
Submission to

Inquiry into privatisation of state and
territory assets and new infrastructure

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February 2015

1. INTRODUCTION

We have had a long term interest in public finance including the privatisation of public assets.¹ Accordingly, we welcome the opportunity to comment on the federal government's plan to offer incentives to states and territories to privatise assets and recycle the proceeds into new infrastructure.

Before addressing the terms of reference, we suggest that the Committee might consider what it regards as the role of government (and the Commonwealth government, in particular). That would be challenging, but would provide a framework for its inquiry.

It is difficult to locate statements from political leaders that set out their views about the role of government in contemporary society. Former Prime Minister John Howard was one of the few who ventured to describe their ideas about core government functions, though his listing included references to processes rather than objectives:

I believe there will always be an irreducible minimum of public service functions. Defence, justice, a social security safety net, the monitoring of outcomes of, and alternatives to, existing policies – all these will require public service input. And there will always be a need for high quality, economic, constitutional and other policy advice....

Howard added that 'the examples cited are just that: they are illustrative, not exclusive. They highlight the key discrete public service functions that are distinct from the private sector'.

In our view, so long as political leaders avoid articulating their vision about the role of government in Australia, we will continue debating the merits or otherwise of privatising the latest target – without reference to overall objectives.

We have previously outlined our views about the role of Commonwealth or state governments 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

¹ As noted in our book, *Privatisation: sell off or sell out?*, first published by ABC Books in 2000, reprinted in 2006, and republished with a *New Introduction* by Sydney University Press in 2008, we are economic rationalists who do not oppose privatisation as a matter of principle. We argued that governments cannot do everything, nor should they try. However, we are opposed to the privatisation of agencies with the characteristics of natural monopolies that provide essential services. For example, we explained why the privatisation of profitable agencies delivering electricity and water services would not represent good financial management.

opinion can be freely disseminated within the community (Walker & Con Walker, 2000, page 279).

Some might contend that governments need not provide all of their currently provided services themselves. There may be areas where governments originally became engaged in activities in the face of market failure – but that subsequent developments mean that those services can be provided by the private sector. We have also proposed that in those circumstances, governments can use the proceeds of privatisation to reinvest in projects that are of higher priority (and to some extent are pleased to see that this concept has been labelled ‘recycling capital’ – though that it should not be viewed as an end in itself).

But we stop short of accepting the idea that governments need only ‘steer not row’, or of the related advocacy of ‘virtual government’, the notion that governments can be stripped down via privatisation to concentrate on outsourcing the delivery of functions, and to focus on the management of outsourcing contracts. We have noted that the respected management writer Henry Mintzberg described the ‘virtual government model’ as ‘the great experiment of economists who have never had to manage anything’ (‘Managing government – governing management’, *Harvard Business Review*, May-June 1996).

(a) The role of the Commonwealth in working with states and territories to fund nation-building infrastructure, including:

- (i) the appropriateness of the Commonwealth providing funding, and**
- (ii) the capacity of the Commonwealth to contribute an additional 15 per cent, or alternative amounts, of reinvested sale proceeds.**

(i) the appropriateness of the Commonwealth providing funding

Turning to the specific matters listed in the terms of reference: as for the role of the Commonwealth in working with states and territories to fund nation-building infrastructure, a response may best be provided by examples.

- The Commonwealth has a role in facilitating common standards for infrastructure that it utilises on a national basis or across state lines. Past examples include assistance in the development of a standard railway gauge, or a national highway network.
- Since infectious diseases are not contained by state borders, the Commonwealth has a role to assist the states and territories to maintain high standards in the operation of services that are fundamental to public health – for example, local water treatment plans and sewerage systems.
- Just as Telstra played a role in the development of a national telecommunications network, that role has been assumed in part by the NBN. The Commonwealth has the capacity to contribute to nation building by the development of a national broadband network that would enhance the delivery of a range of services in the fields of education and medicine – while also contributing to the dissemination of information and opinion (particularly

for states and cities where major news outlets are controlled by a single, foreign domiciled corporation).

That said, in our opinion it would be inappropriate for the Commonwealth to meddle in the governance of the states and territories by offering financial incentives for privatisation.

Decisions about the sale or retention of public trading enterprises are matters for the states and territories. On the face of it, the current Commonwealth Government is proposing to use taxpayers' money to promote an ideological agenda that involves promotion of the ideal of 'smaller government'.

