

The Privatisation of ACTEW

The fiscal, efficiency and service quality implications
of the proposed sale of ACT Electricity and Water

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Abbreviations

ACTEW	Australian Capital Territory Electricity and Water Corporation
CEO	Chief Executive Officer
CSL	Commonwealth Serum Laboratories
EBIT	Earnings before interest and tax
ESAA	Electricity Supply Association of Australia
GBE	government business enterprise
GDP	Gross Domestic Product
GWh	gigawatt hours
IPARC	Independent Pricing and Regulatory Commission
IPPs	Independent power producers
kWh	kilowatt hour
MWh	megawatt hours
NEC	National Electricity Code
NEM	National electricity market
NEMMCO	National Electricity Market Management Company
ROI	return on investment
SECV	State Electricity Commission, Victoria
SMHEC	Snowy Mountains Hydro-Electricity Corporation
WACC	weighted average cost of capital

Executive Summary

The ACT Government proposes to privatise ACTEW through the sale of electricity assets and the sale and long-term lease of water and sewerage assets. The arguments that the Government has used to support privatisation include:

- ACTEW will not be able to compete in the national electricity market;
- failure to sell will mean an effective loss of up to \$500 million in the value of ACTEW;
- privatising ACTEW will see improvements in price and service quality for ACT electricity and water consumers; and
- there is a major fiscal problem associated with the government's unfunded superannuation liability and the best way to solve the problem is to provide for all of this liability through the sale of ACTEW.

The ACT Government commissioned a study of the financial and efficiency impacts of the proposed sale as against retention in public hands by the consulting firm ABN AMRO/DGJ Projects. The Government has used the results of this study to support its case for the sale of ACTEW.

This report evaluates the impact of the privatisation of ACTEW on the financial position of the ACT public sector. In so doing, it examines the structure of ACTEW and the impact of the competitive electricity market on ACTEW's profitability. It also assesses the options for dealing with the government's unfunded superannuation liability.

ACTEW and the National Electricity Market

The introduction of the national electricity market has resulted in far-reaching changes to the electricity sector. The generation, transmission, distribution and retailing of electricity are now seen as separate business activities. ACTEW's electricity business is in fact two quite separate and markedly different businesses – energy networks (distribution) and electricity retailing.

The energy networks business is, and will remain, a regulated natural monopoly. This business currently contributes about half of ACTEW's gross margin and earnings. It is a business from which a steady stream of dividends can be expected.

The retail electricity business, by contrast, is an unregulated business facing many competitors. It currently contributes relatively little to ACTEW's gross margin and earnings. A realistic appraisal of the medium term outlook suggests that this modest contribution is likely to fall significantly over the next five years because of the extremely low margins being experienced by every Australian electricity retailer.

There is no functional requirement for electricity retailing to be combined in a single business with electricity distribution.

While the competitive market carries risks for ACTEW's electricity retailing operations, its networks business will be little affected. Over the three years 1996-1998, electricity retailing contributed an average of 10.6% of ACTEW's earnings before interest and tax, and it is only this part of the Corporation's profits that is under threat from competition.

ACTEW's water business

Water and sewerage services are natural monopolies and it is not possible to introduce competition into their supply. Sale of these assets would simply convert a public monopoly into a private one. The ACT Government suggests that a lease over water and sewerage assets would allow contestability, but the proposed 50-year lease (or even a 25-year lease) would be effective monopoly ownership for the successful tenderer.

If ACTEW's water and sewerage supply assets were privatised or subject to long-term lease, the government will continue to be held responsible for the supply of safe water services and the environmental impacts of water and sewerage. The 'threat of bankruptcy' that a private provider may be subject to will not solve the problems Canberrans would face in the case of system failure.

Evidence on efficiency impacts of privatisation

There is an extensive international literature on the effects of privatisation on the efficiency of businesses. It is now generally agreed, even by the Industry Commission, that privatisation is neither a necessary nor a sufficient condition for improving the efficiency of government business enterprises. The efficiency of an enterprise is determined by the management and operating environment, not by its ownership.

The research evidence indicates that in industries where there is a natural monopoly – notably in electricity distribution and water supply – public ownership performs as well or better than private ownership. Thus, in situations of natural monopoly, privatisation often results only in a transfer of wealth from public to private hands with little if any gain in efficiency.

The ABN AMRO report, on which the Government's case for privatisation of ACTEW rests, explains the large financial returns from privatisation by efficiency gains that are possible under private ownership but not under continued public ownership. However, the study on which this assumption is based is confidential so that the public is being asked to accept the sale of its largest asset on faith. In addition, another study commissioned by the ACT Auditor General suggests that potential cost savings are much less than claimed by ABN AMRO. The international evidence contradicts the ABN AMRO assumption that ACTEW would be more efficient under private rather than public ownership, with the possible exception of the electricity retailing operations which make up a relatively small part of ACTEW's operations.

Assessing the value of public assets

In deciding whether to sell ACTEW, or any public asset, the most important initial question is whether it will lead to an overall improvement or an overall decline in the financial position of the owners, the ACT public. There are two main technical issues that must be resolved in the valuation of public assets:

- the choice between cash-based accounting and accrual accounting; and
- the use of private sector or public sector discount rates.

On the first question, it is now generally recognised that accrual accounting provides a more realistic picture of the government's fiscal position than traditional cash-based measures. All governments throughout Australia, including the ACT Government, are implementing accrual accounting. However, the case for the sale of ACTEW in the ABN AMRO report is based on cash-flow analysis.

