Submission
No 12

INQUIRY INTO LEASING OF ELECTRICITY INFRASTRUCTURE

Organisation: On-Market BookBuilds

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The Director
Select Committee on the leasing of electricity infrastructure
Parliament House
Macquarie Street
Sydney NSW 2000

Lodged via website and email: electricityleasing@parliament.nsw.gov.au

Dear Committee Members

Inquiry into the leasing of electricity infrastructure:
Using the ASX BookBuild facility to optimise pricing and allocations in an IPO

On-Market BookBuilds Pty Limited (OMB) welcomes the opportunity to provide information to the Select Committee on the leasing of electricity infrastructure. We refer to paragraphs (e), (f), and (g) of the Terms of Reference and provide this submission for the Committee's consideration.

Executive Summary
This submission respectfully makes the following observations and recommendations:

1) An IPO of the State's assets, rather than a trade sale, will allow NSW residents to participate directly in future ownership of the businesses comprising the leased assets
2) Following on from the 2013 Royal Mail IPO, the UK Government undertook a major inquiry into the practices of conducting IPOs, which "strongly recommended" the approach used by the ASX BookBuild facility for future government privatisations
3) This Inquiry referred to flaws in the methods by which IPOs (and placements) are priced and allocated, which prevent the State from eliciting true demand from ordinary investors, and cause ordinary investors to be unfairly scaled back compared to other bidders
4) The ASX BookBuild facility offers a world-first innovative solution, which does not disrupt the process of obtaining institutional bids

The ASX BookBuild facility allows every Australian investor and every broker to bid and be allocated shares using existing ASX infrastructure. Unlike previously used initial public offering (IPO) methods for government privatisations, it is the only way to attract the true volume of bids from every possible investor, at the marginal prices that they are willing to pay, and allow these bids to create a fully contestable pricing outcome.

The ASX BookBuild facility enables the State to continue to control pricing and allocation. Pricing and allocation is not 'determined by the market', but via controls in the facility that interact with the demand from the market, to overcome the problems with the traditional process.

Importantly, the ASX BookBuild facility is deemed a "financial market" for the purposes of Corporations Act 2001 (Cth) and all transactions are subject to the applicable market manipulation, insider trading prohibitions and market integrity principles.

The ASX BookBuild facility will enable the State to give priority to NSW taxpayers, and reflects the Government's stated intentions of *transparency, probity, fairness* and *broad based participation*.

About Us
On-Market BookBuilds is a private company that developed and patented a method of ensuring that capital raisings (i.e. IPOs and placements) achieve the issuer's optimal pricing outcome as well as a fair, transparent and efficient means of allocation. OMB licenced its intellectual property to the Australian Securities Exchange (ASX), for the purpose of building the ASX BookBuild facility. OMB is independent of ASX and has been authorised by ASX to promote ASX BookBuild facility. The views expressed in this submission are solely those of OMB.

The ASX BookBuild facility is part of the infrastructure of ASX Trade, on which over $1 trillion trades per year are conducted. The ASX BookBuild facility operates under rules that were given regulatory clearance by ASIC and Treasury.

OMB's mission is to allow every investor (including retail investors) to bid for and be allocated securities in capital raisings, and for those capital raisings to be priced and allocated in a fair and transparent manner.

These aims align perfectly with aims of the State and the needs of the people of NSW in relation to the anticipated IPO of leased NSW electricity transmission and/or distribution business and associated infrastructure investment.

1) <u>IPO versus Trade Sale</u>
We refer to the document tabled before the Committee "Rebuilding NSW - Long Term Lease of the NSW Electricity Networks". This document states that "*The Government is planning to undertake trade sales for each of the three businesses*". It further states that "*Domestic superannuation funds will allow mums and dads to participate in this transaction*."

If it is the State's intention that "*mums and dads*" should have the opportunity to bid for and own the three businesses, then this second statement should be examined more closely.

A) Proposed trade sales would exclude participation by self-managed superannuation funds (SMSF). According to ATO's Dec 2014 report, SMSF nationally account for:
   - more than 1 million members
   - 30% of the $1.9 trillion superannuation assets (ATO, Dec 2014).

   Of SMSFs, 31.8% are based in NSW. This translates to ~320,000 NSW residents with SMSF that will be excluded should the three businesses be disposed of by trade sale.

B) The general statement that "domestic superannuation funds will allow mums and dads to participate", further ignores:
   - whether a NSW resident's super fund is actually one of the successful bidders;
   - if the NSW resident's super fund is the successful bidder, then a resident may not have an asset allocation within that super fund that gives him/her exposure to the asset; and
   - the NSW resident has no direct ownership in the asset, nor voting rights.

C) The ASX offers a deep, liquid market with its listed companies having a market capitalisation of ~$1.7 trillion. An IPO of the businesses provides the means for all NSW residents and Australian investors to have the opportunity to continue to own the assets.

