

**Notes on the economic implications of privatisation of SA Ports
and Homestart**

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SA Ports

This paper contains notes on the economic implications of privatisation of SA Ports. Using a conservative projection of earnings, it is concluded that a sale price of \$500 million would be required to offset the loss of dividends, retained earnings and tax equivalent payments to South Australian taxpayers.

Monopoly status of the enterprise

SA Ports currently operates ten ports, and it is therefore important to consider whether a breakup of the enterprise would create potential for competition. Analysis of the operations of the ports shows that the principal port, Port Adelaide is the sole container port and is responsible for the majority of all shipping including nearly all imports. There seems little likelihood that a competing port could be established. The smaller ports serve regional needs for the shipping of bulk commodities. Some competition among them, for example in shipping of grain from Cape York Peninsula, may be feasible. For practical purposes, however, SA Ports may be regarded as a natural monopoly.

Profit risk

In the short run, earnings risk for SA Ports depends primarily on fluctuations in shipping volume, which in turn depend on wheat harvests and on the general state of the economy. Since the wheat harvest is not correlated with general movements in the economy, risk associated with fluctuating harvests can be diversified whether SA Ports is in private or public ownership and is, therefore, of little relevance in valuing the enterprise. Risk associated with the economy as a whole is relevant in valuation, but appears to be relatively modest.

As with other natural monopoly enterprises, the principal earnings risk for SA Ports relates to possible changes in regulation. Regulatory risk is relevant in determining the market value of SA Ports under privatisation, but does not affect the value of SA Ports in public ownership, since it is internalised within the public sector.

Interest and debt

Until 1996-97, SA Ports borrowed through the South Australian Financing Authority, paying above-market rates of interest, with interest of more than \$7 million being paid on a debt of \$65 million. In 1996-97, \$20 million of the debt was repaid, and the remainder (\$44.5 million) refinanced at market rates. These changes are likely to lead to a decline in interest payments to around \$3 million per year, and a corresponding increase in net profit. Under continued public ownership, the changes in net profits and in interest payments would cancel out, leaving no effect on the value of the enterprise. In the analysis of privatisation presented below, it will be assumed that SA Ports is sold with its existing assets and debts.

Medium-term projections of the fiscal impact of privatisation

To compare the likely effects of privatisation and continued public ownership, three projections have been considered. The first, referred to as the central projection, is based on total revenue rising by around 2 per cent per year in real terms. The second, referred to as the low projection, incorporates an annual decline of 1 per cent in real revenue. This projection incorporates adverse regulatory decisions, bearing in mind the monopoly status of SA Ports. The third, referred to as the high projection, is based on the assumption that real revenue will grow in line with gross state product, at a rate of around 3 per cent per year. Although the actual outcome will doubtless be different from any *ex ante* projection, the central projection appears to be the most reasonable, at least assuming a stable regulatory outcome.

Tables 1-3 show estimates of revenue, expenses and profits for SA Ports under the three projections. It is assumed that reductions in employment continue, but at a slower pace, consistent with natural attrition. Other variable costs are assumed to grow in line with revenues. Column 2 shows projected revenues for the financial year shown in Column 1. Column 3 represents earnings before interest and tax. Column 4 shows net profit excluding

abnormal items. Column 5 shows tax equivalent payments. The sum of Columns 4 and 5, shown in Column 6, is the flow of income to South Australian taxpayers, including dividends, retained earnings and tax equivalent payments.

Table 1: Projections of revenue and profit SA Ports

Medium projection					
Year ending June 30	Revenue (\$m)	EBIT ^a (\$m)	Net profit ^b (\$m)	Taxes ^{b,c} (\$m)	Total (\$m)
1997	49	23	10	6	11
1998	51	25	14	8	22
1999	53	26	15	8	23
2000	55	28	16	9	25
2001	57	29	17	9	26
2002	60	31	18	10	28
2003	62	33	19	11	30
2004	64	34	20	11	31
2005	67	36	21	12	33
2006	70	38	23	13	35
2007	73	41	24	14	38

a: Earnings before interest, tax and abnormal and extraordinary items

b: Excluding abnormal items

c: Company tax equivalent paid to SA government

Table 2: Projections of revenue and profit SA Ports

Low projection					
Year ending June 30	Revenue (\$m)	EBIT ^a (\$m)	Net profit ^b (\$m)	Taxes ^{b,c} (\$m)	Total (\$m)
1997	49	22	23	6	11
1998	49	22	23	7	20
1999	50	22	23	7	20
2000	50	22	24	7	21
2001	50	22	24	8	21
2002	50	22	24	8	21
2003	51	22	24	8	21
2004	51	22	25	8	22
2005	51	22	25	8	22
2006	52	21	25	8	22
2007	52	21	25	8	22

a: Earnings before interest, tax and abnormal and extraordinary items

b: Excluding abnormal items

c: Company tax equivalent paid to SA government

Table 3: Projections of revenue and profit SA Ports

High projection					
Year ending June 30	Revenue (\$m)	EBIT ^a (\$m)	Net profit ^b (\$m)	Taxes ^{b,c} (\$m)	Total (\$m)
1997	49	22	23	6	11
1998	51	22	25	8	22
1999	54	23	27	9	24
2000	57	23	29	9	26
2001	60	24	31	10	28
2002	63	24	33	11	30
2003	66	25	36	12	33
2004	69	25	38	13	35
2005	72	26	41	14	38
2006	76	26	43	15	40
2007	80	27	46	16	43

a: Earnings before interest, tax and abnormal and extraordinary items

b: Excluding abnormal items

c: Company tax equivalent paid to SA government

Impact of privatisation

The projections presented in Tables 1-3 may be used as the basis for an assessment of the financial impact of privatisation. For illustrative purposes, a sale price of \$300 million has been assumed. Privatisation is assumed to take place in 1997-98. Assuming an interest rate of 6 per cent, and that all privatisation proceeds are used entirely to repay debt, use of sale proceeds to repay debt will yield annual savings on public debt interest of \$18million.

