Supplementary Submission No 2a

INQUIRY INTO GENTRADER TRANSACTIONS

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Latest information on NSW Government Finances confirms the futility of Electricity Privatisation

1. Introduction

In 2008, former Treasurer Michael Costa and former Premier Morris Iemma proposed the sale of state-owned electricity utilities that provided a basic service to residents of NSW. The Costa-Iemma privatisation proposals were resoundingly defeated by a 7 to 1 vote at the ALP State Conference, and were about to be rejected by the Legislative Council when they were withdrawn.

Costa is no longer Treasurer. Iemma is no longer Premier. But before being forced to resign, Iemma announced amended privatisation proposals, in defiance of the Labor Party's decision. It is that version which was adopted by replacement Treasurer Roozendaal - and by Premier Keneally, who at the abovementioned ALP Conference was unpersuasive in her support of the Costa proposals.

In their advocacy. Costa and Iemma engaged in 'strategic misrepresentations' about State finances, including the following claims:

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

Some of these claims were repeated by Keneally and Roozendaal in their rationalisation of the part privatisation of the State's electricity assets.

However, the facts did not then (in 2008) and do not now support such rash claims. In particular, the State's financial position is far stronger than represented or predicted. And the State's electricity needs are far less than represented or predicted.

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2. NSW Report on State Finances 2009-10

Following the release of the *2010-11 NSW Budget* in June 2010 we issued a *Briefing Note* which referred to the improved economic and financial position of NSW and the concomitant turnaround in the projected 2009-10 Budget result from an estimated deficit of $990 million to a surplus of $101 million. At that time, we noted that the State's financial position was likely to be better than outlined in the June Budget since the forecast increase in general government revenues over the next four years was believed to be conservative.

The *NSW Report on State Finances 2009-10* released on 27 October 2010 confirmed that belief. It showed that instead of a turnaround of $1,091 million in the 2009-10 Budget result (that is, from an estimated $990 million to a surplus of $101 million), there was in fact a more substantial turnaround of $1,984 million to a surplus of $994 million as shown below.

Table 1

NSW Budget Result 2009-10

	2009-10 2009-10 Budget $m	2009-10 2010-11 Budget $m	2009-10 State Finances Report Actual $m
Budget Result	(990)	101	994

Source: *2009-10 NSW Budget Paper No. 2*; *2010-11 NSW Budget Paper No. 2*; *NSW Report on State Finances 2009-10.*

The 2010-11 Budget also showed the Government's forecasts of Budget surpluses in the next four years (see Table 2 below). These are also probably conservative and future surpluses are expected to be higher than forecast in the Budget.

(We note that lower forecasts were presented in the *Half-Yearly Review 2010-11* but these figures are hard to believe. They were released by NSW Treasury on 15 December 2010 in the middle of the electricity sale process. Time will tell.)

Table 2

NSW Budget Results 2009-10 to 2013-14

2009-10 Budget $m	2009-10 Actual $m	2010-11 Budget $m	2011-12 Estimate $m	2012-13 Estimate $m	2013-14 Estimate $m
101	994	773	885	863	628

Source: *2010-11 NSW Budget Paper No. 2*; *NSW Report on State Finances 2009-10.*

3. Growth in NSW Budget Revenues

Our June 2010 Briefing Note noted that the 2010-11 Budget forecast general government revenues to increase over the next four years at an annual average rate of 3.6 per cent (p. 1-5), and that this appeared conservative when compared with the increase in 2009-10 over 2008-09 at 11.7 per cent (see Table 3).

Table 3

NSW General Government Revenues 2008-09 to 2013-14

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

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

The 2010-11 Budget revenue forecasts over the next four years also appeared conservative when compared with the annual average rate of 7.3 per cent in the five years since 2004-05 (p. 9-10) (see Table 4).

Table 4

NSW General Government Revenues 2008-09 to 2013-14

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

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

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

Table 5

NSW General Government Revenues 2008-09 to 2013-14

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

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

The *NSW Report on State Finances 2009-10* released in October 2010 confirmed our reservations about Treasury's revenue forecasts. As shown below, in one year alone, that is, in 2009-10, general government revenue was $3,375 million higher than the original Budget estimate.

