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Privatisation of state and territory assets and new infrastructure

Submission
January 2015

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Introduction

This inquiry has been established to examine the so called “Asset Recycling Program”. In 2013 state, territory and federal treasurers agreed to the program, under which the states would receive incentives from the federal government to privatise assets in order to promote the building of new infrastructure projects.¹

The asset recycling program will cost the federal government \$5 billion. Details of the program payments were presented in a press release by the Treasurer dated 28 March 2014 and the financial impact was given in the May 2014 budget. Those figures are reproduced in Table 1 below:

Table 1 Asset recycling costs

Year	(\$millions)
2014-15	\$335
2015-16	\$1,278
2016-17	\$1,285
2017-18	\$1,007
2018-19	\$1,095
Total	\$5,000

Source: http://www.budget.gov.au/2014-15/content/bp2/html/bp2_expense-22.htm Note that the budget's forward estimates only go to 2017-18 but the commitment of \$5.0 billion over five years to 2018-19 was used to calculate the 2018-19 implied commitment

The budget papers add that the Asset Recycling Program:

Will be supported by a National Partnership Agreement with participating states and territories that will provide incentive payments set at 15 per cent of the sale price of the asset, paid in two instalments on the completion of set milestones. Incentive payments will be available for asset sales and reinvestment programmes agreed with the Commonwealth prior to 30 June 2016. The Initiative is time limited and will close at the end of 2018-19, or once funds have been exhausted.

From an economic perspective this proposal raises a number of questions:

- Is privatisation of government assets always desirable and should it be encouraged through Commonwealth payments?
- Is the Asset Recycling Program the best way to assist the financing of new infrastructure investment?
- Is private sector funding of infrastructure always desirable?
- How many assets are available for privatisation and where are they?

¹ Coorey P (2013) ‘Hockey offers states billions to sell off assets’, *The Australian Financial Review*, 28 November.

Is privatisation of government assets desirable?

The key argument in favour of privatisation is that private operators are more efficient than public operators. The claim is that private operators will want to maximise their profit which means, among other things, minimising their costs. Managers of public enterprises are assumed not to be motivated so much to keep down costs since they are someone else's money.

The government's views on privatisation have been reinforced by the National Commission of Audit which advised that:

the Commonwealth should not take equity positions where the activity can be undertaken by the private sector, with private investors, rather than taxpayers, risking their own money. (vol 1, p 64)

The head of the previous competition review, Fred Hilmer, was reported as saying that privatisation was an 'unfinished business and everything feasible should be privatised'.²

Treasurer Hockey says that the States should privatise virtually everything they can. According to the *Australian Financial Review* there is a \$220 billion "hit list" of assets that could be privatised.³ States are being urged to use the Yellow Pages test—if you can find an alternative provider in the Yellow Pages then government should not be doing it.⁴

However, economics and history has shown that the story is not so simple. Where a market is a 'natural monopoly', such as telephone or electricity networks, ports, most railways, etc, economic theory says that public ownership is preferable. Even Milton Friedman believed that in the case of a natural monopoly:

*there is only a choice among three evils: private unregulated monopoly, private monopoly regulated by the state, and government operation.*⁵

Friedman suggested that government operation was the lesser evil.

Under a private unregulated monopoly the community is held to ransom by an individual or corporation and so is forced to pay much more than the cost of delivering the service. This delivers excess and unjustifiable profit to someone who is in a position to exercise economic power. At least in government ownership the management is not expected to charge whatever the market will bear at the expense of consumers.

Because of this most economists agree that large utility-type natural monopolies should normally be operated by government. Historical Australian examples include the Postmaster General, most of the state utilities, the Snowy Mountains Scheme, TAA the airline the Government Aircraft Factory and so on. In some cases the situation has changed over time and the monopoly is no longer absolute – there are now many competing airlines for example. When these enterprises operate in more general markets, the question arises as to

² Coorey P and Khadem N (2014) 'Review could mean price hike', *The Australian Financial Review*, 28 March.

³ Coorey P (2014) 'Hockey's cash for asset sales', *The Australian Financial Review*, 28 March.

⁴ Anderson F (2014) 'It's the incredible shrinking government', *The Australian Financial Review*, 28 March.