The remainder of this submission concerns the method by which IPOs are priced and allocated, should an IPO be the chosen path by the State.

2) Evidence: UK inquiry recommends ASX BookBuild facility to UK Parliament for privatisations

In October 2013, the UK Government floated Royal Mail and its shares rose by 38% on the first day of trading. If the UK Government had used a process to obtain the end-of-first day price for the benefit of the taxpayer, then the Government would have collected £1 billion more in proceeds (A$1.96 billion). The price continued to rise to a high of 86% above the issue price in January 2014.

In response, the UK National Audit Office instructed Lord Myners CBE to conduct an *"Independent Review for the Secretary of State for Business, Innovation & Skills: IPOs and Bookbuilding in Future HM Government Primary Share Disposals"*.

The Committee interviewed more than 100 market participants in the world's second largest financial market. The final report was published on December 16, 2014, and recommended that the UK Government adopt the approach of the ASX BookBuild facility for future UK Government privatisations:

*"In Australia an innovative hybrid between auctions and book-building has been developed. This system aims to allow fair, orderly and transparent pricing and allocation of new securities 'on-market' by using the existing stock exchange infrastructure…We welcome the principles behind this approach and **strongly encourage** this and any other digital auction method that helps to remove gaming from the process and brings wider transparency to enhance price discovery".*

It is significant that an Australian financial innovation to promote fair participation in capital raisings has been recommended as an ideal method by a highly regarded, independent inquiry into IPO and equity raising practices in one of the world's most significant financial markets.

3) Issues with the existing capital raising process

As stated earlier, unlike previously used IPO methods for government privatisations, the ASX BookBuild facility provides the only method to attract the true volume of bids from every possible investor, at the marginal prices that they are willing to pay.

Some of the well documented issues with the traditional IPO method include:

A. Price – set by reference to a sub-set of investors, bids from all other eligible investors do not drive price contestability.

B. Demand – while many investors can bid for shares, true demand is not sourced from the majority of investors due to the well-publicised significant scale-back that occurs to all retail and sophisticated investors.

C. Allocation – investors are treated differently, depending upon whether they are an institutional or retail investor. For example in the Medibank IPO, bids by individual investors above $14,000 were scaled back by ~95%. However, the level of scale back for institutional bidders was not made public.

D. Conflict of interest - the Issuer (seeking the highest price) and the Lead Manager's regular trading clients (seeking the lowest price) are both clients of the Lead Manager.

4) <u>Benefits of using the ASX BookBuild facility</u>

By using the ASX BookBuild facility, the State will be delivered the following 4 benefits:

A. Democratisation of the float of a State asset without disrupting the IPO process
B. Increased investor participation and enhanced returns for taxpayers
C. Minimises risks of under-pricing and ensures a fairer allocation process
D. Significant national interest benefits & support of a NSW innovation with global potential

A. Democratisation of the float of a State asset without disrupting the IPO process

In simple terms, the ASX BookBuild facility allows the pricing and allocation process to be conducted 'on-market' using a unique ticker code which is assigned to the new company by ASX. That code is visible to all market participants and retail investors via their usual trading interface. By way of example, the ASX code for BHP Billiton is "BHP". If BHP were to use the facility, then it would have a code issued specifically for the capital raising, "BHPXBB". All investors can bid into the bookbuild using this ticker code, in a similar way to how they currently bid into the secondary market.

The facility has a number of levers that enables the State to control the pricing and allocation outcomes. For example, the State can specify how much of the transaction is reserved for priority bidders. Different levels of priority can be afforded to different classes of investors. For example, one class could be NSW residents, another Australian institutional investors, and another overseas investors.

Under the ASX BookBuild facility rules, investors will know the minimum percentage of the offer that will be available for on-market bidders.

Lead managers will still collect institutional bids in the manner in which they do today. The role of the lead manager is not removed; using the ASX BookBuild facility does not disintermediate the investment banks, it simply means there is a better way for the Issuer to elicit and understand the investor demand from all legally eligible bidders. The Issuer can then use this information to make more informed pricing and allocation decisions.

The ASX BookBuild facility is deemed a "financial market" for the purposes of Australian securities laws and these regulatory principles are backed by the suite of legal prohibitions against insider trading, market rigging, false markets and market manipulation. By operating as a financial market (regulated by ASIC) the ASX BookBuild facility provides a "fair, orderly and transparent" mechanism for primary issuance.

As an additional layer of protection and to prevent the manipulation of closing prices, the precise closing time (and the resulting final price) is calculated by a random close mechanism controlled by the exchange. By adopting a clear and transparent process, lead managers cannot arbitrarily reduce the pricing of securities without causing grater scale-back to all bidders (including potentially their own clients). Additionally, the ASX BookBuild facility contains a number of mechanisms to deter 'gaming' by investors.