The 'incentives' offered by the Commonwealth are being used in NSW to support the advocacy of the privatisation of certain electricity assets. But they could have dysfunctional consequences that are not in the best interests of that State. For a start, sale (or long-term leasing, apparently for a lump sum) will deprive the state of a reliable and stable source of revenues. That will make the state of NSW more dependent on volatile revenues from property taxes. Indeed, our assessment is that NSW would have recorded budget deficits in recent years without the dividends and tax equivalents paid by those agencies to the general government sector. Second, privatisation of monopolistic assets providing essential services could impact on prices charged to consumers. Third, service delivery could be adversely affected.

If the Commonwealth wants to take a lead in promoting better management of public assets, it could take alternative steps:

- (i) by promoting the refinement of the mandate of Auditors-General so that holders of the office of the Auditor-General are expected to keep Parliaments properly informed about the merits or otherwise of privatisation proposals, and the outcome of privatisation transactions. There have been a number of instances in which Auditors-General have failed to ensure that Parliamentarians are well informed, for example:
 - a former NSW Auditor-General announced that he would only advise that Parliament about the merits of the strategy to sell certain electricity assets, not about the merits of the proposed sale *per se*;
 - an anomaly in Australian Accounting Standards has had a particularly adverse effect on public sector accountability – but it appears that some holders of the office of Auditor-General have chosen to turn a blind eye to the financial effects of what can only be regarded as the manipulation of financial reporting in the public sector. The particular anomaly arises from a rule that accounting 'errors' are to be adjusted retrospectively; an associated rule of some relevance requires that assets 'held for sale' are not to be recorded in financial statements at figures in excess of their 'fair value' (the estimated proceeds of sale). In Queensland, for example, even though the former Bligh Government had announced plans to sell certain trading enterprises, the investments in those enterprises were not immediately treated as being 'held for sale'. Rather, retrospective adjustments were made to asset

valuations supposedly to 'correct errors'. The overall effect was that published financial statements did not report the extent of 'losses' on the sale of those enterprises. (Details are provided in a report we prepared for the Queensland Council of Unions, *Review of the Costello report: Crude analysis. Not 'independent'. Not an 'audit'*, 2012). At the time, the Queensland Auditor-General accepted the use of such 'creative accounting' without demur;

- in NSW the Baird Government is treating the forthcoming state election as a referendum on proposals to privatise electricity network agencies. A relevant consideration is the profitability of those agencies in state hands, and their contribution to the State's budget. Recent changes in accounting practices have distorted published key indicators of the financial performance of those agencies. For example, one of the agencies slated for sale revalued its system assets upwards by \$2.6 billion on the last day of the 2012-13 financial year – which had a material effect on published rates of return on assets and shareholders' equity. In a report to Parliament, the Auditor-General simply repeated the published figures without drawing attention to the impact of those changes (or to a failure of the agency concerned to report such matters in compliance with accounting standards).

Arguably some these concerns would not have arisen if the office of Auditor-General was held by someone with appropriate tertiary qualifications, training and expertise in accounting. Many office-holders have not had those qualifications, and some appear to have been 'political' appointments. Both sides of Parliament deserve better.

(ii) The 'capacity' of the Commonwealth to contribute 15 percent of 'reinvested sale proceeds' to the States

Such contributions may be affordable in dollar terms (particularly in the event of growth in government revenues).

However, in view of the Government's cries of a 'debt crisis' this initiative is surprising and inconsistent.

Perhaps it is a veiled admission on the part of the Government that, after all, the Commonwealth's debt levels as a percentage of Gross Domestic Product are low in international terms. The facts are that the levels of Commonwealth net debt at around 14% are miniscule in comparison to those of many developed countries in the OECD with an average of net debt to GDP of 71%. The latest general government net debt figures for some OECD countries are shown in the table below.

Table 1
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.*

Moreover there is an opportunity cost to this policy. If the Commonwealth proposes to transfer billions of dollars to the States for pursuing an ideological agenda, then one consequence will be a reduction in spending in other areas. Cuts to the budget and staffing of the Australian Tax Office seems particularly anomalous at a time when the Commonwealth is experiencing a decline in revenues. In this context, the granting of financial incentives to the States and Territories will also involve cuts to services.

