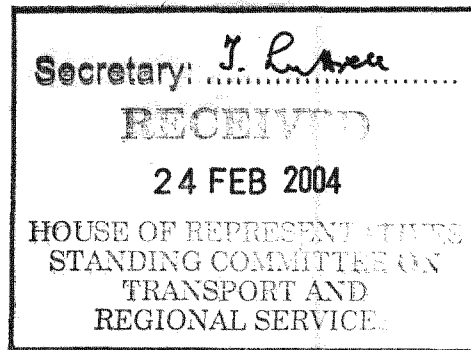




DPC 03/0574
03PO655



Hon. Mike Rann MP

The PREMIER of SOUTH AUSTRALIA

State Administration Centre
200 Victoria Square, Adelaide

GPO Box 2343
ADELAIDE SA 5001

Telephone
(08) 8463 3166

ISD
61-8-8463 3166

Facsimile
(08) 8463 3168

premier@saugov.sa.gov.au

[www.ministers.sa.gov.au/
premier](http://www.ministers.sa.gov.au/premier)

Mr Paul Neville MP
Chair of the House Representatives Standing Committee
on Transport and Regional Services
Parliament House
Canberra ACT 2600

Dear Mr Neville

South Australian Government submission to the Inquiry into Privatisation of Regional Infrastructure and Government Business Enterprises

Thank you for inviting the South Australian Government to contribute to this Inquiry. The Inquiry provides a timely opportunity for Australian Governments to openly and honestly disclose the frailty of previous policy decisions relating to the privatisation of essential services to the Australian community.

The South Australian Labor Party has a long-standing opposition to privatisation of infrastructure and Government Business Enterprises (GBEs). In 2002, the first action of the Labor Government was to call a halt to privatisation.

Notwithstanding this, the South Australian Government understands the need for innovative approaches to design, construction, financing, maintenance and operation of our infrastructure services if we are to meet the challenges and community expectations into the future. We believe more strategic approaches to infrastructure delivery are required and that increased coordination and cooperation between the three levels of Government and the private sector is also critical.

South Australia is actively pursuing opportunities, together with local government, for private sector partnerships for infrastructure provision, such as in the management and upgrade of septic tank effluent disposal schemes throughout the State.

There is a need to be open to opportunities for the private sector to participate in infrastructure delivery. Governments, however, must still remain accountable and responsible for ensuring the security and provision of essential services to the community.

Many studies have been done on the impact of privatisation. The Productivity Commission's "Impacts of Competition Policy Reforms on Rural and Regional Australia: Modeling the Regional Impacts of National Competition Policy Reforms: Supplement to Inquiry Report"¹ discusses the privatisation issues. Overall this report states that there is a net benefit but most regional areas would initially lose before gaining.

South Australia's experience is that the delivery of essential services to the community cannot be left solely to market forces and the private sector. Although market provision can sometimes operate successfully where there is an adequate concentration of demand or a population base to support it, private provision of essential services also has the potential to deliver very poor outcomes for the community. This is particularly problematic in smaller states, such as South Australia, and in regional and remote areas where there is insufficient demand to support the positive interaction of market forces and viable, cost effective service delivery.

The South Australian experience shows that contrary to many of the stated benefits of privatisation, household and business consumers have been disadvantaged through increased prices without any increase in service levels, particularly in regional and rural areas. Privatisation has failed many South Australians and there is little evidence of the claimed financial benefits or of superior efficiency and performance under private ownership.

This submission therefore highlights the experience of South Australians, drawing on the example of privatisation of the Electricity Trust of South Australia (ETSA) Corporation, and the resultant impact on the community.

Background

On Wednesday 18 March 1998, the former Premier John Olsen, introduced into the South Australian Parliament the *Electricity Corporations (Restructuring and Disposal) Bill 1998*, based on stated objectives that the electricity reform and privatisation process would be:

- an efficient, competitive electricity supply industry in South Australia, within the context of the National Electricity Market and the National Competition Policy
- sustainable lower electricity prices and choice of supply for consumers
- an appropriate regulatory environment to encourage competitive outcomes and to provide protection for consumers
- long-term security of supply
- repayment of budget-supported debt
- reduced risks to taxpayers

¹ Productivity Commission, Commonwealth of Australia September 1999

- acceptable access and equity to supply for regional South Australia.

