak demands for power. Its plan is then to shift capital expenditure from peak-demand driven projects to replacing assets so as to maintain network reliability.[3]

The latest Budget Papers concede that the electricity sector is at the end of a peak capital investment period and that there will be some reduction in capital expenditure due to reform initiatives and the subdued energy demand forecasts (*2014-15 Budget Paper No. 2*, p. 9-9).

2.6 Network agencies are highly profitable

It is no surprise that that there is a potential market for the state’s electricity assets since they are highly profitable.

The network agencies slated for sale are even more profitable than their accounts show due to curious accounting used to understate that profitability – particularly since 2013.

[3] This means that the business has an appropriate plan in place to avoid the reported danger of cables failing by the summer of 2018 (*The Sun-Herald*, 15 June 2014).

In their 2013 audited financial reports, the NSW network agencies enjoyed high returns on assets and equity as shown in Table 9 below. According to key financial indicators highlighted in their reports, these businesses reported returns on assets ranging from 5.7% to 10.9% per annum and returns on owner's equity of 5.8% to 23.2% per annum.

Table 9
Network agencies' returns on assets and equity 2013 – as reported

	Return on Assets %	Return on Equity %
Distribution Networks		
Ausgrid	10.9	23.2
Endeavour Energy	10.3	20.2
Essential	10.8	18.7
Transmission Network		
TransGrid	5.7	5.8

Source: Annual Reports of the nominated agencies.

These rate of return figures are understated, relative to how private sector firms calculate profits. In broad terms (and as discussed in more detail below), that is because listed public companies do not revalue their depreciable assets upwards, since the effect of increased depreciation charges is to reduce reported profits.

It should be noted that the returns recorded in Table 9 are based on profits after payment of 'tax equivalents' to the state government. State-owned corporations are not subject to Commonwealth tax, and these 'tax equivalents' are only notional figures. Accordingly, the actual returns to the state were higher. For example, in Ausgrid's case, by $293.1 million, giving a 2013 pre-tax profit of $999.3 million. A better indicator of the contribution of these agencies to the state would be to use 'profit before [notional] income tax'.

Counting these notional taxes as part of the returns from the network agencies is important since (as explained below) proposals for even part-privatisation will not only see the loss of these revenues but also mean that the partly-owned businesses will have to pay 'real' taxes to the Commonwealth.

The same could be said for loan guarantee fees 'as assessed by NSW Treasury' – sums also paid to the state government and hence ultimately included in the budget results. But these were not separately reported and only included as part of Ausgrid's 'interest and finance charges' of $606.9 million.

But before considering the effect of this adjustment, turn to Table 10 and it will be seen that Ausgrid's rate of return on assets and on equity (based on after tax profits) dropped substantially in the following year.

Table 10
Network agencies' returns on assets and equity 2014 – as reported

	Return on Assets %	Return on Equity %
Distribution Networks		

Ausgrid Endeavour Energy Essential	8.5 8.7 8.6	14.1 18.2 14.5
Transmission Network TransGrid	Not reported	Not reported

Source: Annual Reports of the nominated agencies.

It should be noted that comparisons of the performance of the distributors are hazardous because of differences in the way reported indicators are calculated. For example, even though they had a common chairman and CEO, Ausgrid calculated returns using 'after tax profits', while Essential Energy used 'earnings before interest and taxes'.

While Ausgrid's reported after tax profits were lower in 2014 (2013: $706.2 million; 2014 $607.5 million), that could not in itself explain such a major reduction in Ausgrid's returns - a fall in the rate of return on equity from 23.2% in 2012-13 to a 2013-14 figure of only 14.1%.

Why such a change?

The answer may be found from two items in the fine print of Ausgrid's 92-page 2013 report. The first explained that ***Ausgrid had revalued its system assets upwards by $2.9 billion during the year ended 30 June 2013.*** Actually ***that revaluation was booked on the last day of the 2012-13 financial year*** (p. 7). The second was in a footnote to a table in an appendix to the financial statements on page 89: return on equity was calculated on 'average equity'.

Upward revaluations of 'system assets' have two effects on reported profitability. First, they lead to increases in depreciation charges, which affect the numerator in these 'rate of return' calculations. Second, they increase the reported value of assets and the reported value of equity – the denominator in the calculations. The fact that the revaluation was only booked on the last day of the 2012-13 financial year meant that the effect on depreciation charges and hence on reported profit would have been minimal in that year. Similarly, booking an upward asset revaluation on the last day of the financial year would mean that the revaluation would have a minimal effect on the 'average equity' calculations since the increase was only in place for one day out of 365.[4] But for the following year, the effect would be to substantially reduce reported returns.

To estimate the effect of these accounting changes, one would usually start by looking at Ausgrid's accounting policies for depreciation. But Ausgrid only disclosed that it was depreciating its system assets over between one to 70 years (*2014 Annual Report*, p. 35), and that the 70 year period only related to recently capitalised expenditure on two cable tunnels, not to pre-existing system assets. The reader is thus 'informed' that the bulk of the system

[4] Such an exercise is reminiscent of the manner in which during the 1980s Christopher Skase's Qintex repeatedly issued new shares on the last days of a financial year, which enabled Qintex-calculated 'earnings per share' – based on 'average' shares on issue throughout the year not those on issue at year end – to present a rosy picture (until Qintex ran out of cash).

assets were being depreciated over a period that could be between one and 69 years. Hardly useful.

Hence one needs to use other, crude estimation techniques.[5] In the absence of more informative disclosures, it was assessed that the $2.9 billion write-up added around $130 million in depreciation in 2013-14, and hence reduced reported profits by the same amount.

The effect of these adjustments is startling – and suggests that Ausgrid (and other electricity agencies) may have sought to understate their profitability at a time of consumer concern about rising prices.

If Ausgrid had used private sector accounting methods (and if notional 'tax equivalents' were counted as part of the state's returns), it would have reported higher profits and rates of return. It appears that Ausgrid's calculations of returns were based on 'averages' of assets and equity at the beginning and end of the financial year. A few lines in the notes accompanying the financial statements enable adjustments to a 'private sector' accounting basis:

> The carrying amount of assets had they been carried under the historic cost model is:
> Land and buildings $458.3 million (2013: $516.4 million)
> System assets $11,149.8 million (2013: $10,696.4 million)
> (page 48).

No one would quarrel with the use of updated values for readily saleable assets such as land and buildings. But the valuation of 'system assets' is more problematic. A comparison of data in this note with the book values of system assets indicates that total upward asset revaluations exceeded the $2.9 billion recorded on the last day of 2012-13 – aggregate upward revaluations were $3.2 billion (2013) and $3.3 billion (2014).

Recalculations of reported returns produce some startling figures. ***A return on investment of around 83% is astonishing.***

Table 11
Ausgrid's return on equity 2013-14

	As reported	Recalculated
2012-13	23.2%	27.9%

[5] Ausgrid disclosed that it was writing off buildings over 40 years, and 'plant and equipment' over three to 25 years. If the $2.9 billion revaluation of system assets was to be written off on a 'straight line' basis over 40 years that would have increased depreciation charges (and reduced reported income) by around $72.5 million per annum. If over 25 years, the effect would have been to reduce reported income by around $116 million per annum; over 20 years, it would have been around $145 million per annum. As a cross check, Ausgrid's depreciation on system assets increased from $327.8 million in 2013 to $463.4 million in 2014 – an increase of $135.6 million. That implies that the assumed useful life of the assets was closer to 25 years than 40. An adjustment was also made for the fact that the increase in depreciation in 2013-14 would have included depreciation on $805 million worth of additions undertaken in that year. Similar estimates were made for 2012-13.

2013-14	14.1%`	82.8%

Note: Based on 'average' of opening and closing balances of equity, after adjustment for upward asset revaluations of system assets, and using 'profit before tax' (given that 'tax equivalents' were payable to NSW Treasury) but excluding loan guarantee fees as they were not disclosed. It was considered that the use of 'tax effect accounting' by Ausgrid would not materially affect these indicators.