(b) The economics of incentives to privatise assets

At the outset, let us say that monetary considerations should not be the only factors to warrant consideration in relation to privatisation proposals. Governments are not in business to make money but to provide services to their communities. Consideration should be given to the likely impact on service provision of the transfer of responsibility from government to profit-seeking private sector firms. Consideration should also be given to the effect on 'accountability' arrangements in relation to the quality and effectiveness of those services.

But to focus on 'economic' considerations: the foregoing response to item (a) addresses these issues, in part.

One problem, as we see it, is that some economists take data from published balance sheets and income statements at face value - without understanding (or considering) how the numbers they rely upon have been calculated.

For example, we recall past advocacy of the privatisation of water authorities because they were supposedly generating a poor rate of return. The Industry Commission had criticised the 'low real rates of return' achieved by water authorities (1990) and reported that their earnings for the 1987-88 year were only 1.5 per cent per annum. EPAC claimed that water authorities 'achieve quite low rates of return' – citing an average rate of return during 1990-91 of only 4.74 per cent, and 'profitability' (defined as rate of return on total assets) of only 2.36 per cent. Both the Industry Commission and EPAC had taken reported asset valuations and profit figures at face value, even though the public sector agencies had been using different accounting treatments for 'donated' assets (contributions from developers

towards the cost of extending infrastructure), Commonwealth grants and catch-up provisioning for employee pension entitlements. EPAC in particular had compared the profitability of water authorities with private sector firms – even though private sector firms do not write-up depreciable assets. Moreover, some water authorities had treated gains from ‘donated’ assets as giving rise to revenues in the year of receipt (rather than treating those gains as adding to ‘reserves’ or only recognised them as revenues over the expected life of the assets so acquired). An exercise was undertaken to restate the reported results of ten water authorities to be consistent with the accounting practices adopted by listed public companies. The adjusted data presented a quite different picture of water industry profits:

	Water authorities	ASX-listed corporations
	%	%
Return on equity	15	4.5
EBIT/total assets	12	7.4

Note: EBIT = earnings before interest and taxes

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

That exercise led to the restatement of the financial statements of some water authorities and steps taken by the Australian accounting profession to require the treatment of ‘donated’ assets as giving rise to revenues.

Other public sector trading enterprises have continued to understate their reported profits, relative to what might be recorded by major listed industrial firms, because of their practice of periodically revaluing legacy assets to higher values (supposedly representing current replacement costs, less estimates of depreciation). Since 2013 some agencies have adopted more vigorous upward asset revaluations, supposedly based on the value of the overall business (the ‘income approach’). The significance of these practices is they affect both the numerator and denominator of rate of return calculations. The numerator – reported profit (often after notional taxes paid to State Treasuries) – is reduced by higher depreciation charges. The denominator – reported total assets or reported shareholders’ equity – is inflated. The overall effect of these accounting practices has been to reduce key indicators of the underlying profitability of government trading enterprises. That in turn makes it easier for advocates of privatisation to advance their proposals in the political arena.

It is accepted that there is a strong case for revaluing long-lived infrastructure assets to a figure other than depreciated historical cost, but recent practices have taken the revaluation exercise to extremes. In effect, the choice of accounting policies prepares the ground for privatisation, and shapes perceptions about the (apparently modest) profitability of state-owned businesses. No doubt, potential bidders can devote the time to analyse these practices and recognise the underlying profitability of what are commonly, natural monopolies.

But, in short, public sector accounting practices themselves create incentives for privatisation.

(c) What safeguards would be necessary to ensure any privatisations were in the interests of the state or territory, the Commonwealth and the public

We have argued that the public interest can best be protected through the engagement of better-qualified financial officers and advisers within the public service.

If governments were provided with high quality financial information they would be better able to evaluate the pros and cons of privatisation proposals.

In relation to item (c), it is assumed that the reference to 'privatisations' here relates not just to the sale or long-term lease of assets, but to other forms of private-sector involvement (such as in public private partnerships). If the proceeds of a sale are to be reinvested in new projects, one of the currently-favoured vehicles is via a PPP.

Two of the claimed 'safeguards' in relation to PPPs are (i) proposals to publish contract summaries and (ii) use of the so-called 'public sector comparator'.²

(i) Publishing contract summaries

In our view in the interests of accountability, governments that enter into PPPs should publish a summary of the key elements of those arrangements. Early experience with the publication of contract summaries has been disappointing.