This submission focuses on how these claimed benefits failed to eventuate and highlights that in respect of many of these areas, South Australians are without doubt worse off.

National Competition Policy

An important distinction worth noting is the difference between the requirements under the National Competition Principles (NCP) agreements for Government Business Enterprises (GBEs) to divest ownership and an individual Government's policy of privatisation.

It needs to be acknowledged that there is no requirement for Governments to pursue privatisation policies under the NCP agreements. The competition agreements specifically recognise this by requiring the application of competitive neutrality principles to GBEs where government ownership is retained. With regard to electricity policy, the New South Wales Government has shown that Government ownership is not inconsistent with the NCP agreements, or entry to the National Electricity Market (NEM).

The proponents of privatisation of GBEs often quote the loss of competition payments as a reason for the need to privatise. In the case of South Australia, Parliament was told that South Australia stood to lose more than \$1 billion in competition payments from the Commonwealth. This was clearly never the case as the NCP agreements do not require private ownership of GBEs.

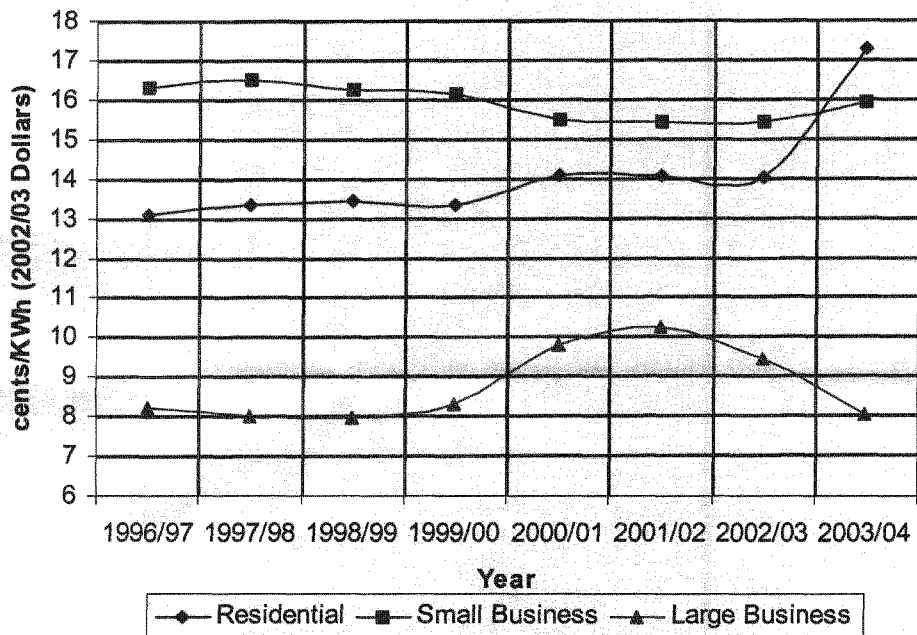
South Australia considers that the Committee should note that Government ownership and the NCP agreements are not mutually exclusive.

The "benefits" of privatisation

The former South Australian Government's stated benefits for privatising the ETSA Corporation were articulated under four main headings: decreasing prices through competition; retirement of State debt; decreasing risk to Government; and acceptable access and equity to supply for regional South Australia.

Reduction in prices

The key benefit identified during the privatisation debate in the South Australian Parliament centred around privatisation leading to cheaper power. The former Premier claimed that "research indicates that the fierce competition between private suppliers always results in prices dropping." Clearly, this has not been the case for South Australia's power prices, as illustrated in the following graph.

Figure 1: Electricity Prices in South Australia²

On 28 March 2001, the former Premier appointed a taskforce to examine the rules of the NEM and its impact on South Australia. In its final report of 29 June 2001, the taskforce found that from 1 July 2001 nearly 3000 commercial consumers of power faced price increases averaging 35%, with some increases as much as 100%.

Although the electricity industry is now operated by private companies, the South Australian Government has acted to reclaim a significant role in protecting the interests of the public to ensure that residential customers do not suffer the same fate as did business customers in July 2001. That is why the Government has:

- established the Essential Services Commission of South Australia (ESCOSA) as a strong regulator to protect the long term interests of South Australian consumers
- amended the *Electricity Act 1996* to empower the ESCOSA to ensure that electricity retailers justify price increases to small customers
- legislated for penalties of up to \$1 million for companies that breach licence conditions
- negotiated an agreement with the other States to support harsher penalties for electricity generators who spike prices in the electricity market by using inappropriate rebidding strategies. Legislation creating a tougher new penalty of up to \$1 million and \$50,000 for each day that a breach continues, received royal ascent on 20 November 2003.