⁵ Friedman M (1962) *Capitalism and Freedom*, Chicago University Press.

whether or not it might be better to convert them into private operations or otherwise involve private interests.

Even in markets we might think are best served by privately owned operators the evidence does not necessarily show that. Well before the Australian experiments with privatisation and corporatisation US studies had shown that municipal electricity firms were more efficient than private firms even when the comparisons were controlled for size, access to hydro power and so on. Similar results were obtained for telephone companies. Similarly the performance of the state-owned Canadian National railroad company was the same as that for privately owned Canadian Pacific.⁶

When we privatise government businesses we often fail to take account of why they were government owned in the first place and whether those arguments are still relevant. A senior public servant involved in the 1990s privatisations has commented that large scale privatisations and outsourcing around the world have given mixed results, often do more harm than good and end up costing more and delivering poorer quality services.⁷

The most obvious example in Australia has been the privatisation of Telstra and the difficulties in developing a high-speed broadband network. Subsequent to privatisation Telstra was able to ignore the national need for network improvement as customers generally had nowhere else to go. Australia then fell behind in the international rankings on internet performance. The bipartisan support for the NBN Co with its massive budget can be regarded as a monument to the folly of privatising a natural monopoly like Telstra.

With hindsight we see that Telstra should not have been privatised. The internet may have been little more than a curiosity when the decision was made to sell Telstra. However, what we did know was that telecommunications was changing rapidly and there was a strong argument that to keep up to date Telstra needed to be retained in public ownership.⁸

Another example comes from the provision of services to the mining industry. Where governments have privatised assets associated with mining infrastructure the experience has not been positive.

The Costello Commission of Audit commissioned by the Newman Queensland Government recommended that the government sell or lease assets that service the mining industry such as the Gladstone Port.⁹ The government subsequently rejected that recommendation to lease the port¹⁰ but prior to the release of the report the mining industry expressed concerns about the potential sale. Queensland Resources Council chief executive Michael Roche wrote:

Our experience with privatised ports has not been a good one... our industry has not been happy about the Beattie government's sale of Dalrymple Bay and the

⁶ Aharoni Y (2000) 'The performance of state-owned enterprises' in Toninelli PM (ed) *The Rise and Fall of State-Owned Enterprise in the Western World*, Cambridge University Press, pp 49-72.

⁷ Towell N (2015) 'APS outsourcing: no-one is safe, says 1990s outsourcing guru', *The Canberra Times*, 27 January.

⁸ Some of the arguments are canvassed in Richardson D (1996) 'Telstra: Privatisation issues', *Current issues brief no 8, 1996-97*, Parliamentary Research Service, Parliamentary Library.

⁹ Queensland Commission of Audit (2013) *Final Report – February 2013*, 30 April (Costello report).

¹⁰ Queensland Government (2013) *A Plan: Better Services for Queenslanders, Queensland Government Response to the Independent Commission of Audit Final Report*, 30 April.

*subsequent regulation of the port. It has struggled to meet its capacity. It was supposed to be 85 million tonnes [a year] but it doesn't do that.*¹¹

The private buyers of Dalrymple, merchant bank Babcock and Brown, were not prepared to invest in increasing the capacity of the port. This annoyed the miners who wished to open new mines in the region and needed more port capacity. Dalrymple Bay often had dozens of idle ships at sea waiting for their turn to enter the harbour. The costs of the delays were borne by the miners and buyers while Babcock and Brown made healthy profits from their existing infrastructure and were happy to exploit the excess demand rather than expand to meet the local miners' needs.¹²

The Costello commission was aware of such issues and recommend that the government should:

*Reserve the right to take action to prevent delays in port development, to enable increased capacity to be developed by Government or other users in the event that a leased port does not wish to invest to meet such capacity.*¹³

The Costello Commission does not discuss how a government would do this in practice. Doing so would likely result in years of legal dispute. But the wider importance is the recognition that neither society nor the mining industry can necessarily rely on commercial incentives to get what they need out of companies that have bought once-public assets.

We could cite many more studies that show difficulties with privatised assets. The important thing here is that the Asset Recycling Program is based on the presumption that privatisation is always preferable despite there being no logical or empirical basis for this view.