In 2001 NSW Guidelines decreed that after PPP contracts between the Government and private sector parties have been signed

Contract summaries will be prepared, audited, and then tabled in Parliament within 120 days of the contract becoming effective (NSW Government, *Working with Government, Guidelines for Privately Financed Projects*, 2001, p. 12).

In practice, contract summaries were not 'audited' but only examined by the Auditor-General, to provide assurance that they provide a summary of key points in the documentation. The then NSW Auditor-General described the process as a 'procedure' rather than an 'audit review'.

An examination of contract summaries (published before 2008) revealed that they included minimal information about the financial merits of the proposed project, as opposed to alternative modes of financing. The majority of the contract summaries had not been prepared by agency staff, but by consultants – suggesting that staff of the agencies involved had some difficulty in understanding and summarising the complex legal documents that had been prepared to handle this form of privatisation, let alone summarise their financial impacts.

But the worst element of the contract summaries was the cursory presentation of the financial justification for the use of a PPP rather than conventional government

² The following comments are extracted from Walker & Con Walker, *New Introduction* (2008), loc. cit.

finance delivery (i.e. government would finance the construction of physical infrastructure, to be constructed by private sector operators).

Nevertheless, the merits of disclosure of these arrangements – in the interests of accountability – are compelling. It is likely that firms interested in participating in PPPs may claim that contracts or trust deeds incorporate intellectual property', or that the terms of these deals should be treated as 'commercial in confidence'. Our experience is that the structure of these arrangements is fairly common to different PPPs. Some states have in the past, published full details of PPP contracts. Hence we reject claims about 'intellectual property' and in any event, consider that a contract involving the use of public property and taxpayers' funds should never be considered 'confidential' (though obviously there would be merit in limiting disclosure to contracts involving *material* outlays – excluding minor contracts for, say, cleaning offices or servicing equipment).

(ii) The public sector comparator

In the UK in the late 1990s the Blair Government promoted the idea of preparing a 'public sector comparator' (PSC) to be used as a benchmark for evaluating competing 'Private Finance Initiative' (PFI) proposals. In 2001 both Victoria and NSW proposed that the assessment of proposals for 'public private partnerships' (PPPs) should involve comparing the costs of private sector delivery and conventional government procurement, through compilation of a 'public sector comparator' (PSC).

The PSC was described in NSW Government guidelines as:

... a model of the costs (and in some cases, revenues) associated with a proposal under a government financed method of delivery (NSW Government, *op. cit.*, 2001, p. 45).

On the face of it, this promised a higher standard of accountability about decisions to enter into public private partnerships. However the guidelines for the compilation of a PSC (if anyone read them at the time) should have been cause for alarm. In summary, they were fundamentally biased against conventional government procurement, in a range of respects. The elements are somewhat technical, but include the following:

- a focus on the *cost* of building a tollway or other revenue producing projects, while ignoring the *revenues* that might be derived from those projects if maintained in government hands;
- the inclusion within the PSC of hypothetical costs not actually incurred by state governments (e.g. council rates, land taxes, notional payroll taxes, etc), all in the name of 'competitive neutrality';
- exaggeration of the cost of public sector delivery by counting not 'best estimates' of likely costs, but 'risk adjusted' costs or cash flows. The NSW guidelines specify that the PSC depicts 'the hypothetical risk-adjusted cost of

government delivering the required project outcomes' (NSW Government, *op. cit.*, 2001), and while they do not explain how these risk adjustments are to be undertaken, an illustration of 'risk adjustments' is available from guidelines produced in Canada (Industry Canada, *The Public Sector Comparator: A Canadian Best Practices Guide*, 2003), which are summarised in the following illustration:

Suppose that a project involves capital outlays of \$100 million, and that there is a 50% probability that the public sector would experience a 20% overrun on costs. This is then quantified. The hypothetical cost for use in the PSC would not be \$100 million, but this would be inflated to \$110 million via risk adjustments:

Expected cost	\$100 m
plus	
Allowance for risk	
Expected cost overrun 20% = \$20 m	
Probability 50%	
Allowance for risk = 50% of \$20 m	<u>10 m</u>
<i>Hypothetical risk adjusted cost</i>	<u>\$110 m</u>

The rationale for these 'risk adjustments' is dubious. The public sector in most countries routinely calls for tenders and then contracts-out construction projects to the private sector. Such projects still experience cost-overruns, even though the work is undertaken by private contractors. It has been suggested that cost-overruns can be explained by misrepresentation and deception by those responsible for championing major infrastructure projects).³ Another explanation is that 'cost overruns' arise from client-initiated changes in project specifications – so that the costs would be incurred whether the project was government funded or a PPP. For example, contractual arrangements for one NSW PPP (the failed Sydney Airport Link) provided that the State Government would bear costs incurred by the operator in excess of the original budget. Other PPP contracts have provided that the Government would cover additional costs that arose from government-initiated design changes, including additional compensation to a PPP operator for consequential changes in maintenance charges and anticipated profits.