² Electricity Supply Association of Australia, *Electricity Prices in Australia 2003/04*, Table A4.

The Government is also tackling the issue of electricity price increases by ensuring that the supply of electricity to South Australia is sufficient to avoid excessive price hikes at times of high demand. To this end the Government has:

- worked with energy companies to ensure the completion of the SEAGas pipeline from Victoria. The new pipeline will allow increased competition in both the gas and electricity markets and improve the security of supply. The pipeline came on-line on 1 January 2004.
- played a key role in developing reform proposals for market institutions and regulatory processes in the NEM. The reforms will help to improve the security and affordability of power supplies for South Australian consumers.
- negotiated with the NSW and Victorian Governments to facilitate an upgrade of the NSW-VIC electricity interconnector. The upgrade will increase the amount of power available for transfer from Victoria to South Australia at times of high demand.

The Energy Consumers' Council, established to provide high-level energy advice to Government, concluded in its 2002-2003 report that as a result of the 23.7% residential price increase of January 2003, South Australian residential electricity prices are the highest of any State. Some of the reasons for this increase are discussed below.

The South Australian Government established the ESCOSA on 12 September 2002. In the lead-up to electricity Full Retail Competition (FRC), the ESCOSA was directed to undertake a review of AGL SA's proposed price increases and determine whether the prices can be justified as reasonable, having regard to the contributing factors and the overall objectives of the ESCOSA.

The ESCOSA's Price Inquiry final report indicates that South Australia's higher prices are primarily driven by higher network charges, which were locked in by the pricing arrangements established to maximise the privatisation proceeds by the former Liberal Government. The final report states that the high network valuation (trebling in value from approximately \$0.9 billion to \$2.8 billion) was locked in via the Electricity Pricing Order (EPO).

The Energy Consumers' Council advice on the effect on retail prices of the network revaluation prior to privatisation accords with the conclusion of ESCOSA. The primary conclusion of the Energy Consumers' Council was that the privatisation of electricity assets in South Australia by the previous Government, and the accompanying revaluation of ETSA's distribution and transmission ("network") assets (locked in by the privatisation agreements), raised the retail cost of electricity in South Australia and has been an important factor in the 2003 increase in residential power prices. The revaluation of network assets substantially increased the 'network costs' component of the electricity tariff.

This highlights a crucial point to be considered in the privatisation of essential services. There is an inherent conflict between the desire to maximise the sale proceeds from privatisation and the need to provide these services at a reasonable cost. If the expected revenue stream from these services is diminished, for example by placing a cap on the price that may be charged or by favouring a market structure with a number of competing providers, the expected revenue from the sale of the asset will also be discounted.

In the case of electricity in South Australia, the former Government sacrificed the long-term interests of consumers for the short-term gain of extra revenue from the privatisation process. In effect, the previous government reduced debt by imposing the equivalent of an additional tax on South Australian households and businesses.

Retirement of State Debt

The former Government claimed that the privatisation of ETSA would make South Australia debt-free, releasing \$2 million a day or \$750 million a year extra to spend on schools, hospitals, police, the environment and other initiatives.

This claim, based on the premise that the sale was equivalent to the entire amount of debt retired after the sale, ignored the fact that ETSA earned hundreds of millions of dollars each year for the taxpayer and these profits would be lost if ETSA were not retained in public ownership. To be of any financial benefit to South Australia, ETSA's sale price would need to have been large enough to reduce interest on public debt by more than the State received in earnings from continuing to own ETSA. Even if achieved, this would likely be a far smaller financial benefit.

Of course, action to maximise the sale price of an asset is no guarantee that sale of the asset will have a positive impact on the budget.

Before being appointed Chair of the Energy Consumers' Council, Professor Dick Blandy³ estimated that for the ETSA sale to be revenue neutral, that is, to leave the taxpayer no worse off, or no better off, the Government needed to achieve a sale price of around \$6 billion. Anything substantially below \$6 billion and South Australia would be worse off financially. The former Government sold ETSA for \$5.3 billion of which only \$4.9 billion went to pay off debt. Transaction and sales costs absorbed this difference of \$400 million.