The case for privatisation put forward by the ACT Government is internally inconsistent because it uses a mixture of cash-based and accrual accounting methods. Rather than applying a consistent analysis, the Government has arbitrarily selected

measures that make its current fiscal position look as bad as possible and the benefits of privatisation as large as possible. In particular, the ABN AMRO report has used cash-based methods to value the Government's major commercial asset, ACTEW, while the Government has used an accrual method to value its largest liability, the obligation to pay superannuation benefits to public servants.

On the second question, ABN AMRO's treatment of discounting is even less satisfactory. ABN AMRO have counted the risks associated with public ownership twice, using a private sector discount rate (which incorporates risks) *and* adding an additional risk premium. At the same time, public sector discount rates are applied to make the superannuation liability appear as large as possible. The case for privatisation put forward by the Government is, therefore, based on serious accounting errors.

The value of ACTEW under sale and retention by the public

Using consistent accounting methods, this report assesses the financial value of ACTEW under continued public ownership by comparing the earnings that would be forgone as a result of privatisation with the proceeds of the sale anticipated by ABN AMRO.

Using ABN AMRO's worst case or cost blowout scenario, consistent application of accounting methods shows that the value of ACTEW in public hands is \$1144 million (see the table below). If ABN AMRO's sale price range of \$970-1140 million is accurate then, in the worst case, the public would be no better off from privatisation of ACTEW.

On the other hand, if we take ABN AMRO's central projection (i.e. without a cost blowout) then, using consistent accounting methods, the value of ACTEW in continued public ownership is estimated to be \$1327 million, or around \$270 million more than the sale price expected by ABN AMRO. Thus, even using ABN AMRO's revenue and cost projections, proper accounting shows that ABN AMRO's valuation of ACTEW in continued public ownership at \$530 million is a serious underestimate, and the claim that the public will lose at least \$500 million if ACTEW is not sold is based on accounting errors.

Estimates of the value of ACTEW in public and private ownership

Valuation method	Total value (\$m)
If sold to the private sector	970-1140
If retained in public hands	
using ABN AMRO low projection	1144
using ABN AMRO central projection	1327
using best estimate projection	1766

The first two scenarios adopt the very conservative revenue and cost estimates used by ABN AMRO. The low earnings projected under public ownership result in lower estimates of the value of ACTEW. A third scenario is based on less conservative (but still cautious) estimates of future revenues and costs under public ownership. The cost estimates are the same as in ABN AMRO but real revenues are slightly higher. In this 'best estimate' scenario, ACTEW's total value is \$1766 million, so that privatisation of ACTEW would reduce public sector net worth by approximately \$700 million (depending on the sale price achieved).

Financing the unfunded superannuation liability

This report analyses a proposal for ACTEW to make a \$400 million payment to the ACT government along with an annual dividend of \$25 million to be allocated to the Superannuation Provision Account. The analysis shows that it is feasible to use such a capital repayment and income from ACTEW to fund the superannuation liability, resulting in repayment within the next 12-21 years (after which ACTEW is still publicly owned). The credit rating of ACTEW remains strong with such a capital injection.

It is worth noting that this option would not be available if a previous government had already sold ACTEW. From a fiscal point of view, the responsible course is to maintain public ownership of essential services and to insist that those services generate an adequate financial and social return to the community.

Because of its partial and inconsistent application of accrual accounting procedures, the ACT Government has presented a misleadingly negative picture of its financial position. Moreover, the claim that the ACT government's unfunded superannuation liability can only be addressed by the sale of ACTEW is false.

Service quality after privatisation

Water and sewerage are essential services the quality of which are important for health and environmental amenity. Profit motives may be inconsistent with maintaining a reliable, high quality water and sewerage system and experience shows that it may not be possible to enter into contracts that maintain sufficient flexibility to ensure that changes in technology and standards can be accommodated.

ACTEW currently provides the most reliable and cheapest electricity supply in Australia. The price of this reliability is slightly higher maintenance costs. While much has been made of the impact of privatisation of electricity generation and distribution in Victoria, there is no evidence that privatisation has improved either price or service quality in the electricity market in Victoria. However, there is evidence that the disaggregation of electricity distribution and generation into competing enterprises has improved reliability and price.

ABN AMRO believe a commercial operator of ACTEW can cut maintenance costs to average Australian levels. If this occurs then service quality will tend towards average Australian levels including a substantially higher rate of blackouts.

Conclusions

In contrast to the ACT Government's arguments in favour of privatisation of ACTEW, this report demonstrates the following points.

- Competition in the electricity industry will not have a marked effect on ACTEW's overall viability because the great bulk of ACTEW's operations will never be subject to competition.
- The claim that the ACT will be better off financially as a result of the sale of ACTEW is based on accounting errors. Rather than experiencing a loss of up to \$500 million if ACTEW is not sold, correct application of accounting principles leads to the conclusion that, even in the worst case, there would be no benefit from the sale. In a more realistic assessment, the sale of ACTEW would result in a loss to the ACT public of around \$700 million.
- There is no reason to believe that privatising ACTEW will result in improvements in price and service quality for ACT electricity and water users. Some evidence suggests that privatisation may result in a decline in the extent and quality of some services provided by ACTEW.

The problem of unfunded superannuation liabilities has been overstated by the Government. Rather than selling ACTEW to solve the problem, a better solution would be to use the financial strength of ACTEW to provide a capital transfer to the government plus an annual dividend payment which would fully provide for the superannuation liability and leave the ACT with a valuable asset at the end of the process.