Table 6
NSW General Government Revenues 2008-09 to 2013-14

	2008-09 Actual $m	2009-10 Revised $m	2010-11 Budget $m	2011-12 Estimate $m	2012-13 Estimate $m	Total $m
2008-09 Budget	47,882	50,665	53,223	55,186	Na	
2009-10 Budget	48,818	52,958	55,322	57,170	59,365	
2010-11 Budget	49,663	55,492	57,669	59,962	62,196	
2009-10 ROSF	49,663	56,333				
2009-10/2008-09	936	2,293	2,099	1,984	Na	7,312
2010-11/2009-10	845	2,534	2,347	2,792	2,831	11,349
2009-10 ROSF /2010-11 Budget		841				
2010-11/2008-09	**1,781**	**5,668**	**4,446**	**4,776**	**2,831**	**18,661**

Note: 2009-10 ROSF – *Report on State Finances* 2009-10.
Source: *2008-09 NSW Budget Paper No. 2*, p. 4-7; *2009-10 NSW Budget No. 2*, p. 5-5; *2010-11 NSW Budget Paper No. 2*, p. 5-8; *NSW Report on State Finances 2009-10*, p. 1-6.

4. NSW Government Debt

The *NSW Report on State Finances 2009-10* showed NSW general government sector net debt as a percentage of Gross State Product increased slightly from 2 per cent in June 2009 to 2.2 per cent in June 2010 (p. iii). (This was a small improvement on the 2010-11 Budget figure of 2.5 per cent in 2009-10.) (*2010-11 NSW Budget Paper No. 2*, p. 7-10) (see Table 7 below). The 2010-11 Budget also showed an increase in NSW general government sector net debt as a percentage of Gross State Product to 2.7 per cent in June 2011, before falling back to 2.5 per cent by June 2014 (*ibid.*)

Table 7
NSW General Government Net Debt

	June 2007 Actual $m	June 2008 Actual $m	June 2009 Actual $m	June 2010 Budget $m	June 2011 Revised $m	June 2012 Estimates	June 2013 Estimates	June 2014 Estimates
Net Debt	3,645	5,663	8,108	10,375	12,228	12,574	13,113	13,485
% of GSP	**1.0**	**1.5**	**2.0**	2.2	2.7	**2.6**	**2.6**	**2.5**

Source: *2010-11 NSW Budget Paper No. 2*, p. 7-10 and the *NSW Report on State Finances 2009-10* , p. iii.

Even net debt for the total State sector in 2009-10 was $33.698 billion or only 8 per cent as a proportion of Gross State Product.

These levels are miniscule in comparison to those of many developed countries in the OECD. OECD countries have an average of net debt to GDP of nearly 65 per cent. The latest general government net debt figures for some OECD countries are shown in the table below.

Table 8
OECD General Government Net Financial Liabilities
% of GDP

	2007	2008	2009	2010	2011	2012
Australia	-7.3	-7.6	-3.8	0.4	2.7	3.6
Germany	42.2	44.0	48.5	50.5	51.6	52.0
Japan	81.5	94.9	108.2	114.0	120.4	127.1
United Kingdom	28.5	33.0	43.8	51.5	57.6	62.3
United States	42.4	48.3	59.7	67.8	74.3	78.2
Euro Area	42.1	46.4	53.7	58.7	61.7	63.3
Total OECD	**38.0**	**43.3**	**51.9**	**57.9**	**62.3**	**64.9**

Source: *OECD Economic Outlook 88 database, November 2010.*

5. Electricity privatisation confirmed unnecessary

While the 2010-11 NSW Budget claimed that the State's financial circumstances are better than previously claimed by ex-Treasurer Costa, it also confirmed that there is no fiscal need to privatise the NSW electricity industry. This was also confirmed by the *NSW Report on State Finances 2009-10.*

The positive turnaround in general government revenues outlined above should be seen in the context of the Costa-Iemma rationale for privatisation.