Importantly, it must be recognised that the consequence of Governments seeking to maximise the sale proceeds for debt retirement in effect transfers the debt burden from the Government to the community through increased prices, thus affecting those in the community who can least afford it, as well as having an adverse impact on the competitiveness of the State's businesses.

The South Australian Government strongly recommends that the Committee consider the impact of selling off 'profit making GBEs' in favour of a once-off retirement of debt. The South Australian experience shows that it is not clear that reduction in debt and therefore a reduction in interest payable is preferable to forgoing dividend payments from GBEs to Government. The sale of ETSA actually reduced rather than enhanced budget flexibility, through narrowing of the State's revenue base.

³ Richard Blandy, "Power sell-off a trivial pursuit", Australian Financial Review, 21 January 1999.

Reduction in risk

The former Government also claimed that ETSA should be sold to reduce risk based on the argument that the risk inherent in operating in the NEM is best managed by private firms.

It should be noted, however, that of the \$5.3 billion raised from the sale of ETSA, over three-quarters of these proceeds were received from the sale of 'natural monopolies.' Natural monopolies (distribution and transmission) face very little risk compared to the competitive generation and retail sectors.

In a speech to the Australian Academy of Technological Sciences and Engineering (SA Division) and Business SA Conference on 5 September 2001, Mr Owens⁴ described the risks inherent in the NEM:

"In the period before the NEM, all of the risks associated with electricity supply were managed internally by the public electricity authority monopoly. Tariffs were set at a level to recoup all costs (and even to pay large dividends to Governments and put aside funds for future investment). The tariffs were applied to broad customer categories (residential, commercial, industrial) with little attempt to separate out different costs at peak/off-peak periods or to differentiate between individual consumers.

The introduction of the NEM has seen these bundled tariffs (prices) "pulled apart" to expose the different components and in some cases, to pass these costs through to consumers in proportion to their responsibility for incurring them.

These changes have resulted also in the unbundling of risk, of exposing the different risks in each sector of the market, and of the allocation of these risks to consumers. Risks that were previously hidden, or internally neutralised, or averaged, or non-existent, are now significant components of the delivered electricity price because they have become additive."

The cost to the community of paying for these risks was highlighted in the Energy Consumers' Council report for 2002-2003. The report states that risk components, such as hedge⁵, mismatch⁶ and other risks contribute around 25% of the wholesale price of electricity determined by ESCOSA for residential consumers. This means that consumers pay around 1.8 c/kWh (about 10% of the retail price of electricity) just for additional capacity to be made available during infrequent times of peak demand.

The New South Wales Government has addressed this issue through the establishment of the Electricity Tariff Equalisation Fund (ETEF). Under this scheme, generators pay into a fund pool revenue they receive above a regulated strike price (around \$42/MWh), whereas retailers draw from the fund when the pool price is above the regulated strike

⁴ http://www.escosa.sa.gov.au/resources/documents/SAIIR_MarketCompilation-011219.pdf

⁵ Insurance type financial contracts between retailers and generators to reduce risk. Retailers are required under the National Electricity Code to purchase their energy from the pool at the prevailing pool prices. This exposes them to high risks, because their gross expenditure varies with fluctuating pool prices and volumes, while their revenue from sales of electricity tends to vary only with volumes (because their customers' prices tend to be fixed).

⁶ The difference between the retailers' customer load and the amount of hedging cover that the retailer has contacted for.

price and vice versa. This arrangement is only possible when entities are retained in Government ownership.

The South Australian Government does not consider that the reduction in risk to taxpayers argument is robust. Either the risk is merely transferred to the private sector, which then includes the cost of managing this risk into its pricing structure (which in turn results in consumers paying a premium) or the government retains certain residual risks and liabilities after sale.

If entities are retained in Government ownership, it is possible to establish internal hedging contracts and other arrangements that more effectively manage risk, including final prices.

Far from protecting consumers from risk, the privatisation of South Australia's power has amongst other things resulted in unacceptably high prices to households and businesses, required extension of public subsidies for low income earners and increased the cost and complexity of infrastructure augmentation.

The South Australian Government believes that the Committee should consider the risk that arises from commercial incentives (the need to maximise profit and shareholder value) not aligning with the interest of the general public, particularly in regional areas where maintaining infrastructure may be less profitable or unprofitable altogether. Accordingly, when essential services are removed from public hands into private enterprise, it tends to be regional and rural areas that are worst affected.