If nothing else, these recalculations suggest that Ausgrid's upward revaluation of system assets by $2.9 billion on the last day of 2012-13 was designed to ensure that its financial reports would not show the extent or trends in its profitability. Recall that at that time, consumers and media were expressing concerns about increasing energy prices.

The basis of these revaluations on an 'income approach' will be examined further below. But it should be noted that Ausgrid's 2012 financial statements disclosed that Ernst & Young had been engaged to apply this method of valuing system assets (which involves calculating the present value of future cash flows) and concluded that the then-book values 'did not differ materially to the discounted cash flow' (2012 report, p. 35) – then $10.4 billion.

That report was signed by the CEO and chairman in September 2012. By 30 June 2013 – just over nine months later – a newly-appointed CEO and chairman decided that system assets were understated by no less than $2.9 billion. Apparently this valuation was undertaken in-house by Ausgrid employees.

It is also noteworthy that Ausgrid was able to generate such high returns on equity because of its capital structure. Against reported equity of $4.4 billion (or the adjusted equity figure estimated here of $1.2 billion) Ausgrid had total liabilities at 30 June 2014 of $11.8 million. While a high debt to equity ratio might be regarded as hazardous in many situations, plainly Ausgrid was in a position to earn more on its assets employed than it was paying in interest on borrowed moneys (even after Treasury's loan guarantee fees which were designed to eliminate the effect that government agencies can borrow at lower interest rates than private sector firms).

This places in perspective much of the political debate about the 'evils' of public sector debt, and references to 'debt disasters' and the need for 'budget repair'. Successive governments have been happy to borrow to fund investment in infrastructure by government businesses (in the 'non-financial public trading enterprise sector'). Yet according to some commentators, borrowing to fund investment in infrastructure within the 'general government sector' is inappropriate.

Ausgrid was not alone in booking upward revaluations of system assets – so too did Endeavour.

In 2014 Endeavour disclosed total reserves of $927.4 million, but did not provide details of the nature of these reserves (notably how much arose from upward asset revaluations, or revaluations of system assets in particular). On the face of it, this was contrary to the requirements of Australian Accounting

Standard AASB 101 ‘Presentation of Financial Statements’ (as revised 2012) which prescribed that there should be disclosure either in the statement of financial position or in the notes, of further subclassifications of line items, including subclasses of ‘equity capital and reserves’ (paragraph 78) – having regard to the ‘size, nature and function of the amounts involved’. Since Endeavour reported ‘reserves’ that were unquestionably material (they represented 54% reported total equity) additional disclosure was certainly warranted.

To track down the amount of upward revaluations of system assets it would be possible to go through prior annual reports to see when balance sheet figures were last subject to major upward revaluations. However (as with Ausgrid) those responsible for preparing Endeavour’s financial statements helpfully included a few lines that would enable estimation of the effect on reported profits and returns of these revaluations i.e. that the historical cost of system assets was $5.02 billion (page 60). When compared with the balance sheet figure for those assets of $6.2 billion, that indicated that the upward asset revaluations had added just over $1.1 billion to total asset values and to equity. Endeavour reported that it depreciated system assets over ‘7 to 60 years’. It was estimated that Endeavour’s revaluations added around $44 million to depreciation charges in 2014.

As for TransGrid, in 2013 it also changed its valuation of property, plant and equipment to an ‘income approach’ but this led to a *downward* adjustment of $440.5 million. Transgrid estimated that the change would reduce depreciation expense and increase profit before tax by approximately $21.0 million in future years (page 44). It also disclosed that after these changes, the balance of upward revaluations for these assets was $1.4 billion. That implied that the increased depreciation arising from all past revaluations was around $49.6 million in 2014.

One curiosity was that TransGrid (unlike the other agencies) avoided reporting key financial indicators (such as ‘return on assets’ or ‘return on equity’). Indeed, while its 2014 annual report of 175 pages included 26 pages of performance indicators, all showing ‘good news’, these did not include any indicators of financial performance. There was a reference to ‘return on assets’ in the index to the annual report, but the relevant ratio was not found on the page specified, or elsewhere. Possibly it had been included in a draft report, but was then considered inappropriate to highlight how profitable TransGrid had become.

In summary, the product of these recalculations was as follows. The agencies’ ‘return on asset’ figures could not be reconciled with reported financial statement data and the recalculated indicators were somewhat lower than as claimed in annual reports – even after using ‘profit before tax’ data and adjusting for depreciation on selected revalued depreciable assets. But the ’return on equity’ figures were consistently high for all three agencies.

Table 12

Network agencies' returns on equity 2013-14
– as reported & recalculated to be consistent with private sector accounting practices

	Reported Return on Equity %	Recalculated Return on Equity %
Ausgrid	**14.1**	**82.8**
Endeavour Energy	**18.2**	**80.8**
TransGrid	**Not reported**	**32.1**

The recalculations show that all of these agencies have been extremely profitable - with Ausgrid and Endeavour earning 'super profits', with returns on equity over 80% per annum. ***The profitability of these agencies – when assessed on a private sector accounting basis would be the envy of most investors. Few listed public companies can boast a rate of return on shareholders' funds of 32.1% to 82.6%.***

Yet even those figures are understated, since another appropriate adjustment would have been to add-back the payment of loan guarantee fees to the state government. A government document distributed to Coalition MPs and selected journalists identified these payments from the electricity businesses as amounting to $338 million in 2012-13 – or roughly 20% of the adjusted earnings for all four agencies (including, for this purpose, Essential). The agencies' financial statements did not separately disclose loan guarantee fees but aggregated them with other expenses.

It is difficult to avoid the conclusion that the accounting practices adopted by these agencies – particularly their post-2013 changes in valuation methods – have been designed to shape perceptions by affecting key indicators of profitability. The basis of the upward revaluations of system assets is examined in detail in an Appendix to this report.

In our opinion, the fact that these agencies changed their accounting policies just before a scheduled election – while presenting inadequate and misleading information about financial performance – is a matter of grave concern.

We believe that the NSW Auditor General should review the financial statements of these agencies with a view to having them re-stated or re-issued in an am ended form. We are encouraged to take this stance by the fact that a former Auditor-General responded to comments in 1992 by one of the authors of this paper by requiring the then Sydney Water Board to restate its accounts. Sydney Water had failed to comply with requirements of the accounting profession and by doing so had significantly understated reported profits and rates of return – at a time when some (notably the Industry Commission and EPAC) were calling for water agencies to be privatised because they were generating low rates of return.[6]

[6] See Bob Walker, 'Water authorities: nice little earners', *New Accountant*, 29 October 1992; and 'Evaluating the financial performance of the Australian water industry", in M. Johnson &

It appears that the current Auditor-General, in a report to Parliament that focused on the electricity and water industries (*Financial Audit,* Vol. 5, 2014) was content to summarise data prepared by the network agencies. He simply repeated references to ‘total assets’ and ‘rates of return’ without explaining, for example, how these numbers had been affected by the upward asset revaluations that followed Treasury’s U-turn about use of an ‘income approach’ to the valuation of system assets. Ausgrid’s $2.9 billion upward asset revaluation on the last days of 2012-13 did not even rate a mention.

In our view, members of Parliament have a reasonable expectation that an Auditor-General will take steps to ensure that they are fully informed about key matters that may affect their decisions about such matters as privatisation proposals. There was a failure of the reporting process on this occasion.