Loading up the Public Sector Comparator with these costs has the effect of fundamentally and wrongly **biasing** the exercise in favour of private sector delivery;

- requiring the use of private sector discount rates to compare the projected cash flows from a hypothetical government-funded project with those in the PPP.

³ B. Flyvbjerg, M.S. Holm and S Buhl, 'Underestimating Costs in Public Works Projects: Error or Lie', *Journal of the American Planning Association*, Vol 68 No. 3, 2002, pp.279-295. See also (by the same authors) 'What Causes Cost Overrun in Transport Infrastructure Projects?', *Transport Review*, Vol. 24 No. 1, 2004, pp. 3-18.

A 2007 NSW Treasury Technical Paper, *Determination of Appropriate Discount Rates for the Evaluation of Private Financing Proposals* (commissioned by the Australian Government) reiterated and extended this approach. It presented alternative discount rates for the PSC, distinguishing projects that were likely to generate a *net cost* to the public sector, and those likely to produce *net revenues* (such as tollways). It claimed that it was appropriate to use a discount rate that reflected the systematic risk transferred to the private sector in a PPP. For *net cost* projects, the paper advocated use of the risk-free discount rate (p. 10). For *net revenue* projects, the paper advocated use of a higher discount rate in the PSC, reflecting market evaluations of the cost of capital in projects of equivalent risk (p. 62).

Colleagues have described this analysis as having the quality of an essay that might have been produced by an undergraduate student in finance. It reflects a misunderstanding of the 'capital asset pricing model', since it focuses on the returns available only from stock market investment not returns from other assets held within the economy. It advocates *ad hoc* adjustments to the product of a calculation that is based on guesses. It ignores decades of economic debate about the 'social discount rate'.

Use of the risk-free rate for *net cost* projects would almost inevitably make the conventional government delivery less attractive than a PPP, while use of a private sector discount rate for *net revenue* projects would have the same effect. These biases are compounded by the fact that the private sector discount rate would be applied to cash flows adjusted for 'risks' (as outlined above). ***That is a blatant exercise in double counting.***

In summary, the procedures advocated in recent government guidelines are pre-destined to produce results totally biased towards PPPs (rather than delivery by government agencies). This bias against the public sector is exacerbated by a failure of the guidelines to require assessments of the on-going costs to be incurred by government in monitoring PPP projects.

It would be entirely appropriate for project proposals that may be undertaken either 'in house' (by government agencies) or 'out house' (by private sector firms) to be the subject to rigorous analysis. But the guidelines issued in Australia by various governments are inappropriately biased and consistent with an effort to pursue an extreme ideological agenda – the downsizing of the public sector.

(d) The process for evaluating potential projects and for making recommendations about grants payments, including the application of cost-benefit analyses and measurement of productivity and other benefits

It is assumed that the reference to 'potential projects' relates to proposed privatisations – though recommendations regarding 'grants payments' imply that it also refers to evaluation of requests for Commonwealth grants to subsidise project proposals for investments in new physical infrastructure by a state or territory.

Cost-benefit analysis has been described, by a distinguished (and deceased) economist, as ‘nonsense on stilts’. That is because many exercises in cost-benefit analysis are inconsistent in their identification of costs (on the one hand) and benefits (on the other) – and the arbitrary assignment of values to non-financial factors (e.g. the value of time ‘saved’ for motorists from a proposed motorway; the value of supposed reductions in the number of injuries from traffic accidents).

When it comes to analysis of an investment project, the focus is primarily on financial factors. Key assumptions that may affect the results of a cost-benefit analysis concern (a) the time frame of the analysis, (b) the residual value assigned to an asset acquired from that investment at the end of that time period; and (c) the discount rate used to convert both the positive and negative cash flows associated with a project to a ‘present value’.