It is worth remembering many advocates of privatisation have a vested interest in it. Most obviously, the National Commission of Audit was headed by Tony Shepherd who had recently been head of the Business Council of Australia and Chairman of Transfield. Government contracts are an important source of Transfield's revenue, for example servicing detention facilities on Nauru. It is in the interests of business such as Transfield that government privatise or contract out as much as possible of their operations. As investor Warren Buffett once said:

If you want independent advice, don't ask a barber whether you need a haircut.

Clearly, privatisation is not always desirable and in many cases leads to poor outcomes for stakeholders and the wider public interest. The government should not be offering a blanket incentive for privatisation which will encourage sales of assets which are important to the public. As privatisation is not necessarily desirable in itself, we now ask whether this is the best way to build infrastructure the infrastructure that Australia needs.

¹¹ Ludlow M and Cranston M (2013) 'Miners wary of another port sale in Queensland' *The Australian Financial Review*, 4 March.

¹² Babcock and Brown Infrastructure held the assets put together by Babcock and Brown an investment bank that was often described as a 'Mini Macquarie' the much larger investment bank. BBI was subsequently Prime Infrastructure Holdings and Dalrymple is now part owned by it and Brookfield Asset Management.

¹³ Queensland Commission of Audit (2013) Final Report – February 2013, 30 April (Costello report), p 2-147.

Is the Asset Recycling Program the best way to finance new infrastructure investment?

Australia has a massive infrastructure gap as a result of population growth and infrastructure decay and obsolescence. State governments are in the unfortunate position that some 45 per cent of their revenue comes from the Commonwealth Government through GST payments and special purpose payments and those revenues have not kept pace as a result of the global financial crisis and the later slow growth.¹⁴

State governments face several options for financing new infrastructure. They can borrow money themselves, get assistance from the Commonwealth, involve the private sector, or a combination of these strategies.

As this is being written interest rates on 10 year Commonwealth Government bonds are 2.618 per cent (16 January 2015). Cameron Clyne, the CEO of the National Australia Bank, put the view that with interest rates currently so low, the government should borrow more and use its good credit rating to access cheap capital. In his view government can finance long-term roads, rail and ports 'far more effectively'. He also said:

*We don't have enough [debt]. We have a lazy balance sheet...We have a unique window as a AAA nation with strong demand for AAA debt to issue that debt and divert it to productive infrastructure.*¹⁵

Mr Clyne is absolutely right. The Commonwealth government has been able to borrow at well below four per cent or well under two per cent in real terms. Periods of low interest rates are the perfect time for investing in capital intensive projects. The hurdle rates of return that projects need to generate is so much lower and the borrowing costs are easily serviced.

State governments cannot borrow as cheaply as the Commonwealth. Over the last decade NSW has had to pay an average premium of 49 basis points over the Australian Government borrowing rate. Over the life of a 50 year, billion dollar project the difference could cost \$245 million or just under a quarter of the cost of the project. It is likely that the smaller states would have to pay a premium even higher than that paid by the NSW government.

Both Commonwealth and State Governments enjoy lower borrowing rates than private corporations. For example over the last decade the bank lending rate for large business was 118 basis points above the Australian Government 10 year bond rate.¹⁶ Likewise, RBA data indicates that AA rated corporate bonds are typically at least 100 basis points above the government bond rate. Hence any form of indirect borrowing via the corporate sector is going to require a considerable premium. A premium of 100 basis points on a 50 year, billion dollar project would cost over \$500 million more than at the Commonwealth borrowing rate.

There are many examples of where private rates of return have led to reduced services to the public, even when the service is profitable and or economically desirable. To return to Telstra and the NBN, Telstra would not build the NBN because its rate of return is not high enough for the private corporation, even though it is forecast to be around seven percent.¹⁷ By contrast Telstra earns a return on equity of 31.7 per cent¹⁸ which implies a pre-tax rate of

¹⁴ ABS (2014) *Government financial estimates, Australia 2014-15 final issue*, Cat no 6501.0.55.001, 18 November.

¹⁵ Bennet M (2013) 'Clyne pitches big-picture view on debt' *The Australian*, 2 August.

¹⁶ That uses the RBA/APRA series the large business weighted average rate on credit outstanding.

¹⁷ NBN Co (6 August 2012), *Corporate Plan 2012-2015*, NBN Co, p. 71. Press reports suggest that may now be revised down somewhat.