B. Increased investor participation and enhanced returns for taxpayers

In recent years, market structure has changed considerably. In particular:

– The Self-Managed Super Fund (SMSF) pool has grown by 10x in 10 years to $550 bln

- SMSF is now the largest component of the super fund sector in Australia (1/3rd of all super)
- Much of SMSF is managed outside of traditional broker channels, whereby SMSF is self-directed, or taking advice from financial advisers
- The methods currently employed to conduct IPOs do not encourage bidding from this pool of SMSF assets

In 2013, only 16% of IPOs greater than $400 million were allocated to retail investors (source: AFR).

In past IPOs using the traditional process, retail bidders were guaranteed only a minimum amount, therefore bidders were reluctant to place large bids, due to the perceived or real likelihood of significant scale-back. For example, if non-institutional investors are ensured to only receive $10,000 of allocations, then bidders with $100,000 of demand will be unlikely bid their true demand, as cheques will be "tied up" for a month, with $90,000 likely returned a month later.

This means that the State does not see the *latent demand*, which only comes through in the secondary market, resulting in profits going to sellers (who were allocated in the IPO) rather than taxpayers.

The process employed by the ASX BookBuild facility encourages all bidders to bid their "true demand' at their "true price". The process extracts all-of-market demand, allowing the State to see the likely post-IPO price. Consequently, the State has full knowledge of demand and can maximise price and decide how much to "leave on the table" for investors, how much of the offer will be allocated to identified investors in the priority stage, and the process has the benefit of full price contestability.

The disclosure obligations contained in the Corporations Act in Australia are designed to ensure that all information required for retail investors to make an investment decision, both in terms of price and volume, are contained in the prospectus. There is no valid argument that retail investors are unable to make a pricing decision when they are entitled to buy 'on-market' in secondary trading immediately after the IPO (usually at a higher price than the issue price of the shares).

C. ASX BookBuild facility Minimises risks of under-pricing

"Under-pricing" is relative. If the share price substantially increases post-IPO, then there is a strong argument that the issuer may have not received the optimal price, as the difference between the issue price and the trading price is a profit to the acquirer of the shares rather than the issuer. The ASX BookBuild facility allows the issuer to see all of the demand, at each price point.

This means the issuer can assess the likely price in secondary trading. This reduces the likelihood of extreme price movements. It also means that that the State, and its advisers, have a full defence against allegations that they mis-priced the issue, as they have made the pricing decision in light of all available information (including the full demand profile of all investors at the time of pricing and allocation).

D. Significant national interest benefits & support of a NSW innovation with global potential

OMB was the recipient of a grant from Commercialisation Australia. One of the criteria of that program was that the OMB technology serves the national interest by improving the capital markets. In particular, we wish to draw your attention to the following:

– The weighted average discount (by size of raising) for ASX listed companies undertaking placements is amongst the highest in developed capital markets (meaning the issuers obtain lower proceeds when raising capital)
– By encouraging all legally eligible investors to bid in capital raisings, making the pricing process more contestable, and ensuring fair allocations, the facility can lower capital raising costs without reducing fees to brokers & bankers
– A lower cost of new capital means more projects are undertaken, creating more jobs

Lowering the cost of raising new capital has significant implications for the productivity of the nation. It is worth noting that the following highly regarded, peak bodies or their leaders, have been publicly supportive of ASX BookBuild:

– Australian Institute of Company Directors (AICD)
– Business Council of Australia (BCA)
– Australian Shareholders' Association (ASA)
– Self-Managed Super Fund Association
– Governance Institute of Australia (GIA)
– Association of Mining and Exploration Companies (AMEC)
– Australian Council of Superannuation Investors (ACSI)

In Conclusion

Some will make the argument that the NSW Government should not use the ASX BookBuild facility because it is relatively new, having been launched in October 2013. OMB respectfully submits that this serves as an even stronger argument for use of the ASX BookBuild facility by the State. Few listed companies (or private companies looking to IPO) have the power of the State to ensure than the facility is used to ensure the most optimal pricing process. The State can take comfort in the fact that ASX operates the facility, and it is part of the infrastructure of ASX Trade, which conducts >$1 trillion trades p.a. Its rules and procedures have been given regulatory clearance by ASIC and Treasury.

By using the ASX BookBuild facility for the IPO of NSW electricity assets, the State will provide a precedent for listed companies to follow, benefiting all Australians with lower a cost of new capital, and a fairer process for participating in IPOs and placements. The State can play an important role in enabling a NSW innovation to be used in Australia and exported to the world's largest capital markets.

We thank the Committee for considering this submission, and look forward to the opportunity to deliver the best outcome for the State and residents of NSW.

Yours faithfully

Ben Bucknell
Chief Executive Officer

Appendix: *"Independent Review for the Secretary of State for Business, Innovation & Skills: IPOs and Bookbuilding in Future HM Government Primary Share Disposals"* (UK Government, Dec 2014)