We also believe that the Public Accounts Committee of the NSW Parliament should take an interest in why these agencies failed to comply with basic requirements of accounting standards, why in 2012 Treasury reversed its prior advice regarding the inappropriateness of using the ‘income approach’ to value infrastructure assets, and why the Auditor-General failed to require the network ***agencies to disclose the effect*** *of these changed accounting policies on reported profits, asset valuations and profitability.*

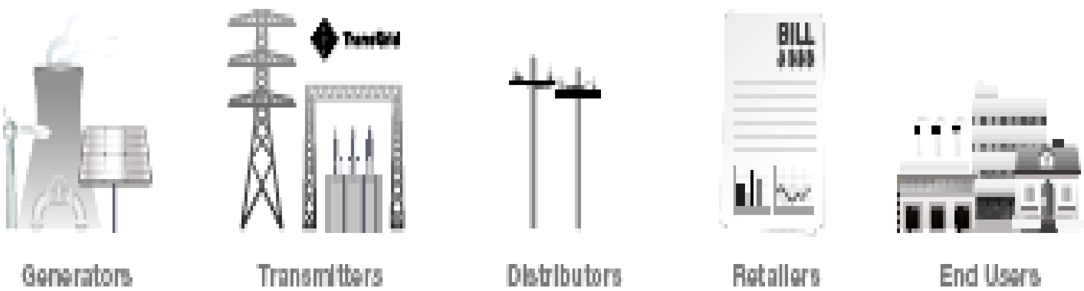
S. Rix (eds.), *Water in Australia*, Pluto Press and UNSW Public Sector Research Centre, 1993.

3. BAIRD GOVERNMENT PRIVATISATION PROPOSAL: FALSE AND MISLEADING INFORMATION

On 10 June 2014, the Baird Government announced its intention to take to the next election a proposal for a 99-year lease of 49 per cent of the state's total electricity network and distribution assets – the so called 'poles and wires' (hereafter, 'network agencies'). It was claimed that this would yield $20 billion to be spent on a variety of projects.

These agencies consist of the integrated distribution businesses of Ausgrid and Endeavour Energy which distribute electricity to urban households and businesses; and Essential Energy which serves rural areas. The long-distance, high voltage transmission network is managed by TransGrid. It connects generators, distributors and major end-users in New South Wales and the Australian Capital Territory.[7]

The role of the network agencies as a component of the electricity industry is illustrated below.



Source: *2012-13 TransGrid Annual Report*.

3.1 Preparing the ground with manipulated (and deficient) financial reports

The curious accounting adopted by the network agencies has been mentioned above. While there may be merit in periodically revaluing assets held by public utilities, the practices adopted in NSW in 2013 are extraordinary, and do not convey relevant information to users of financial statements. For example,

[7] As TransGrid describes its role: electricity is transported from generators along TransGrid's high voltage transmission lines and underground cables, through substations and delivered to distributors. Electricity travels through distribution lines and substations where smaller pole-top transformers progressively reduce the voltage for use in homes and businesses. Retailers sell electricity and manage customer accounts and billing. Homes and businesses across NSW and the ACT use the electricity supplied by their local distributor.

Ausgrid revalued system assets upwards by $2.9 billion on the last day of the 2012-13 financial year without explaining how those book entries had affected reported indicators of profitability.

The Australian Energy Regulator (AER) has advised that it pays no heed to the recent asset revaluations and uses its own (arguably, generous) calculations of a 'regulatory asset base'.

It can be safely concluded that *the 2013 upward asset revaluations were undertaken to disguise trends in the profitability of the state-owned network agencies.*

3.2 Claims state would retain a 51% interest when control of three agencies will be lost

The Government has stated that:

> Under the Government's preferred approach, 51% of total electricity network assets will be retained in Government hands. The shares retained by Government will come under the guardianship of a new NSW Future Fund which will be a statutory asset fund with the potential to fund future liabilities of the state, and with a particular responsibility to protect the value of assets held by the state (*Fact Sheet 9*, June 2014).

The above statement implies that the Baird Government proposes to sell *shares* in the network agencies (or possibly, shares in a newly constituted entity that would hold the electricity network assets). This is not consistent with other statements (cited above) which refer to plans to enter into a *99 year lease* of electricity network and distribution assets.

The lack of any clear explanation of what is proposed and how any proposed privatisation would be structured should be of concern to members of Parliament and the electorate at large.

These comments initially address the possibility that the Baird Government proposes to proceed via the sale of shares.

It must be noted that (after push-back from the National Party) the Coalition Government has retreated from its plans for a full privatisation by announcing that it will retain Essential Energy.

If so, the claim that 51% of total electricity network assets will be retained in 'Government hands' – implying that the state will retain control of those businesses – is quite misleading.

In a draft of this report, it was noted that, after adjusting for the retention of Essential Energy, the state would retain less than a 38 per cent interest in the other three agencies – and, therefore, lose control. Using the book value of the network agency assets as an indicator of what is to be privatised, the

Government's misrepresentation on the issue of control was illustrated as follows:

Table 13
Reported value of network assets 2014

	Assets 30 June 14 $m	49% of assets to be privatised $m	Value of assets to be retained $m
Distribution Networks			
Ausgrid	16,246.0		
Endeavour Energy	6,912.9		
Essential Energy	8,036.7		
Total	**31,195.6**		
Transmission Network			
TransGrid	6,577.5		
Total Assets	**37,773.1**	**18,508.8**	
	100%	**49%**	
Adjusting for retention of Essential: value of assets to be 'leased' vs retained	**29,736.4**	**18,508.8**	**11,227.6**
Private vs public sector shares of the three agencies' assets		**62.2%**	**37.8%**

Source: 2014 Annual Reports of the nominated agencies.

This interpretation was mentioned to journalists in November and December 2014 (but did not lead to any media comment, at the time). It was also commented that if the Baird Government truly proposed to lease assets (rather than sell a majority of the shares of the entities owning those assets), then its public statements had not provided sufficient detail to enable this option to be assessed. For example what proportion of each of Ausgrid, Endeavour Energy and TransGrid would make up the 62 per cent? How could these businesses be split up so that only a portion was to be leased? Indeed, it seemed impossible to lease only a portion of an integrated electricity distribution system. Government statements about leasing a percentage of a system did not make sense.

However just before the Christmas break, the government issued a document, *Rebuilding NSW – update electricity networks* (dated 18 December 2014) which provided a slightly fuller (and more plausible) explanation. It implied that the shares in several network agencies would be held by a holding company which would lease the assets in their entirety to a prospective purchaser. The state – presumably via the proposed Future Fund – would retain a portion of the shares in that holding company.

This document confirmed our analysis that there would be a loss of control of the state's three network agencies proposed for privatisation. ***It revealed, for the first time, that the Baird Government intends to privatise 100% of TransGrid, and 50.4 per cent each of Ausgrid and Endeavour Energy***.

Table 14
Government's privatisation proposal

	Proportion to be privatised	Proportion to be retained

	%	%
Distribution Networks		
Ausgrid	50.4	49.6
Endeavour Energy	50.4	49.6
Essential Energy	0.0	100.0
Transmission Network		
TransGrid	100.0	0.0

Source: NSW Government, *Rebuilding NSW - Update Electricity Networks*, 18 December 2014.

Moreover, the latest announcement still does not provide full details of how the privatisation transactions would be structured, and whether the Government as vendor would provide certain incentives to a prospective purchaser.

3.3 Use of Future Fund shifts responsibility for future sales to trustees

As noted above, it had previously been claimed that a 51% interest in the total network agency assets to be retained by the Baird Government would be placed in a new NSW Future Fund. In December 2014 the Baird Government repeated this claim:

> The NSW Government has confirmed it will proceed with the long-term lease of 49% of the NSW electricity network....

This claim is seriously misleading. As noted in the same document (and summarised in the above table) a majority interest of both Ausgrid and Endeavour Energy is to be privatised, and 100 per cent of Transgrid. A more honest statement about the intention to retain only '49.6%' of two of the three agencies to be privatised and no shareholding at all in the third might have prompted difficult questions about 'control'.

Turning to the role of the proposed NSW Future Fund: on the face of it, trustees of the Fund could dispose of all or part of those shares without Parliamentary or even government approval. This would enable the Government to insulate itself from responsibility for any future sales – since it could claim that those decisions were being made by 'independent' trustees.

This possibility was put to Premier Baird by journalist Quentin Dempster in a November 2014 edition of the ABC's 7.30 program. Mr Baird seemed taken aback by the suggestion that Fund Trustees could sell those assets without reference to the Government or to Parliament – but responded that this could not happen as 'we'll put it in legislation'.

The fact is that future governments can always amend legislation enacted by predecessors.