Connection costs for regional and rural consumers

The South Australian Government urges the Committee to consider the impact of removing Government involvement in the process determining the cost of providing infrastructure in rural areas.

Under the privatised electricity system established by the former South Australian Government, electricity network augmentation and extension costs are largely borne by the consumer or project proponent, with the exact amount determined by complex formulae.

Unfortunately, those most disadvantaged in the community are disproportionately affected by the increased costs of privatisation. Aboriginal communities, for example, particularly those in remote areas, tend to suffer where cost pressures and profit are greater motivating forces than service delivery. Consideration should be given to the wider use of Community Services Obligations⁷ (CSOs) to ensure adequate service delivery in these circumstances. The South Australian Government's success in applying CSOs for the supply of electricity and water in locations such as Oodnadatta and Marree has resulted in better services and more equitable costs.

The adverse consequences of the sale of essential services, such as electricity, is more evident in regional and rural areas in terms of the cost of connection to those services.

⁷ In South Australia CSOs are used by government to require a government business enterprise to provide a concession, a service or to carry out an activity which the enterprise would not elect to do on a commercial basis or which would only be provided at commercially higher prices.

The full cost of connection to services is passed onto regional businesses limiting their capacity to expand and preventing additional jobs and increased economic worth in regional areas. The Government has limited opportunity to act when this occurs because of the privatised market. By way of comparison, with public ownership in New South Wales, developers pay only a nominal connection fee.

The South Australian Government, however, is conscious of the impact of connection and augmentation costs on South Australian customers and developers. Accordingly, the Government has made submissions⁸ to the Essential Services Commission of South Australia's (ESCOSA) review of this issue.

The current rules governing the cost of electricity connection and augmentation have been criticised as being too complex, leading to delays in quotes for works and uncertainty as to the final cost. In response to these concerns, ESCOSA has determined that from 1 July 2005 a new method of calculation for contributions to connection and augmentation will be introduced. ESCOSA has determined that the contribution will be based on a simple formula of the customer's expected demand, multiplied by a unit cost (measured per kVAs) for a given geographic area, based upon the broad costs of upgrading the shared network in that geographic area.

For example, a category is likely to be established for the meshed network in the metropolitan area (with a relatively low unit cost) while at the other end of the spectrum, categories for remote areas will be established with a higher unit cost. The Chairperson of the ESCOSA has indicated that he will shortly undertake public consultation on the development of a guideline to determine the exact methodology for calculating the unit costs that will apply post July 2005.

This will ensure that the developers can determine, with a high level of certainty, the cost of any augmentation required to connect to the grid. Importantly, this proposal will maintain the current system whereby a typical urban residential connection to the distribution network is provided at no cost to the customer. The Government will continue to work with ESCOSA to ensure that the interests of all consumers are appropriately addressed.

Conclusion

This Labor Government has been strongly committed to ensuring that the privatisation of essential services in South Australia is stopped.

South Australians are paying a high price for the privatisation of the electricity assets. There is an inherent conflict between the provision of essential services at a reasonable cost and the desire to sell off essential services for the maximum price. This is particularly true with regard to the provision of services in rural and regional areas and for those sectors of the community that can least afford to bear this cost.

⁸ <http://www.escosa.sa.gov.au/resources/documents/030912-Conlon-DistCodeCh3sub.pdf>

The South Australian Government has a strong commitment to social inclusion and believes that the least well off in society should not be subjected to pure market forces when it comes to essential services. Accordingly, the Government has recently acted to increase energy concessions and rebates to pensioners. The cost of this measure is estimated at \$13 million per annum. The adverse impact of this increase on the State budget has been made necessary because of the privatisation of essential services.

There are many claims regarding the benefits of privatisation and the efficiency gains that can be made by transferring responsibility for the provision of services to the private sector. The South Australian experience, however, shows that gains are often overstated and that the costs to the community are often far too high.

I would be happy to provide the Committee with additional background information detailing the South Australian experience. The first point of contact for discussion of any issue contained in this submission should be Mr Martin Brine, Director, Federal/State Relations, Cabinet Office (08) 8226 2704.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Mike Rann', with a stylized flourish at the end.

MIKE RANN
PREMIER

23/2/2004