It will be recalled that in 2008, then Premier Iemma and then Treasurer Costa were determined to sell these assets. They claimed that unless the State sold the electricity assets it needed to find $15 billion 'to keep the lights on'. Replacement Treasurer Roozendaal continues with this fallacious claim. As was noted in our November 2008 Briefing Paper this was a significant overstatement on many fronts. Suffice it to say that the $15 billion was for a shopping list of projects, and that just one power station may be needed by 2015 at a cost of around $3 billion – not $15 billion. (That 'need' has now been put back to at least 2016-17.) We also noted that the electricity assets were highly profitable, producing a rate of return of around 24% per annum on shareholders' funds. That figure would be even higher if state agencies applied private sector accounting methods.

According to the 2010-11 Budget, ***the State's electricity assets were expected to provide $7.6 billion in dividends and tax equivalents to the consolidated fund over the five years to 2013-14*** (see Table 7). This was not unexpected, given increases in electricity prices approved by IPART (whose terms of reference include having regard to the impact on pricing policies of the dividend requirements of the government agency concerned – see section 15(1)(g) of the IPART Act). Possibly prices were increased to make the sale of state-owned businesses more attractive to prospective purchasers (IPART is directed to have regard to 'any arrangements that a government agency has entered into for the exercise of its functions by some other person or body' – section 15(1)h)).

An alternative view is that the State's taxpayers (not private sector purchasers) could benefit from the flow-through of higher electricity prices to higher profits and stronger cash flows to finance on-going investment and reduction in carbon emissions - if the electricity businesses were retained in government hands.

Table 9
Dividends and Tax Equivalent Payments from the Electricity Sector

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

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

Based on the 2010-11 Budget, strong and stable cash flows from operations would comfortably enable capital expenditure in the electricity sector of some $20.8 billion over the five years to 2013-14 (see Table 10 below) – more than the exaggerated $15 billion that Costa-Iemma claimed necessitated a sell-off of these highly profitable assets.

Table 10
Capital Expenditure in the Electricity Sector

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

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

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

6. Part electricity privatisation creates new problems

Regard should be given to the dangers of selling the retail arms of distributors, and the trading rights to the output of generators which remain in government hands.

First, the separate sale of the retail segments of government businesses contradicts the Owen report's claim that it would be desirable to have some degree of integration between generators and retailing activities – as once was the case in NSW, before Pacific Power was broken up after disastrous losses on speculative dealings in the electricity market.

Back in the 1990s, the argument for the disaggregation of State agencies was that having several 'pure' retailers and generators would encourage competition. Yet overseas experience should have warned that the market could be manipulated, and that prices spike when some generators experience 'maintenance' difficulties and go off-line during times of peak demand. The Enron experience highlights how electricity traders will put their own financial interests ahead of the interest of consumers and the wider community.

Hence the 2007 Owen report recommended that retailers have some generating capacity – to protect retailers against the risks associated with volatility of energy prices. Accordingly a large proportion of the wish-list of $12 - 15 billion new investment in electricity assets suggested by Owen was $2 - $3 billion to assist retailers, $1 billion for a 'portfolio of generating assets' (peaking, intermediate, 'potentially baseload') plus $1 - $2 billion 'to develop an upstream gas position'.

We have yet to see any analysis of what risks have been transferred to the private sector through the transactions currently in progress, and what risks are retained - and what new risks will arise from partial privatisation, particularly the sale of gentrading rights.

As we have noted previously (*SMH*, 24 January 2011), while the State's electricity agencies were all government-owned, and supposedly competing against each other in the National Electricity Market, any losses incurred by one generator could be largely offset by gains of another government owned business – it was in effect a hedging arrangement. If the current transactions proceed, the state-owned generators may well be affected by the interests of the gentraders.

There are further risks associated with the arrangements for the pricing of transmission and distribution services. It is not clear whether contractual arrangements have fixed prices for these services in future years, and there has not been (to our knowledge) any assurance that those prices will be sufficient to enable future investment in government-owned infrastructure. In particular, it is not clear whether the arrangements establish appropriate incentives for the government-owned businesses to foster further development in renewable sources of energy.