Since then, the Government's statement, *Rebuilding NSW – update on electricity networks* issued late in December 2014, referred to the establishment of a holding entity as lessor of the network agencies' assets, but added

> Essential Energy will remain a State-Owned Corporation and will not be transferred to the holding entity

That statement stopped short of advising that previous proposals for transferring assets to a NSW Future Fund would be reversed – so it would appear that the current plan is still for shares in Essential Energy to be transferred to that Fund (if not to a ‘holding entity’ within that Fund). Hence the potential for a future sale of Essential Energy should be of concern to the National Party.

3.4 Confusion: still no details on structure of lease arrangements

While it had claimed that a 51% interest in the total network agency assets would be placed in a new NSW Future Fund, there was no explanation of how the 49% lease would be implemented. Would only some assets be leased? If so, which parts of an integrated system?

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.

But this is speculation. The Baird Government has failed to explain how it will structure these transactions – or explain the consequences of setting up a holding company as lessor.

3.5 Exposure to 'real' not notional taxes.

Presently State-Owned Corporations do not pay corporate income taxes to the Commonwealth – only notional taxes to the state Treasury. If the proposed holding company is not wholly owned by the state, then it would be liable for Commonwealth taxes. Indeed, a government document distributed to Coalition MPs and selected journalists acknowledged that the 'lease' arrangement would see a loss to the state of both tax equivalents and loan guarantee fees.

Further support for this interpretation comes from evidence presented at a public hearing of the Senate committee inquiring into 'privatisation of state and territory assets and new infrastructure'. Mr Chris Legg, who glories in the title of 'Chief Adviser, Industries and Infrastructure Division' at the Commonwealth Treasury, initially argued that when a state-owned business became partly owned, it would be up to the ATO to decide how it was to be taxed (and, he claimed, the ATO was prohibited from revealing the circumstances of individual taxpayers). Mr Legg admitted that the Commonwealth *could* benefit from taxing privatised entities, but maintained that the 15% was an 'incentive' and not intended to compensate fully a state for this loss of revenues (the tax equivalents).

3.6 Proposal does not add up: the supposed proceeds

The claimed potential proceeds and the proposed expenditure on new (electorally attractive) projects do not add up.

Since the June 2014 announcement, Premier Baird and Government literature have repeatedly referred to $20 billion flowing from the partial sale stating that the proposal:

> … will unlock $20 billion in infrastructure funding, including $6 billion for regional NSW, by undertaking a long-term lease of 49 per cent of the "poles and wires" network (*Rebuilding NSW – $20 billion plan to turbocharge economy*, 11 June 2014).

And again on 18 December 2014:

> The lease of the Network Businesses will unlock $20 billion (*Rebuilding NSW - Update on Electricity Networks*).

It has been reported (and not denied) that the $20 billion is made up as follows:

- $13 billion net from sale;
- $2 billion from the federal government under the asset sales incentive program; and
- $5 billion in interest earned from investing the sale proceeds over 10 years.

There are issues with all three components.

It is unclear as to what is meant by the reference to $13 billion 'net proceeds' – net of what?

At 30 June 2014 the assets of the three agencies totalled $29.7 billion (at book value). 49% of that amounts to $14.6 billion. But there are also financial obligations that need to be considered. For example, at 30 June 2014 the three agencies had formal borrowings totalling $15.2 billion as shown below.

Table 15
Borrowings of network agencies

	30 June 2013 $m	**30 June 2014 $m**
Ausgrid	8,502.6	8,696.3
Endeavour Energy	3,358.4	3,767.7
TransGrid	2,435.9	2,738.5
TOTAL	**14,296.9**	**15,202.5**

Source: 2014 Annual Reports of the nominated agencies.

As well, provisions for accrued employee benefits (including defined benefits superannuation obligations, annual leave, pre 93 sick leave, long service leave and workers' compensation liabilities) amount to nearly $1.4 billion.

Questions arise as to how these obligations will affect the sale price and what has been assumed by the Government in announcing $13 billion net sale proceeds.

For example, will the Government pass on to the purchaser(s) the debt of the agencies to be fully or partially privatised – while guaranteeing those borrowings to ensure that the agencies continue to enjoy the benefits of the relatively low interest rates enjoyed by governments? There is a precedent for a Coalition Government providing guarantees – recall the sale of the State Bank, when the Government guaranteed most of a $13 billion loan book – resulting in the state losing most of the sale proceeds. But more likely, 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.

In which case, are the net sale proceeds of $13 billion 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?[8]

Given that the Baird Government has made the 2015 election virtually a referendum on the privatisation of the 'poles and wires', the community should be told exactly what is being proposed.

Second, the $2 billion supposedly to be received from the Federal Government's asset recycling incentive program is based on 15 per cent of the proceeds of asset sales. According to the COAG *National Partnership on Asset Recycling Agreement* (May 2014) in order for a payment to be made, both the Commonwealth and the relevant state government have to identify the asset(s) to be sold and the project(s) to be funded by 30 June 2016; the sale of the asset(s) must be completed and construction of new infrastructure must commence on or before 30 June 2019. The future of this program has yet to be decided following the Senate's amendments to the Government's legislation to allow Parliament to veto the payments to states on a case-by-case basis, with cost-benefit analysis by Infrastructure Australia before payments are approved. There is now further doubt about the future of this scheme with the Senate launching an inquiry.

Third, the $5 billion interest assumed from investing the sale proceeds over 10 years is unrealistic.

If at least part of the estimated net proceeds of $13 billion are to be invested in new infrastructure by 2019 to secure the Commonwealth's $2 billion incentive, then obviously some of those funds would only be earning interest for as little as one or two years. This alone would leave the so-called $20 billion bucket of money short by billions of dollars.

---

8 A more conservative estimate was provided by *S. Koukoulas and S. Devlin* in a McKell Institute publication, *Nothing to gain, plenty to lose - why the government, households and businesses could end paying a high price for privatisation, Koukoulas and Devlin* (December 2014) p. 53. Citing G. Winestock and A. MacDonald-Smith, 'NSW power sale faces $2B shortfall', *Australian Financial Review*, 12 June 2014, they stated that 'USB has calculated the total value of the NSW network businesses at between $21.3B and $22.2B, after debt of $18.6B has been paid off. This implies that the NSW Government's proposed privatization of 49% of the assets should generate between $10.7B and $11.1B'.

It should be noted that the Commonwealth payment will be made in two instalments of 50% – the first when sale processes have commenced and the state government has commenced obtaining planning approvals for the approved projects. The second payment will only be made when the states have completed the asset sale and commenced construction.

After comments that the hypothetical $20 billion would not cover all of its proposed projects, in December 2014 the Baird Government sought to explain this away by claiming that funds would be reinvested with ‘strong returns’ and not drawn down until needed up till ten years later:

> This investment is only possible with the proceeds generated by recycling capital locked up in the electricity networks. Proceeds from the transaction will be supplemented by an estimated $2 billion from Commonwealth asset recycling incentive payments, and earnings from transaction proceeds that will be invested until required for Rebuilding NSW projects. Investment earnings on the transaction proceeds are based on an investment strategy to deliver strong returns, commensurate with appropriate risk management and liquidity needs, as well as the drawdown over a 10 year delivery timeframe for Rebuilding NSW projects (*Rebuilding NSW - Update on Electricity Networks*, 18 December 2014).

An obvious contradiction is that, as just explained, the Federal funds will only be payable in two tranches, the second if expenditure on new infrastructure has started by 2019. Another is implicit recognition that it would make sense to invest the proceeds of sale in high yielding investments rather than pay down debt. Yet, as explored in more detail in this paper, it would be difficult to find investment opportunities that could produce stronger returns than are currently earned from ownership of the network agencies.

If the estimated net proceeds of $13 billion have to be at least partly invested in new infrastructure by 2019 to secure the Commonwealth’s $2 billion incentive, then obviously some of those funds would only be earning interest for as little as one or two years. This alone would leave the hypothetical $20 billion bucket of money short by billions of dollars.

