Chapter 5

Government Business Enterprises

5.1 Governments typically provide a number of services through a government-owned, commercial enterprise mechanism. These can include electricity, water, gas and public transport. While these businesses usually have government as their sole shareholder, they are ostensibly managed by an independent board. The committee was interested to learn, in the context of state Government Business Enterprises (GBEs), where ownership ends and management begins. It is principally this dynamic that underlies the discussion in this chapter.

Payment of dividends from GBEs

5.2 A number of witnesses commented on the way in which state and territory governments receive dividends from their GBEs. The committee's interest in payment of dividends was twofold.

5.3 The first concerned the impact that payment of dividends to government might have on the ability of the enterprise to re-invest in infrastructure. This potentially affects the ability of utilities to provide essential services to customers, but also has severe implications in relation to the longer term value of utility assets. The current situation in New South Wales electricity generation was used as an example in this regard. Of significant concern to the committee was Mr Baird's report that:

> I have been told by board members of some of these companies, as an example, that over the last three or four years they have been told, 'Do not do any strategic investments,' and that is specifically about the carbon scrubbing that we are talking about. In the US they have introduced carbon scrubbing across a lot of their generators, and emissions last year, for the first time, went backwards across the US because of this technology. That has been under way for over a decade. There has been informal advice to the various companies that, 'You're not to do that. We're just doing tactical capital expenditure.'[1]

5.4 Victorian Shadow Treasurer, Mr Kim Wells expressed similar misgivings:

> The government is taking significant dividends from the water authorities and at the same time is forcing the water authorities to increase their debt. The dividends from the water authority run into hundreds of millions of dollars, and we will get an exact figure. But it does seem ironic that the water authorities are being charged the dividends and then being expected to build infrastructure. You would expect them to use those retained earnings to build infrastructure. $2.4 billion in dividends is coming from the

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1 Mr Mike Baird MP, Shadow Minister for Finance for New South Wales, *Committee Hansard*, 24 July 2008, p. 6.

> water authorities—which is ironic, as I said, because you would expect those retained earnings to be used for building infrastructure, such as dams and pipelines—which is increasing their debt significantly.[2]

5.5 The committee's other focus in relation to dividends was the degree of independence exercised by enterprise managers in relation to the decision to pay dividends, and their quantum.

5.6 Mr Baird pointed out that the payments in New South Wales seemed to coincide with election periods:

> You cannot help but look at the electoral cycle of dividends. In 2003 there was a peak in the dividends in that election cycle, 2003 being the election. There was $768 million paid to the state government in dividends. In 2007 that rises to again another peak of $1.1 billion and, in the forecast estimates the next peak, not surprisingly, is 2011, being $1.4 billion. So the dividends are at their highest level at the point of each state election. The [GBEs] is an issue that we do not take lightly and we certainly think that the committee should look at them in terms of the overall management of a state government.[3]

5.7 In Queensland, Dr Flegg spoke more broadly about the lack of independence of GBEs in that state. When asked whether major asset decisions, such as the sale of the Mackay Airport, were made by the governing Board or the shareholding ministers, Dr Flegg responded:

> I have had very strong information from the boards, concerned that they did not even know these assets [Mackay Airport] were being considered for sale. I have no doubt that that was the case. This was a political decision, and I do not think the government have tried to hide that. When they got up and made the announcement, they simply said, 'The government have decided to sell the airport.' I think that reinforces the point that I was making before: that, in order to fund a hospital project, the government has to scratch around in the silver cabinet and find something to sell. That approach is not necessarily going to produce as good an outcome as a thought-through, economically responsible approach.[4]

5.8 Dr Flegg went on to explain the extent of political control in GBE decision making:

> I think there is little doubt in Queensland that the government views the assets of its [GBEs] as under political control. You have seen a lot of activity in Queensland Rail in recent days, and you have seen very significant privatisation with little or no consultation. Queensland owned a

2 Mr Kim Wells MP, Shadow Treasurer for Victoria, *Committee Hansard*, 19 May 2008, p. 15.

3 Mr Mike Baird MP, Shadow Minister for Finance for New South Wales, *Committee Hansard*, 24 July 2008, p. 3.

4 Dr Bruce Flegg MP, Shadow Treasurer for Queensland, *Committee Hansard*, 17 July 2008, pp 4–5.

> good portfolio of Australian wind farms; they were sold recently. Why you would want to sell a portfolio of wind farms on the eve of emissions trading defeats me. The government owned North Queensland gas pipelines. There was never any indication they were to be sold. It basically just came up with a sale announcement. There is a whole succession of those things. I have no doubt that other assets are under active consideration for sale—no doubt at all. Golden Casket is another example. All of a sudden it was announced that it was to be sold to UNiTAB.[5]

5.9 As Professor Davidson said, in a quotation elaborated at paragraph 5.15, it is not unreasonable for a controlling shareholder to tell the company that they would like to have a dividend. However, this highlights that, at times, the lack of independence of the Board in determining a dividend policy.