¹⁸ Telstra (2013) *Annual Report*.

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return of 45 per cent. Given this return on equity there is simply no way that Telstra would contemplate investing in a broadband network with a return of seven per cent.

The asset recycling initiative does at least recognise that the Federal government should be putting more money into infrastructure.

Is private sector funding of infrastructure always desirable?

A condition for eligibility for the Asset Recycling Program is the requirement for private sector involvement in funding and financing 'where possible'. However, as government funding is much cheaper than private funding, government finance will impose a smaller cost on the users of infrastructure and/or taxpayers.

To reiterate, the lowest cost finance for infrastructure funding is available through Commonwealth Government borrowing. Australian infrastructure would be best financed by the general borrowing program—the regular issuing of government bonds. At the other end of the spectrum is privatising infrastructure development by giving responsibility for project investment and management to the private sector. The private sector requires much higher rates of return which would increase costs to the community. (Or in the case of the provision of infrastructure financed by fee-for-service the commercial charge will be higher than the equivalent government charge because of the higher return on equity demanded by the private sector.)

For example, economic assessment of the High Speed Rail proposal found that the project would have a benefit cost ratio of over two – meaning the project is economically worthwhile. However, the assessment of the project pointed out that:

An expected return of at least 15 per cent would be required at this stage of project development to be attractive to commercial providers of debt and equity to major infrastructure projects.¹⁹

A 15 per cent hurdle is very high and it is therefore unsurprising that there are no private companies proposing to build the very fast train. The economic benefits of the project accruing to the Australian public could only be realised with government investment utilising the low cost of government borrowing.

Another example is retail banking. Since being privatised and largely deregulated, many bank branches in regional centres have closed. Former governor of the Reserve Bank, Ian Macfarlane, noted that because the banks required very high rates of return, they were not investing in regional services. Even if the services were profitable, branches were closed where they were not able to reach hurdles of 18 to 20 per cent. While still profitable, regional banking was just not profitable enough.²⁰ As a result, banks have made it less convenient for customers to undertake their banking.

Another example is the Clean Energy Finance Corporation (CEFC). In recent evidence to the Senate, CEFC chair Ms Jillian Broadbent stressed the importance of the fund for emissions

¹⁹ Grimshaw, KPMG, SKM, ACIL Tasman, Booz & Co and Hyder (2011) *High speed rail study: Phase 2 report*, p ix.

²⁰ See Macfarlane I (1999) 'Transcript of evidence', *House of Representatives, Standing Committee on Economics, Finance and Public Administration Inquiry into Reserve Bank of Australia annual report 1997–98*, Melbourne, Thursday 17 June. Available at: <http://www.aph.gov.au/hansard/reprs/commttee/R2365.pdf>.

abatment and that the CEFC would contribute significantly to the budget balance.²¹ According to the last annual report of the CEFC is earning 7 per cent on its investments and well above the benchmark five year bond rate it uses. However, at this rate of return, the services of the CEFC would not be provided by the private sector, as demonstrated by a 2013 submission by Westpac to the Productivity Commission. Westpac says its:

Infrastructure equity track record [through a subsidiary since 1992] has seen it produce returns after fees in excess of 12% per annum for its investors.²²

That of course represents a very large hurdle and so it is likely there many projects that Westpac would reject but that the CEFC would accept.

These examples show that governments are able to operate with a much lower internal rate of return than the private sector. Any 'rule' that says it should be private or involve private money will discriminate against projects that earn a reasonable return but not a high return. It means that Australia will miss out on projects that would have enhanced economic welfare.

How many assets are available for privatisation and where are they?

The drive for privatisation through the Asset Recycling Program suggests that there are a lot of assets that can be privatised throughout the country. However, in Australia government businesses do not have a very large share of the economy. The Organisation for Economic Cooperation and Development (OECD) notes that State Owned Enterprises' (SEOs) retain a significant presence in many countries and often account for up to ten per cent of national output in some countries.²³ By contrast public non-financial corporations in Australia had sales of goods and services of just 4.2 per cent of GDP in 2013-14.²⁴ Australia does not have a large part of its economy owned by the public sector and available for privatisation. Furthermore, the assets that are available for privatisation are not distributed evenly between the states.