3.7 Proposal does not add up: claimed cost of new projects

The Baird Government’s June 2014 *Fact Sheet* claimed that the proceeds from privatisation would be used to fund ‘investment in public transport, roads, water, hospitals, schools and other projects that improve services, increase opportunity and grow the economy’. The list was as follows:

- Sydney Rapid Transit – including a second harbour rail crossing and Western Extension, to the North West, Bankstown and Inner West;

- Sydney Roads Renewal – major projects to key arterial routes across Sydney, including in Southern Sydney, the West and Northern Beaches;
- Regional Roads Fund for roads and bridges in regional areas, with an expected contribution of at least $1 billion as part of the overall $6 billion available for regional infrastructure;
- Regional Water Fund with an expected contribution of at least $1 billion;
- Schools and Hospitals Building Fund with an expected contribution of at least $2 billion;
- Sports and Cultural Fund with an expected contribution of $500 million.

This led to criticism that the claimed proceeds from privatisation would not come close to covering the cost of this wish-list.[9]

But in December 2014 a new version was issued with a different description of projects and costings - and this seemed to be an attempt to fudge the figures. The new version was as follows:

- $1.1 billion investment in the WestConnex northern and southern extensions and the Western Harbour Tunnel;
- $7 billion investment in Sydney Rapid Transit to fully fund a second Harbour Rail Crossing;
- Increasing the Government's commitment to the Sports and Cultural Infrastructure Fund from $500 million to $1.2 billion;
- Reserving $4.1 billion for regional transport;
- Reserving $1 billion for regional and metropolitan schools;
- Reserving $1 billion for regional and metropolitan hospitals;
- Reserving $1 billion for water security for regional communities;
- Reserving $300 million for regional tourism and the environment

It will be seen that this wish-list (without further explanation) dropped direct reference to any expenditure on Sydney Roads Renewal. And several contributions to projects totalling $7.4 billion apparently were not to be spent but only 'reserved'.

However, even a full bucket of $20 billion would not fully pay for all the promised projects on this shortened list, even accepting current cost estimates (which are probably conservative). The second rail harbour tunnel and linking networks, are estimated to cost $10 billion - though transport experts have warned that tunnel projects tend to experience massive cost overruns. The new list claims that $7 billion would 'fully fund' the harbour

---

[9] See, e.g. the authors' opinion piece, 'NSW electricity privatisation is a question of why, not how', *The Sydney Morning Herald*, 18 June 2014.

crossing but made no mention of the cost of linking networks. And details are not provided as to what projects are covered by ‘regional transport’. Overall, it seems more likely that the $20 million would only enable a start to be made on several projects. That does not leave anything from the heralded $20 billion for the proposed arterial roads across Sydney. They have been estimated by commentators at $10 billion (a figure not yet denied).

Table 16
Part privatisation revenues and proposed expenditure do not add up

Part privatisation proceeds		Proposed allocation of proceeds	
Source of proceeds	**$b**	**Expenditure**	**$b**
Net sale proceeds	13	Second rail harbour tunnel & linking networks	10
Commonwealth asset sale incentive	2	Arterial roads across Sydney including southern Sydney, the west & northern beaches	10
Interest on proceeds over 10 years	5	Regional Roads Fund for rural & regional projects	6.4
		Regional Water Fund	1
		Schools and Hospitals Building Fund	2
		Sports and Cultural Fund	1.2
TOTAL with 10 years’ interest	**20**		**30.6**
TOTAL with 2-5 years’ interest	**16-17**		**30.6**

Notes: 1. The Government’s $20b total proceeds unrealistically assume sale proceeds are held for 10 years.
2. More realistically total sale proceeds will earn interest for two to five years.

The above estimates of the cost of projects at nearly $31 billion far exceed the heralded $20 billion proceeds of the part privatisation which include the unrealistic assumption of 10 years worth of interest from investment of the proceeds. The more realistic assumption of a couple of years’ worth of interest – or even five years’ worth of interest – would increase the gap between revenues and expenditure to more like $14-$15 billion.

3.8 Claims about a ‘lease’ are misleading: ‘lease’ soon becomes a ‘sale’ and a partial sale turns into a full sale

The Baird Government proposal involving a 99 year lease provides no comfort. What is the value of an 'iron clad guarantee' from politicians who are unlikely to be still in office five or ten years hence? Experience has shown that long-term leases become outright sales when no-one is looking.

Sydney has already seen that a heritage building – the Old Treasury Building, now part of the InterContinental Hotel in Macquarie Street – was initially leased for 99 years, only to have the freehold transferred a few years later, when public interest had evaporated. The transfer of land ownership between small proprietary companies does not make news.

As to part sales, they soon become full blown sales. One cannot forget the purported part sale of Telstra by the Howard Government which soon became a full sale. Not only was there a loss of an asset providing an essential service to a country of this geographic size but there is the loss billions of dollars in dividends each year. In addition, when the Government wanted to establish the National Broadband, it was forced to pay billion of dollars to the now privatised Telstra in order to access its network assets.

As noted above, the Government intends to place its 51 per cent share of the network assets in a new NSW Future Fund. This is a neat way for politicians to avoid been blamed for a 49 per cent lease becoming a full sale.

3.9 Claims that prices inevitably fall with privatisation are misleading

Advocates have argued that privatised assets lead to lower electricity prices than in public hands.

In support of its partial privatisation proposal, the Baird Government released a consultant's report which NSW Treasury commissioned to analyse the long-term trends in the prices and costs of providing electricity network services. The Government partly summarised it in colourful brochures as follows:

> Ernst & Young advises that network prices for typical customers in Victoria and South Australia have fallen in real terms since becoming privately owned.[10] By contrast, NSW network prices have significantly increased over the past decade (NSW Government, *Fact Sheet 11*, June 2014).

The E&Y report actually stated that 'various factors can and do contribute to the discrepancy (e.g. the starting position in respect of price levels, the age of the assets and therefore the need for investment, service standards etc.).' It noted that the networks in NSW and Queensland have invested particularly heavily in their networks, and added:

> In contrast, the businesses in Victoria are approaching a stage in their life cycle which may require substantial further investment. South Australia may also have recently entered a similar stage in their investment life cycle as is the case in Victoria.

In other words, Victoria and South Australia can expect to experience increased electricity prices once local operators undertake a necessary investment program.

3.10 Impact of price regulation

The Baird Government has claimed that

> electricity network prices and household bills are on their way down in NSW and will continue to fall as a result of the [Australian Energy Regulator] determination.

[10] In comparisons made with Victoria which was the first to privatise its electricity industry, the Kennett Government imposed a 10 per cent increase in electricity prices - presumably to 'fatten the cow' - before beginning the privatisation process.

Since 2009 pricing is regulated by the AER (previously by NSW's IPART). The AER determines the value of a defined 'regulatory asset base' (RAB) – and allows agencies to earn a rate of return on their RAB. Consequently substantial capital expenditure in NSW and Queensland has been reflected in increased electricity prices.

One enduring theme in the economics literature on price regulation has been that industries subject to 'rate of return' regulation face incentives to over-invest in capital works[11]. That is because the higher a firm's asset base, the higher the returns a regulator will allow that firm to enjoy (including via higher prices).

It has been said that those who cannot remember the past are condemned to repeat it. Anyone familiar with the academic literature on price regulation may have recalled this saying when looking at the NSW electricity industry over the past decade – and shaken their heads in dismay.

For regulatory purposes, electricity agencies in NSW were allowed to value their assets at current replacement costs and earn a rate of return on those investments. This is of course quite different from the way that listed public companies value their assets – at historical cost less depreciation. The effect of this is to lower reported profits (via higher depreciation) and reported lower rate of return on assets and equity (since both the numerator and denominator in rate of return calculations are affected by these accounting practices).

In principle, use of replacement cost (less an allowance for depreciation) could have been acceptable, particularly for those agencies that had not kept detailed records of their spending on elements of infrastructure prior to the introduction of full accrual accounting in the late 1980s and early 1990s. The Australian Energy Regulator (AER) has allowed network agencies to earn a 'fair rate of return' on that investment – while also allowing annual indexation of the adopted values of system assets. That in itself would have allowed these public utilities to increase the recorded value of their asset base, and hence to increase their prices over time.