5.10 In June 2008, the Productivity Commission released the latest in a series of research papers looking at the performance of Australian industries and the progress of microeconomic reform. The latest paper examines the financial performance of GBEs from 2004–05 to 2006–07. In his foreword to the report, Chairman Gary Banks summarises the Commission's findings as follows:

> It is imperative that [GBEs], as significant providers of infrastructure services, operate efficiently. Those services are key determinants of Australia's international competitiveness as well as being fundamental to community wellbeing.
>
> Despite commitments by governments to operate their businesses on a fully commercial basis, many [GBEs] continue to be commercially unsustainable. The majority failed to achieve even the risk-free rate of return in 2006-07. [6]
>
> This under-performance impedes efficient capital management, the focus of a three year research program which concludes with this report. The research has emphasised the inter-relationship between [GBEs] operating profitably, properly managing their assets and providing efficient services.[7]

5.11 The report, which examined 86 GBEs, found that:

- Just over half of monitored GBEs failed to achieve a return on assets above the risk-free rate of return in 2006–07. This implies that an even greater proportion did not earn a commercial rate of return;
- Twelve GBEs (14 per cent) failed to achieve a positive return on their assets;

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5 Dr Bruce Flegg MP, Shadow Treasurer for Queensland, *Committee Hansard*, 17 July 2008, p. 5. See also, Ms Vicky Chapman MP, Deputy Leader of the Opposition for South Australia, *Committee Hansard*, 27 March 2008, pp 29–30; Mr Geoffrey Anderson, personal capacity, *Committee Hansard*, 27 March 2008, p. 56.

6 The 'risk free rate of return' is defined as the 10 year government bond rate, which is currently 5.8 per cent.

7 Productivity Commission, *Financial Performance of Government Trading Enterprises 2004–05 to 2006–07*, Research Paper, June 2008, p. iii.

- In total, GBEs made dividend payments to owner-governments of almost $4.4 billion in 2006–07. In addition, income tax and tax-equivalent payments totalled $1.8 billion; and
- Poor profitability can lead to inadequate investment and asset maintenance, which can in turn reduce the future profitability of GBEs. Without a return to commercially sustainable operations, this cycle can persist.[8]

5.12 The report also found that nine GBEs in 2006–07 (six in 2005–06) reported dividend payout ratios of over 100 per cent, mainly in the water and ports sectors. That is, the dividends paid or provided for exceeded operating profit (after tax) in that year. It implies that the GBE might be required to fund the dividend payment from previous years' retained earnings or from borrowings. Some GBEs (seven in 2005–06 and six in 2006–07) made dividend payments after reporting after-tax losses, resulting in negative dividend payout ratios. This can be explained by their owner-governments requiring them to pay pre-determined special dividends of a given amount regardless of after-tax profits.[9] A list of GBEs that have reported dividend payout ratios of over 100 per cent is included at Appendix 6.

5.13 Mr Tim Marney, Under-Treasurer for Western Australia, explained the dividend settings in his state this way:

> It is based on a 50 per cent payout ratio, which is a decision by government based on analysis of what is a competitive payout ratio relative to similar entities in other jurisdictions... We try and ensure that those entities have the right payout ratios appropriate to their balance sheet and we try and keep them stable.[10]

5.14 While unable to comment on the impact that payment of dividends has on public utilities' ability to invest, Commonwealth Treasury submitted that:

> On the broader issue of dividend payments from the sector, it should be noted that the payment of dividends to state governments is analogous to the payment of dividends to shareholders in private companies. That is, the payment of dividends merely emulates a common method of return of profits to the investor. It is desirable that public corporations act competitively. Accordingly, the making of a market return on the provision of goods and services is desirable, and a return on the investment incurred by state governments for the provision of goods or service is not, in itself,

8 Productivity Commission, *Financial Performance of Government Trading Enterprises 2004–05 to 2006–07*, Research Paper, June 2008, p. 1.

9 Productivity Commission, *Financial Performance of Government Trading Enterprises 2004–05 to 2006–07*, Research Paper, June 2008, p. 33.

10 Mr Tim Marney, Under-Treasurer, Department of Treasury and Finance, Western Australian Government, *Committee Hansard*, 12 June 2008, p. 25.