All of these factors are relevant when considering the quality of analysis of certain projects (e.g. the cost-benefit analysis of the Coalition Government’s recent scaling down of the NBN). But in the current context (and in the interests of brevity) the following comments focus on the choice of discount rates.

It has become the common practice for Australian state governments to apply a discount rate that supposedly represents the weighted average cost of capital (WACC) facing private sector firms when considering investment in a project of similar risk to that in contemplation (or the retention value of that project when considering privatisation).⁴ WACC supposedly is derived from an average of the cost of borrowing (interest) and a calculation of what investors in equity securities ‘demand’ as a return on their investment. The history of the use of the concept of WACC is linked in the literature in business finance to the proposition that new business investments should only proceed if they will add to the ‘value of the firm’. Hence the WACC provided a notional ‘hurdle’ rate for screening new investment proposals: only those projects whose projected future cash flows would generate a positive net present value when discounted using a firm’s WACC should be accepted.

However governments are not elected to maximise the value of state-owned assets. They are elected to provide services and benefits to the community.

Use of WACC is not appropriate for the public sector. Calculation of a WACC involves the adoption of several assumptions, some of which are not relevant to the public sector. When debt securities are traded, yields to investors in government debt securities can be independently calculated and verified. However, governments do not raise equity, so the use of a WACC approach to the calculation of the cost of capital for the evaluation of a public sector project is not appropriate

An alternative to the use of private-sector notions of WACC in evaluating public sector projects is for these to be evaluated by reference to a ‘social discount rate’ (SDR).⁵ The SDR aims at measuring the value society places on forgoing present

⁴ See e.g., NSW Treasury, *op. cit.*

⁵ For a discussion of SDR see M. Spackman, ‘Time Discounting and the Cost of Capital in Government’, *Fiscal Studies*, Vol. 25 No. 4, 2004, pp. 467-518.

consumption, whereby the benefit of investment in public projects accrues to both current and future generations. The time preferences of private investors differ from those of socially conscious governments. Private investors require returns in their own lifetime, while governments ideally represent the interests of current and future generations. Accordingly, the SDR would assume a lower value than the private sector cost of debt. The SDR would exceed the supposed 'risk free rate' (commonly taken as the yield on Commonwealth bonds) but would be considerably less than the private sector cost of capital.

Without exploring the technicalities of the estimation of one or other notion of the cost of capital, it may suffice to note the potential dysfunctional consequences of using WACC to evaluate privatisation proposals.

One of the few occasions when data are available about privatisation transactions concerned the sale of the State Bank of NSW in 1995. The following summarises the impact of that transaction:

Early in 1995 the State Bank of NSW was sold by the Fahey Government for a headline price of \$576 million to Colonial Mutual, after the major trading banks were excluded from bidding, supposedly to promote increased competition in the banking sector. One of the conditions of the sale was that the NSW Government would assume most of the risks of bad debts on a \$13 billion loan book. After the first \$60 million in bad debts, prospective purchasers were to be reimbursed for 90% of any further losses.

.... the \$576 million headline price paid by Colonial Mutual was quickly eroded by indemnity payouts. Details were recorded for a period in NSW Budget Paper No. 2. Subsequently information about payouts were recorded (without explanation of line items) in the annual accounts of the 'Crown Entity'.

The outcome was a financial disaster for the State of NSW.

The bottom line is that net sale proceeds ended up being as little as \$80 - \$100 million. That was less than one year's profits - in its first year of private ownership, the bank reported a pre-tax profit of \$146.9 million.

Before Colonial merged with the Commonwealth Bank in 2000, an Independent Expert's Report included a valuation of Colonial's banking business – which, (apart from very minor investments in Tasmania and Fiji), was for all intents and purposes the old State Bank of NSW. The valuation, only four years after the State Government's sale of the bank for what may be as little as \$80 million, was in the range **\$2.5 billion - \$2.75 billion**.

In other words, the **State of NSW lost more than \$2.5 billion** from the premature sale of SBNSW – it was sold at the wrong time, for the wrong reasons (to get rid of it before the story of bad debts and maladministration came to light) and on the wrong terms.

In our opinion, the major mistake made was to evaluate whether to 'sell' or 'retain' the SBNSW using a discount rate based on market-determined estimates of the private sector cost of capital. Consultants CS First Boston used a discount rate of 18.9% after tax. As we have argued elsewhere, this was based on two flawed assumptions. One was that the retention value of the SBNSW to the state was the same as what Colonial, the eventual purchaser, was prepared to pay. The second was that Colonial should have used a discount rate that reflected the return demanded by private investors when investing in high risk banking. The first was wrong in logic. The second was wrong in the context of the transaction – given that the State of NSW was assuming risks associated with the \$13 billion loan book.