But, as noted above, the electricity agencies have been investing heavily on infrastructure. At the same time, consumers have faced higher utility bills (and this was said to be in response to recent increases in the regulatory asset base). Consumer concerns became a matter of political sensitivity.

Now it may be that much of this expenditure was warranted, if the network agencies' assets were coming to the end of their useful lives or if maintenance expenditure was overdue. But the financial statements of government agencies do not disclose the extent of 'deferred maintenance' or routinely report on what expenditure would be required to restore existing infrastructure to a satisfactory condition (or to enhance its functionality). In contrast, in the USA, federal government agencies are required to supplement their financial

[11] The 'Averch-Johnson hypothesis'. See *inter alia*, the much-cited H. Averch & L.L. Johnson 'Behavior of the firm under regulatory constraint', *The American Economic Review,* December 1962.

statements with information related to the condition and the estimated cost to remedy any deferred maintenance of property, plant and equipment.[12] US state-based entities are also expected to provide information about the condition of infrastructure assets.[13]

In the absence of any information about deferred maintenance – and politicians and bureaucrats alike would probably reject suggestions that they had allowed infrastructure to deteriorate by skimping on maintenance – one is left with the fact that the AER has only recently stepped in to allow a rate of return to be earned on that part of new capital spending that is 'efficient'.

No one could accuse the AER of being unaware of the politics. In its own words, it set out to 'incentivise electricity network businesses to spend efficiently and share savings with consumers'. It published a draft guideline and scheme for consultation, and then issued a final version in late 2013. It claimed:

> Our expenditure incentives guideline sets out the new sharing mechanism for capital expenditure. It provides a 30 per cent reward to businesses for becoming more efficient (underspending) and a 30 per cent penalty for becoming less efficient (overspending). In addition, if the business spends more than its allowed forecast we will examine the overspend ex-post; we can disallow inefficient capital overspend from the business's regulatory asset base so consumers do not fund it (*AER Annual Report 2013-14*, page 21).

This announcement was somewhat strange, given that the AER has had this power to adjust for inefficient capital spending for some time. Under the sub-heading 'Reduction for inefficient past capital expenditure**',** the relevant rule states that the AER may determine that 'the amount of capital expenditure as a result of which the previous value of the regulatory asset base would otherwise be increased in accordance with clause S6A.2.1(f) should be reduced'.

On the face of it, the announcement amounts to an admission that some past expenditure has been 'inefficient'. If so, then arguably the introduction of 'incentive guidelines' seems to be a case of closing the stable door after the horse has bolted. Indeed, Endeavour Energy's 2014 annual report noted, for example, that 'the peak of capital investment [is] now behind us' (page 11).

As for the Baird Government's December 2014 claim that

> electricity network prices and household bills are on their way down in NSW and will continue to fall as a result of the AER determination

[12] Statement of Federal Financial Accounting Standards (SFFAS) 6, 'Accounting for Property, Plant, and Equipment' (1995) and SFFAS 42, 'Deferred Maintenance and Repairs' (2012).

[13] See, e.g. Governmental Accounting Standards Board, Statement 34 'Basic financial statements and management discussion and analysis – for state and local governments' (1999).

the latest AER intervention (if its draft guidelines are adopted) would only affect the treatment of post 2014 capital expenditure. Balances of the ‘regulatory asset base’ would remain in place and continue to be indexed from year to year in line with changes in the CPI, reduced by depreciation charges (and possibly incrementally increased as a consequence of the agencies’ differing capitalisation policies).[14] Since system assets are being depreciated over long periods – apparently 50 to 60 years – the level of annual depreciation charges on that part of the regulatory asset base would be maintained in ‘real’ terms at close to current levels. (Depreciation charges in 2013-14 were Ausgrid $549 million, Transgrid $224 million, Endeavour $174 million.) Those charges would translate into a component of the ongoing costs that the network agencies are allowed to recover, over the life of those assets.

What may have a greater effect is that the AER has lowered the rate of return that network agencies can enjoy as a return on assets after 1 July 2015. The AER’s draft determination for Ausgrid, for example, has lowered the return (supposedly based on Ausgrid’s ‘weighted average cost of capital’) from 10.02 per cent to 7.15 per cent.

Granted that interest costs have fallen (e.g. the Reserve Bank’s cash rate was 3.75 per cent in January 2010 and 2.25 per cent in February 2015) – it is a bit of a stretch to claim that ‘electricity network prices and household bills are on their way down in NSW and will continue to fall as a result of the AER determination’.

While the AER may now plan to limit additions to the ‘regulatory asset base’ (RAB) to ‘efficient’ capital expenditure, the opening balances of the RAB will be unaltered – and will remain at inflated prices, relative to the valuations applied by private sector firms. (The methods used to value assets for financial reporting and regulatory purposes are discussed in some detail below in an Appendix.)

4. BAIRD GOVERNMENT PRIVATISATION UNNECESSARY

According to the Baird Government, privatising the state’s remaining electricity assets is the only way to fund $20 billion worth of investment over the next 10 years. It has stated:

> The Government has a 10 year $20 billion infrastructure plan - Rebuilding NSW.

[14] The agencies have treated any maintenance expenditure greater than $500 (Ausgrid), $3,000 (TransGrid) or $1,000 (Endeavour) as adding to the book value of assets.

> This investment is only possible with the proceeds generated by recycling capital locked up in the electricity networks (*Rebuilding NSW: Update on Electricity Networks*, 18 December 2015).

That is just not true. The state could borrow (or use a combination of borrowing and own-source revenues). It beggars belief that a state the size of NSW is not capable of undertaking a $20 billion investment program over 10 years – that is, an average of $2 billion a year – without privatising profitable assets and without affecting its credit rating.

In fact, if the projects proposed by the Baird Government are so crucial to 'turbocharge productivity and improve the daily lives of families right across the state' then Mr Baird should have the confidence to borrow the funds required while retaining the state's profitable assets and their relatively stable revenues.

The state has the capacity to borrow funds in order to invest in important infrastructure without selling monopolistic infrastructure assets especially ones providing essential services.

According to the state's *Report on State Finances 2013-14*, in June 2014 NSW had general government net debt of $6.869 billion or just 1.4 per cent of Gross State Product (GSP). This level of debt is highly manageable on annual budget revenues of around $70 billion. As shown below, net debt is expected to be $9.3 billion in June 2015 and $10.7 billion by 2018 or just 1.8 per cent of GSP (which is forecast at $601 billion).

Table 17
General government sector: Net debt 2011 to 2018

	June 2011 Actual $m	June 2012 Actual $m	June 2013 Actual $m	June 2014 Actual $m	June 2015 Estimate $m	June 2018 Estimate $m
Net debt	7,960	14,127	11,907	6,869	9,300	10,700
% of GSP	1.8	3.1	2.5	1.4	1.8	1.8

Source: *2013-14 NSW Budget Paper No. 2,* p. 1-3, and *2014-15 NSW Budget Paper No. 2*, p. 8-2, *Report on State Finances 2013-14,* p.4-7, *2014-15 Half-Yearly Review*, p. 3.

Adding an average $2 billion per annum borrowings would mean that the state's debt levels would continue to be manageable.

According to TCorp, if the Government was to borrow funds right now, the 10-year bond rate is historically low at 2.90%. On this basis, the annual interest on $2 billion would be less than $60 million – a fraction of the payments expected from the remaining electricity agencies.

The levels of state net debt are miniscule in comparison to those of many developed countries in the OECD with an average of net debt to GDP of over 70%. The latest general government net debt figures for some OECD countries are shown in the table below.

Table 18
OECD general government net financial liabilities
% of GDP

	2011	2012	2013	2014	2015
Germany	50.5	50.5	49.1	47.8	45.8
Japan	127.3	129.5	137.5	142.5	145.4
United Kingdom	66.5	66.1	65.4	67.7	69.1
United States	76.1	80.0	81.2	83.8	84.1
Australia	**5.6**	**10.8**	**11.8**	**13.8**	**14.6**
Euro Area	60.7	65.9	68.5	69.8	69.7
Total OECD	**64.0**	**67.4**	**69.1**	**70.9**	**71.4**

Source: *OECD Economic Outlook 95 database, May 2014*.