> undesirable. Indeed, a policy of retaining all normal profits in a public corporation would be questionable.[11]

5.15 Professor Davidson took a similar view:

> …in many respects these are entities with a controlling shareholder. Any entity with an identifiable controlling shareholder would have to get their controlling shareholder's permission to make major decisions. It is not unreasonable for a controlling shareholder to tell the company that they would like to have a dividend.[12]

5.16 Whilst the Committee notes, however, that the profits of government business enterprises are not always comparable to the profits of private companies the payment of dividends in excess of profits, let alone the provision of dividends when a loss has been taken, can hardly be said to emulate corporate practice. It is difficult to escape the conclusion that some GBEs are being 'milked' for short-term gain at the expense of their medium- to long-term health. Funds transferred to state governments for recurrent spending cannot be used by enterprises to modernise infrastructure and situate themselves positively for the future.

5.17 Witnesses such as AiG specifically identified the danger of practices such as these, as well as their implications:

> Ideally businesses would fund new investments from the most appropriate mix of sources of finance – borrowing, equity and retained earnings. Public ownership may be associated with excessive payouts of dividends when governments would prefer to derive revenue this way rather than find budget savings or raise taxes. This in turn could lead to underinvestment or less than optimal use of retained earnings on the part of the public sector enterprise.[13]

Community Service Obligation equalisation payments

5.18 Another practice of concern to the committee is that of state governments failing to provide capital injections or regular payments to compensate GBEs for activities that would not be undertaken if the enterprise were private, such as offering concession fares on public transport. These community service obligations (CSOs) 'cost' enterprises significant sums, and the Productivity Commission notes compensatory funding can be a significant source of revenue. Nonetheless, examples were given of GBEs which are forced to absorb CSO-related operating losses without recompense. These included Forestry Tasmania, which the Productivity Commission report stated was required to undertake non-commercial activities costing $5.3 million in 2006–07, even though it did not receive CSO payments over the reporting period.

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11 Department of the Treasury, S*ubmission 25*, p.17.

12 Professor Sinclair Davidson, Economist, Institute of Public Affairs, *Committee Hansard*, 19 May 2008, p. 31.

13 Australian Industry Group, *Submission 21*, p. 2.

Indeed, the majority of GBEs received no grant funding from government over the relevant reporting period.[14]

5.19 Substantial emphasis is placed on transparency and accountability in all government CSO policies, which are subject to intergovernmental agreements.[15] Contrary to their stated policies, not all governments are identifying all CSOs. Governments are generally not reporting funding in a transparent manner. Almost no information is reported on the costs of meeting CSOs.[16]

5.20 The Productivity Commission makes the obvious point that inadequate compensation for CSOs affects the financial performance of a GBE and impairs commercial viability which compromises governance and the integrity of operating government businesses on a commercial basis. Under-funding a CSO could also result in under-investment or higher prices for commercial services. Service quality might also be reduced.[17] The committee notes that if the GBE is a monopoly then it can easily overcharge for non-CSO services. The committee makes a recommendation in relation to government funding of CSOs in Recommendation 4 in chapter 8.

Conclusion

5.21 The committee is concerned at the practices of state governments in relation to the management of many GBEs. In particular, the committee is troubled by evidence of dividend policies imposed on GBEs by their state government owners that take little or no account of the operating conditions of the particular business, its market or infrastructure needs. The determination of dividend payments – a decision which should be made by the business' managers – appears commonly to be made, arbitrarily, at a political level. This cannot be said to be in the best long-term interests of any GBE.

5.22 The committee is alarmed by the Productivity Commission's finding that payment of dividends is being directed in excess of profits, or even in cases where businesses make a loss. Such practices cannot be justified, especially at a time when states are enjoying record GST revenue and state tax receipts are high.

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14 Productivity Commission, *Financial Performance of Government Trading Enterprises 2004–05 to 2006–07*, Research Paper, June 2008, p. 34.

15 The Productivity Commission Report identifies policy documents from jurisdictions which acknowledge the existence of agreement to run GBEs on a commercial basis, and to exercise transparency in relation to CSO costs and payments. See, for example, Box 3.1, p. 42. See also evidence from Mr Tim Marney, Under Treasurer, Western Australia, *Committee Hansard*, 12 June 2008, p. 37.

16 Productivity Commission, *Financial Performance of Government Trading Enterprises 2004–05 to 2006–07*, Research Paper, June 2008, pp 41–46.

17 Productivity Commission, *Financial Performance of Government Trading Enterprises 2004–05 to 2006–07*, Research Paper, June 2008, p. 39.

5.23 In addition to 'milking' GBE profits (or in some cases, their asset base) matters are made worse by a tendency on the part of some jurisdictions to inadequately compensate their GBEs for goods and services provided to customers on a subsidised basis. This in spite of firm undertakings by each state and territory to operate GBEs on a strict commercial-equivalent basis.