However this has not discouraged Treasury officials in Australia from continuing advocacy of the use of a variant of WACC in cost-benefit analysis of public-private partnership and other privatisation proposals.

As such, these approaches appear to be out of step with approaches adopted elsewhere. Historically, the discount rates specified by central agencies in the US and Canada have been only slightly above the rate at which governments can borrow to finance those projects (Boardman *et al.*, *Cost-benefit Analysis: Concepts and Practice*, Prentice-Hall, 2001). Significantly, in the UK there has been a reversal in position, evidently in the face of criticism from academic commentators. The UK Treasury recommended that capital projects (which would encompass partnership arrangements) should be evaluated using the risk-free rate of 3.5 per cent 'real', and a lesser and declining rate for long-term projects (HM Treasury, *Appraisal and Evaluation in Central Government*, 2003).

(e) Parliamentary scrutiny

As noted above, the proposals from the current Commonwealth Government to provide what amount to subsidies to state or territory governments to encourage the sale of government business seems designed to promote an ideological agenda that involves promotion of the ideal of 'smaller government'.

There are also concerns that such subsidies could be used to selectively support governments of the same political persuasion.

While we consider that if a state or territory proposes to privatise government business or activities via sales, such decisions are matters for the states and territories, and should stand on their own feet – without the use of incentives paid for by taxpayers.

It might be argued that each proposal to provide a state or territory government with a subsidy to sell public assets should be subject to legislation so that each proposed 'deal' can be reviewed by Parliament.

In our opinion, the Commonwealth should simply abandon the idea of subsidising privatisations as bad policy.

(f) Alternative mechanisms for funding infrastructure development in states and territories

The major vehicle for funding infrastructure development in the states and territories – particularly developments undertaken within the non-financial public trading enterprise sector - would be via borrowings, or revenues from government businesses.

It is unfortunate that some politicians have chosen to ‘scare’ the electorate by emphasising the level of interest being met by governments, either in the budget sector or on a ‘whole of government’ basis. Quoting large numbers (so many millions of interest payable per day or per month or per year) may certainly have an effect on those who have no training in business finance, or who have never read a government balance sheet or income statement.

As noted above, the Commonwealth’s net debt is very low compared to comparable countries. The same may be said for states such as NSW.

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 2
NSW 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.

Moreover, a government business (like any business in the private sector) may do well by funding investment through borrowings – if their revenues from that investment exceed their borrowing costs. The relationship between equity investment and borrowings is called ‘gearing’. Plainly high levels of borrowing may involve risks – if those revenues do not eventuate as forecast, a business may incur losses, even fail. But most government businesses operate as natural monopolies and so can charge high prices for their services (regulatory arrangements may ensure they earn a prescribed rate of return, and can ‘pass through’ certain unexpected costs); governments as a whole are largely insulated from financial risks by the fact that they have the power of taxation. Within limits, of course.

We note that, at a time when NSW’s Baird Government is proposing to sell-off electricity businesses, its 2014-15 Budget Papers refer to several agencies as having ‘inefficient balance sheets’:

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).

The Budget Papers explain that the Government ‘has moved to improve the capital structures of these businesses’ and stating that this will assist to move the capital structures of several agencies ‘closer to regulatory expectations and private sector practice’ – and that ‘this will result in additional dividends’.

The text is written in a form of code. To interpret: an ‘inefficient balance sheet’ is one that has low gearing – that is, ***the agencies concerned did not have enough debt.***

(g) Equity impacts between states and territories arising from Commonwealth incentives for future asset sales

The states and territories hold infrastructure assets of varying age and functionality. Some states have already sold major businesses that were highly profitable, and were generating stable cash flows. Other states may have entered areas of activity that at the time were not attractive to the private sector because of the high cost of entry and the limited opportunities to make them profitable in the short term.

One consequence of past privatisation transactions is that some states (like NSW) have become increasingly dependent on volatile revenue sources (such as stamp duties in property sales).

Arguably, incentives for privatisation from the Commonwealth may place burdens in later years on those states that are thereby encouraged to sell their most profitable businesses that are currently providing essential services.