5. ELECTRICITY PRIVATISATION NOT IN THE PUBLIC INTEREST

State-owned electricity network businesses are natural monopolies and have been highly profitable. Their profitability has been enhanced by a regulatory regime (which, it must be acknowledged, has been adopted with the agreement of the states). That regime enables the network businesses to earn a 'rate of return' on a 'regulatory asset base' the starting point of which was calculated by reference to hypothetical values – 'depreciated optimal replacement cost'[15] - and then adjusted upwards by indexation and additional spending on capital works. The 'rate of return' is fixed for five years in advance and is based not on what governments actually pay to fund their investments but on another hypothetical or unobservable value, the 'weighted average cost of capital' which averages the supposed cost of debt and the supposed returns demanded by investors – in either case, for supposedly 'comparable' private sector firms. For example, an AER determination for Ausgrid for the period 2009-14 was that its pre-tax cost of debt was 8.82%, its post-tax return on equity was 11.82% (equivalent to a pre-tax return of around 12.6%) and that its WACC was 10.02%.

The extent of that profitability has been masked by the adoption of accounting methods that are far different from those adopted by listed public companies in the private sector. Since 2013 the network agencies have adopted curious accounting methods to revalue their assets upwards, and since these valuations do not appear to be utilised by the AER in its determinations, one is left with the conclusion that these book entries were designed to further depress reported rates of return on assets and equity. Ausgrid's upward revaluation of $2.6 billion on the last day of the 2012-13 financial year is a case in point.

Recent investment in system assets has led to increases in financial returns to the state.

Cash flows from the state's electricity businesses are relatively stable – in contrast to the volatility of the state's revenues from property taxes – and hence actually enhance the state's capacity to borrow for investment in new projects in other forms of infrastructure.

The sale of those assets will only lead to a loss of revenue to the state - and (on the basis of past experience) to higher prices to consumers.

Privatising highly profitable assets that provide basic services is not a 'reform' – it is foolish.

---

[15] For a devastating critique of this methodology see D. J. Johnstone, 'Replacement Cost Asset Valuation and Regulation of Energy Infrastructure Tariffs', *Abacus*, Vol 39 No. 1, 2003.

Payments to the Budget, even after the part-privatisation of electricity assets, confirm that retention of the profitable network agencies is not only affordable but financially prudent. If the privatisation of Essential Energy is not a good deal for rural New South Wales then surely the privatisation of the other electricity assets cannot be good for the rest of the state.

Former Premier O'Farrell was elected following his opposition to the electricity privatisation proposals of the Keneally Government. Just like Mr O'Farrell, new Premier Baird does not have a mandate for any further sales. More importantly, even though self-interested parties have succeeded in convincing the Government to reverse its stance, ***further electricity privatisations would not be in the best financial interest of the state or in the best interests of the NSW community with the potential for on-going high electricity prices, reduced services and poor reliability.***

APPENDIX

BASIS OF UPWARD REVALUATIONS OF NETWORK ASSETS

To quote from statements issued by the Australian (and international) accounting profession, general purpose financial statements are 'intended to meet the needs of users who are not in a position to require an entity to prepare reports tailored to their particular information needs'. The financial statements prepared by the state's electricity agencies are not user friendly. They do not make clear the extent to which the choice of unusual accounting methods have affected reported results. The choice of those methods had reduced reported profits to an extent rarely if ever seen in public sector accounting. Rather than 'meet the needs' of ordinary readers (or even regulators) they seem designed to shape community perceptions about the supposed modest profitability of the electricity distributors at a time when they were allowed by regulators to increase prices for consumers. And price increases – legitimised by a regulatory regime – enable state governments planning privatisation to 'fatten the calf for market'.

It is agreed that public utilities that now utilise full 'accrual accounting' should periodically revalue their assets in order to provide a more realistic indicator of the resources invested in those enterprises – and to justify why pricing arrangements should produce a rate of return sufficient to enable those utilities to maintain and reinvest in their infrastructure.

But the major systems operated by public utilities do not have a market price. Nor could they be sold without those entities abandoning that area of business. Hence, the use of current replacement costs, after allowance for depreciation, is arguably a suitable basis for asset valuations by public utilities. But, as argued elsewhere,[16] these base valuations should be retained for a period (five years seems appropriate) to enable indicators of financial performance to be prepared on a consistent basis over that period. Otherwise financial statements would not present a meaningful indication of trends in profitability.

Indeed this was the approach adopted by NSW Treasury prior to 2012 (albeit with some modifications – Treasury proposed that assets be revalued to depreciated replacement costs 'at least every five years'. A vaguely-worded accounting standard AASB 116 'Property, Plant and Equipment' (2004) had provided that 'an item of property, plant and equipment *whose fair value can be measured reliably* shall be carried at a revalued amount, being its fair value at the date of the revaluation less any subsequent accumulated depreciation

[16] See R.G. Walker, F.L. Clarke & G.W. Dean 'Options for infrastructure reporting', *Abacus*, Vol. 36, (2) 2000 and R.G. Walker. F.L. Clarke & G.W. Dean, 'Use of CCA in the public sector: lessons from Australia's experience with public utilities', *Financial Accountability & Management*, February 2000.

and subsequent accumulated impairment losses' (paragraph 31, emphasis added). AASB 116 then observed:

> If there is no market-based evidence of fair value because of the specialised nature of the item of property, plant and equipment and the item is rarely sold, except as part of a continuing business, an entity may need to estimate fair value using an income or a depreciated replacement cost approach (paragraph 33).

'Fair value' is supposedly the price that would be received to sell an asset in an orderly transaction in the principal market for those assets. The reference to the use of estimates of fair value on an 'income approach' did not explain the circumstances in which this method – presumably the discounted present value of forecast future cash flows – could come to be regarded as a *reliable* measure of an exit price. Possibly that could be feasible in some limited circumstances e.g. if contractual arrangements for rental of a specialist building established future returns, and there was market evidence of a suitable discount rate used to price similar arrangements. Otherwise such valuations would be entirely subjective. A calculation based on forecasts would not (save in unusual circumstances) be a 'reliable measure' for accounting purposes.

Possibly in recognition of this, in 2007 NSW Treasury issued a circular NSW TPP 07/01 'Accounting Policy: Valuation of Physical Non-Current Assets at Fair Value' that noted that accounting standards 'did not provide any direction on what is meant by an "income approach" or when to apply it'. Treasury concluded that an 'income approach' should not be used as the primary valuation method for valuing specialised assets when there was no market-based evidence of fair value. Rather, depreciated replacement cost (subject to 'impairment testing') should be used by state agencies. Treasury argued that this information was relevant to 'users and the shareholder', and for managers and the regulator (paragraph 2.3.5).

Then under the Baird Government, in March 2012 NSW Treasury reversed its position. A one-page circular NSW TC 12/05 'Fair Value of Specialised Physical Assets' allowed use of an 'income approach' by NSW public sector entities with cash generating specialised assets in the absence of market-based evidence. Whereas the 2007 circular had included a lengthy explanation of reasons for its ***prohibition of use of an 'income approach'*** to asset valuation, the 2012 document contained no explanation of why this method was suddenly acceptable. It simply stated that 'Treasury no longer considers that it is appropriate ... to restrict the application of this option'. It did not explain how this information could be relevant to any class of 'users'.

Ausgrid was quick to take advantage of the changed policy – writing up its system assets by $2.9 billion on the last day of the 2013 financial year. Mention was made above of how the financial reports of Endeavour (2014: total reserves $927.4 million) did not comply with the requirements of accounting standard AASB 101 'Presentation of Financial Statements' since they failed to disclose the composition of these (material) reserves.

Because of these omissions, it is not possible to track full details of revaluations after the Treasury policy switched from endorsing use of 'depreciated replacement cost' to enabling use of the 'income approach'. Notes to the accounts in the 2013 annual reports confirmed use of the 'income approach' after that change (see e.g. Ausgrid, p. 37; Endeavour, p. 42; TransGrid, p. 44) – but with the honourable exception of TransGrid, did not explain the dollar effect on depreciation charges or reported profits – let alone changes on reported rates of return on assets or equity.