7. The folly of electricity privatisation

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

#1 NSW does not face a financial crisis (and in reality, it never did).

#2 The State's Triple A credit rating has been retained.

#3 It is now widely recognised that a downgrading of a Triple A credit rating would have a miniscule effect on State finances. (For example, an increase of 10 to 20 basis points would only increase interest expense by around $7 to $14 million per annum on a rollover of $7 billion of borrowings.)

#4 NSW is now planning to spend nearly $21 billion on electricity infrastructure by 2014 – and these investments will be self-financed 'through a mix of operating surpluses and debt' (p. 8-12).

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

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

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

One of the critical arguments advanced by Costa and Iemma was that NSW would have to make major investments in new infrastructure 'to keep the lights on'. While increasing population may contribute to increased demand, there have subsequently been some changes in the levels of demand, and increases in supply through recent private sector investment.

The recent *Electricity Statement of Opportunities for the National Electricity Market* (Australian Energy Market Operators, 2010) reported that the need for new generating capacity in NSW is less urgent than claimed in the Owen report - and forecast a need for new capacity by 2016-17 and possibly 2017-18 (not 2013-14 as previously claimed). The report also detailed a substantial number of publicly announced gas-fired, wind, and black coal-fired generation proposals, in various stages of development - matters that contradict earlier claims that unless the NSW Government sold off its electricity assets, the private sector would not invest.

Even so, one can confidently expect that we will soon hear arguments that there is no merit in the government retaining part-ownership of the electricity industry. We have heard those arguments before. Recall the experience with Telstra – sold at a time when the world was on the threshold of a major revolution in communications, rivalling the industrial revolution of the nineteenth century. Since the sale of Telstra the Commonwealth has recognised the need to invest in basic infrastructure to enable the provision of telecommunications services – hence the current initiative to invest in a National Broadband Network.

A counter argument is that maintenance of a government presence in an industry can actually promote competition and restrict the capacity of private firms to exploit a regional monopoly or what could be a State-wide duopoly in retail distribution.

8. Part electricity privatisation should be reversed

Developments since this latest round of electricity privatisation advocacy was begun by Costa in 2008 have confirmed that ***retention of the profitable electricity assets is not only affordable but financially prudent and socially desirable.***

There has been a great deal of reporting on the fact that the State appears not to have received value for the part sale of the electricity assets and businesses. It is difficult to assess the precise value with Treasurer Roozendaal's refusal to release the retention value of the assets. Not even the methodology of the calculation of the retention value has been made available.

Much has been made of the cost of reneging on the transactions undertaken so far with the Premier reportedly stating that:

> ... taxpayers would face damages claims running to 'hundreds of millions of dollars' if the assets were not sold, as agreed with purchasers (Brian Robins, *The Sydney Morning Herald*, 8 February 2011, p. 6

She was outdone by a silly statement emanating from Roozendaal's office the same day:

> These damages could include bid costs, forgone profits, lost opportunity and contract value and could ultimately run to billions of dollars (*ibid.*).

Our understanding is that while contracts for the sale have been signed, final settlement of those contracts has yet to take place.

The Premier has finally committed to not selling any more electricity assets now or after the election. We say if it is wrong now and in the future to sell any more electricity assets, it was wrong to sell any at all.

Accordingly, we call on the Government not to complete the sale contracts and retain these valuable assets for the service of the people of this State.

In this connection we note evidence provided to the Committee by NSW Treasury in a letter dated 25 January 2011, in relation to the 'Gentrader Transaction Proceeds'. The Treasury Secretary refers to the claimed $5.3 billion cash proceeds of the transactions in the following terms:

> The proceeds are a cash financial asset of the state and as such increase the assets on the NSW balance sheet by the full $5.3 billion.

and then notes:

> When I stated that the cash position of the State ... "does not improve by $5 billion as a result of the sale..." I was referring to the net cash position of the State following retirement of all outstanding Delta and Eraring Debt. Retirement of this debt subsequently enhances the State's financial capacity to fund new budget measures.