To our knowledge there has been little discussion of which states and territories are likely to be affected by the present proposals. We have examined the distribution of 'privatisable' assets among the states and territories. The distribution of these assets is very unequal between the states and territories, and on a per capita basis, as shown in Table 2 below:

Table 2: State and territory distribution of 'privatisable' assets.

Government Businesses Assets	Population	Privatisable assets per capita
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²¹ ABC (2013) 'Jillian Broadbent defends the record of the Clean Energy Finance Corporation' *PM*, 27 November.

²² Westpac (2013) *Submission 51 to the Productivity Commission Inquiry into public infrastructure*, December.

²³ see OECD (2014) *The size and sectoral distribution of SOEs in OECD and partner countries*, OECD publishing. http://www.keepeek.com/Digital-Asset-Management/oecd/finance-and-investment/the-size-and-sectoral-distribution-of-soes-in-oecd-and-partner-countries_9789264215610-en#page56

²⁴ ABS (2014) *Government finance statistics, Australia, June quarter 2014*, Cat no 5519.0.55.001, 2 September. GDP was just over \$1.58 trillion (ABS (2014) *Australian system of national accounts, 2013-14*, Cat no 5204.0, 31 October. In addition to sales revenue there was an additional \$7.4 billion in current grants and subsidies mainly from governments.

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	(\$ billions)	(Millions)	(\$ per capita)
NSW	134.1	7.41	18,097
Vic	94.7	5.74	16,498
Qld	65.3	4.65	14,043
WA	75.6	2.52	30,006
SA	25.9	1.67	15,509
Tas	12.2	0.51	23,922
ACT	7.9	0.24	32,917
NT	4.0	0.38	10,526
Total	419.7	23.12	18,152

Source: ABS Cat nos 5512.0 and 3101.0 Note these are gross figures - the value of any liabilities have not been deducted. These figures are indicative only as there may be other assets within state governments that could be sold as business units.

Table 2 clearly shows that there are vast differences in the value of government businesses between the states and territories. The NT has assets worth \$4.0 billion or a modest \$10,526 per head. NSW has by far the largest holding of government businesses at \$134.1 billion but that is a still relatively modest \$18,097 per head. Top of the list in assets per head is the ACT at \$32,917 but closely followed by WA at \$30,006.

We see that funding infrastructure based on asset sales is likely to have bias towards those states that have large per capita holdings, especially the ACT and WA. Payments to the states under the asset recycling program are likely to reflect privatisation propensities and opportunities rather than any actual objective infrastructure needs. These needs are likely to be more pressing in Sydney, Melbourne and South-east Queensland but the funding is likely to be biased towards WA and the ACT.

Conclusion

The Asset Recycling Program amounts to a \$5 billion expense over the forward estimates to induce state governments to sell assets. This is a surprising expense for a government which claims to be in budget emergency. We believe there are several reasons why the Asset Recycling Program should be abandoned:

- privatisation of many types of government assets is problematic and can lead to reduced quality of services for users and the public. Any incentive that does not reflect the merits of particular proposals is likely to encourage wrong decisions.
- Raising money for infrastructure investment is much cheaper through government borrowing due to the low borrowing costs of the Commonwealth and most State Governments.

- Privatisation and infrastructure development that relies on private financing must meet private financing rates of return, which may result in reduced services to the public.

There are some areas such as telecommunications infrastructure that should remain in public hands or control to ensure Australia enjoys world class technology. Government involvement is desirable in areas that are monopolies or near monopolies with little scope to introduce competition. Most privatisations in Australia have merely swapped a public monopoly with a private monopoly. Such asset sales are unpopular, as two recent elections in Queensland have demonstrated.

Appendix: Inquiry Terms of Reference

On 30 October 2014, the Senate referred the following matter to the Senate Economics References Committee for inquiry and report:

Incentives to privatise state or territory assets and recycle the proceeds into new infrastructure, with particular reference to:

- (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;
- (b) the economics of incentives to privatise assets;
- (c) what safeguards would be necessary to ensure any privatisations were in the interests of the state or territory, the Commonwealth and the public;
- (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;
- (e) parliamentary scrutiny;
- (f) alternative mechanisms for funding infrastructure development in states and territories;
- (g) equity impacts between states and territories arising from Commonwealth incentives for future asset sales; and
- (h) any related matter.