However, while these agencies claimed to have complied with the relevant accounting standard AASB 13 'Fair Value Measurement' in valuing system assets, that is either debatable or, in some respects, flatly wrong. The standard specifies that entities applying this valuation technique must have 'sufficient data' which involves 'maximising the use of relevant observable inputs and minimising the use of unobservable inputs'. Forecast cash flows are not 'observable', and more significantly, the discount factor used – claimed to be the 'weighted average cost of capital' (WACC) – is not observable, directly or indirectly. Rather, WACC is calculated by incorporating, *inter alia* unobservable assumptions about what rate of return on equity investment would be 'required' or 'demanded' by shareholders. (The fact that historic reported rates of return of government agencies can be manipulated by selective asset revaluations makes this particularly problematic.)

But readers of these financial statements are not told what critical assumptions[17] were used in the valuation exercise – contrary to AASB 13 which prescribes disclosure of 'the valuation techniques and inputs used' in those calculations (paragraph 91).[18]

Further, the agencies did not comply with several other requirements of AASB 13:

- AASB 13 specifies that 'if there has been a change in valuation technique (e.g. changing from a market approach to an income approach or the use of an additional valuation technique), the entity shall disclose that change and the reason(s) for making it' (para. 93 (d). The agencies simply reported that they had used the 'income approach' as that was

[17] e.g. discount rates, time period over which cash flows were forecasted, residual value of assets at the end of that period.

[18] For example, Ausgrid's 2013 financial statements only provided narrative descriptions of the assumptions that had been used e.g. 'the time value of money, represented by the current market risk-free rate and the price for bearing the uncertainty inherent in the asset, as encapsulated in the Weighted Average Cost of Capital (WACC)' (page 37). Compliance with the standard would have required disclosure of the percentages used. TransGrid's 2014 report only referred to its use of a discounted cash flow methodology (page 137), without further explanation.

permissible (as was the prior practice of using written-down replacement cost) in terms of the 2012 Treasury Circular;

- The standard prescribes that where calculations of ‘fair value’ involve the use of ‘significant unobservable inputs’ (and WACC is an unobservable and critical element of those calculations) – there should be disclosure of the effect of the fair value valuations on profit or loss or other comprehensive income for the period. No such disclosures were made;

- Similarly, the standard requires that where a valuation is based on ‘unobservable inputs’ (such as WACC) there should be provided a narrative description of the sensitivity of the fair value measurement to changes in those unobservable inputs ‘if a change in those inputs to a different amount might result in a significantly higher or lower fair value measurement’ (paragraph 93(h)). Plainly the choice of discount rates based on WACC would affect the asset valuations – but again, no such disclosures were made.

Even the requirements of the 2012 Treasury Circular TC 12/05 were ignored. The Circular stated that ‘where an agency changes from a DRC [depreciated replacement cost] approach to an income approach as a result of this Circular, this change is to be accounted for as a change in accounting estimate, in accordance with AASB 108. The requirements of AASB 108 standard include the following:

> An entity shall disclose the nature and amount of a change in an accounting estimate that has an effect in the current period or is expected to have an effect in future periods, except for the disclosure of the effect on future periods when it is impracticable to estimate that effect (paragraph 39).
>
> If the amount of the effect in future periods is not disclosed because estimating it is impracticable, an entity shall disclose that fact (paragraph 40).

Not all of the network agencies provided this information.

It is a matter of record that the CEO and chairman of both Ausgrid and Endeavour (Mr. Vincent Graham and Mr. Roger Massey-Greene) asserted that the financial statements ‘complied with Australian Accounting Standards’, and that they were ‘unaware of any circumstances … that would render any particulars in the financial statements to be misleading or inaccurate’.

Plainly the financial results of these agencies are a matter of considerable public interest – given political debate about whether they should be privatised and well-publicised claims that the Coalition Government will be seeking a mandate to support privatisation at the next state election.

Valuing the network agencies’ ‘business’

Commentators have not recognised that the post-2013 approach taken by the network agencies to value system assets involves first assigning a value to their ‘business’. This is clear from Ausgrid’s description of the ‘income approach’ in its 2014 statement of accounting policies:

> The valuation methodology reflects a discounted cash flow methodology to value assets, and a calculation to subtract the value of other business assets and liabilities to arrive at a value for system assets.

In other words, the value of system assets was calculated by placing a value on the overall business of Ausgrid (the present value of forecast future cash flows) and deducting the value of other assets and adjusting for liabilities. Restated:

> Value of system assets = value of business – value of ‘other’ assets + liabilities

It follows that:

> Value of business = [value of system assets + value of ‘other’ assets] – liabilities

with one qualification: accounting standards prescribe that the recorded measures of assets must not exceed ‘fair value’. However some assets – such as ‘investment properties’ – could be undervalued.

Arguably, the ‘income approach’ to the calculation of the ‘fair value’ of system assets lays bare an estimate of what the Boards consider to be the ‘fair value’ of their businesses i.e. the likely proceeds of a sale (on the basis of a few assumptions). Accordingly, an attempt was made to calculate the implied value of the business of the three agencies – allowing for the proportion of those businesses slated for sale. These calculations produced an estimate that was substantially less than the Baird Government’s claimed about prospective proceeds.

However such a calculation assumed that liabilities of the relevant agency would be met by a purchaser. If the state chooses to assume responsibility for some of those liabilities (e.g. employee entitlements) the implied ‘fair value’ would be greater. Similarly if the state chooses to ‘dividend strip’ before any sale, the value of the business would be reduced.

Three possible explanations come to mind.

First – that the value of the agencies ‘other’ (non-system) assets had been understated. But a scan of the balance sheets indicates that such items (e.g. TransGrid’s investment properties, $43 million; Ausgrid’s assets described as ‘held for sale’, $53 million) were, in context, not material.

Second – that the valuations placed on 'system assets' were deliberately understated, and only adopted for the purpose of 'managing' reported rates of return to a level that the ordinary reader might consider acceptable. This is difficult to accept, given that the financial statements (and the calculations underlying use of the 'income approach') were audited, and directors and CEOs asserted that they were 'unaware of any circumstances … that would render any particulars in the financial statements to be misleading or inaccurate'.

A third possible explanation is that the Baird Government believes that prospective private sector purchasers will place a higher value on these businesses than their retention value, either because of an expectation that the private sector would be able to cut costs, or that new owners would be able to persuade the AER (or the Australian Energy Market Commission) to allow higher prices for the delivery of electricity to consumers. The Baird Government has claimed that 'as network prices are regulated by the AER, there is no risk of a private operator unilaterally increasing prices'. Obviously any efforts by a private operator to increase prices would require such an application to be accepted by the AER – prices could not be increased 'unilaterally'. But to assess the Baird Government's claim, one needs to review the rules that the AER is required to follow. Those rules occupy more than 1500 pages, but make no direct reference to how the AER should determine the regulatory asset base if there is a change of ownership via a transaction that provides market evidence of the current 'fair value' of a network business or its system assets.

One of those rules indicates that references to 'optimised replacement cost' (the method accepted by the NSW IPART and then the AER for the initial calculation of the regulatory asset base) can be interpreted by reference to the values contained in the accounts of a network agency. And, for accounting purposes, the price paid to acquire the business of a network agencies would lead to the restatement of the previously-recorded 'cost' of a network agency's system assets. That in itself suggests that an entity's regulatory asset base could change after privatisation transactions. On the other hand, the rules refer to the regulatory asset base of a *transmission system* – which presumably would continue to exist regardless of ownership, so that the regulatory asset base would be 'carried forward' from prior periods.

So there seems to be some ambiguity in the rules concerning the interpretation of up-to-date market evidence of 'fair value'.

For its part, the AER has advised that its rules do not 'contemplate' changes in the regulatory asset base in response to market valuations or ownership changes. That may be so. But rules may change.