The author reiterates:

> ... the improvement to the State's balance sheet is what is important here in terms of the overall impact on the State's finances....

These statements prompt the following observations:

(a) balance sheets show the assets and liabilities of a business – not the value of a 'business' per se. The sale of a 'business' (such as an electricity retail business) involved the sale of an item that was not previously fully recognised on a balance sheet;
(b) even so, the Gentrader Transactions involved the divestiture of certain previously-recognised assets; hence the claim that 100% of the proceeds will 'increase the assets' by the full amount of those gross proceeds is obviously wrong;
(c) the State's balance sheet is prepared on an accrual accounting basis, not on a cash basis. That means it shows not only 'assets' but also 'liabilities', and should disclose contingent liabilities. Past experience (such as the sale of the State Bank of NSW) indicates that a 'headline' sale price can be eroded by subsequent payments arising from guarantees and other elements of the transaction. It seems likely that the transactions have been subsidised by concessional arrangements for access to the 'poles and wires' businesses; the State may also be assuming responsibility to compensate the purchasers in the event of system failures – giving rise to future negative cash flows;
(d) any debt held by the non-financial public trading enterprises does not appear in the balance sheet of the State's general government sector. State budgets only encompass the general government sector. The Secretary's letter appears to confuse these concepts;
(e) the sale of electricity assets or businesses is likely to reduce the state's own-source revenue, and in particular the stable income stream from non-financial public trading enterprises to the consolidated fund and the general government sector. Contrary to the claims made in the letter, this is likely to have a deleterious effect on 'the State's financial capacity to fund new budget measures'.

9. Failure of accountability

Parliament has not been provided with access to the contracts underpinning the current transactions. There has been no explanation of how the provision of transmission and distribution services (via government retention of the 'poles and wires' businesses) will be priced. There has been no explanation of what will be established as a reasonable rate of return to government for the provision of those services. Nor has it been revealed what compensation will be payable to private sector retailers in the event (for example) that generators experience unplanned outages, or there are failures in transmission and distribution systems.

These major transactions have been handled by executive government, without sufficient disclosure. Even after contracts that have apparently been signed, Parliament has not been provided with access to relevant documentation – on the basis of flimsy claims about commercial confidentiality.

A key concern is obviously whether the current transactions are for a consideration that exceeds 'retention value'. It is noted that the Treasurer has reversed a previous undertaking to provide particulars of internal calculations of retention value at the conclusion of the recent bidding process. However we reiterate our concerns that the components of the calculation of retention value should be disclosed, including details of any sensitivity analysis undertaken, any 'risk adjustments'; and in particular the discount rate used to calculate the present value of future cash flows (positive and negative) arising from the transactions.

To explain: the higher the discount rate, the lower the retention value. Previously published documents indicate that calculations undertaken to evaluate proposed projects in NSW have used discount rates as high as 17%-22%. Use of such rates in calculations of retention value would produce a very low estimate – making even fire sale prices seem attractive.

This may be contrasted with discount rates used elsewhere. The UK Treasury recently published a *National Infrastructure Plan* (October 2010) which proposed adoption of the following discount rates:

Type	**Funding model**	**Indicative Weighted Average Cost of Capital (per cent)**
Publicly funded	Direct government funded investment...	3.913
Regulated markets	Regulated Asset Base model e.g. Water, Electricity, Regulated Airports	+0.25 – 3.0
Availability based payments	PFI/PPP schemes	+2.0 – 3.75
Unregulated markets – Demand based	User pays such as corporate energy utilities, unregulated airports, waste operators, and communications	+3.5 – 7.0

While we question the relevance of a 'weighted average cost of capital' for government investment – the government is there to provide services to the community not increase the value of its businesses – it is noteworthy that the UK Treasury uses a discount rate of under 7% to evaluate projects or other investments in regulated markets – and only 7.5% - 10.9% for the riskiest of projects.

If NSW Treasury has used a higher discount rate than 7% this either represents an acknowledgement that the State has retained responsibility for a high level of risk, or reflects an effort to deliberately understate retention value.

Possibly both.

10 February 2011