Table 4 is derived from the moderate projections presented in Table 1. With net sale proceeds of \$300 million, the profits foregone as a result of privatisation consistently exceed the interest savings. By 2007, the present value of net loss is approximately \$75 million.

Table 4: Impact of privatisation on public income^a

Medium Projection				
Year ending June 30	Total Income (\$m)	Interest saving (\$m)	Effect of privatisation (\$m)	Present value ^b (\$m)
1998	22	18	- 4	- 3
1999	23	18	- 5	- 8
2000	25	18	- 7	- 13
2001	26	18	- 8	- 20
2002	28	18	- 10	- 27
2003	30	18	- 12	- 35
2004	31	18	- 13	- 44
2005	33	18	- 15	- 54
2006	35	18	- 17	- 64
2007	38	18	- 20	- 75

a: Assumes net sale proceeds of \$300 million

b: Cumulative present value of net impact of privatisation

Table 5 is derived from the low projections presented in Table 2. Even with this unfavourable outcome, the profits foregone as a result of privatisation exceed the interest savings. By 2007, the present value of net loss is approximately \$24 million.

Table 5: Impact of privatisation on public income^a

Low Projection				
Year ending June 30	Total Income (\$m)	Interest saving (\$m)	Effect of privatisation (\$m)	Present value ^b (\$m)
1998	20	18	- 2	- 2
1999	20	18	- 2	- 4
2000	21	18	- 3	- 7
2001	21	18	- 3	- 9
2002	21	18	- 3	- 11
2003	21	18	- 3	- 14
2004	22	18	- 4	- 16
2005	22	18	- 4	- 19
2006	22	18	- 4	- 21
2007	22	18	- 4	- 24

a: Assumes net sale proceeds of \$300 million

b: Cumulative present value of net impact of privatisation

Table 6 is derived from the high projections presented in Table 3, in which revenue grows in line with gross state product. By 2007, the present value of net losses exceeds \$90 million. This is an indication of the scale of the losses that could be incurred as a result of privatisation. Most previous privatisations, occurring after a process of efficiency gains achieved under public ownership have generated losses on a similar scale.

Table 6: Impact of privatisation on public income^a

High Projection				
Year ending June 30	Total Income (\$m)	Interest saving (\$m)	Effect of privatisation (\$m)	Present value ^b (\$m)
1998	22	18	- 4	- 4
1999	24	18	- 6	- 9
2000	26	18	- 8	- 1 5
2001	28	18	- 1 0	- 2 3
2002	30	18	- 1 2	- 3 2
2003	33	18	- 1 5	- 4 3
2004	35	18	- 1 7	- 5 4
2005	38	18	- 2 0	- 6 6
2006	40	18	- 2 2	- 8 0
2007	43	18	- 2 5	- 9 4

a: Assumes net sale proceeds of \$300 million

b: Cumulative present value of net impact of privatisation

The same method of analysis may be applied for a range of possible sale prices. In Table 7, summary results are presented for each of the three projections with the sale price ranging from \$200 million to \$500 million . As shown above, even under the low projection, the interest savings from privatisation are less than the income foregone when the sale price, net of selling costs, is \$400 million or less. If the central projection is taken as a 'best guess' estimate, a sale price of more than \$500 million would be required to generate a sustained net improvement in the state's fiscal position. Even at prices above \$500 million , there is still a significant risk of loss associated with privatisation, as is shown by the high projection.

Table 7: Impact of privatisation on public income for a range of sale prices

Sale price ^a (\$m)	Interest saving (\$m)	Present value under central projection (\$m)	Present value under low projection (\$m)	Present value under high projection (\$m)
200	12	-119.4	-67.8	-138.0
250	15	-97.3	-45.7	-115.9
300	18	-75.2	-23.7	-93.8
400	24	-31.1	20.5	-49.7
500	30	13.1	64.7	-5.5

a: Net of sale costs and provisions

Homestart

This paper contains notes on the economic implications of privatisation of Homestart Finance, an organisation which provides mortgages to low and moderate income, through a number of concessional lending schemes of which HomeStart is the most important.

Current taxpayer benefits from Homestart

At present, taxpayers receive benefits from public ownership of Homestart Finance in a number of forms.

- (i) Dividends
- (ii) Retained earnings
- (iii) Company tax equivalent payments
- (iv) Payments for state guarantee of Homestart debt
- (v) Performance of community service obligations

In 1996-97, earnings before tax totalled \$14.5 million, all of which accrued to taxpayers, with \$5 million being paid in tax equivalent payments, \$7 million in dividends and \$2 million retained by Homestart Finance.

A borrowing fee (\$8.5 million in 1996-97) was paid to the SA government for use of its guarantee in borrowing. This fee must be set against the risk of loss to the government if Homestart defaults on its borrowings, and will therefore *not* be included in a comparison of income foregone with interest savings from privatisation. Conversely, the argument that

privatisation is justified because the taxpayers thereby avoid the risk associated with the government guarantee is not sustainable, assuming the guarantee fee has been calculated correctly. In view of the low-risk nature of mortgage lending and the fact that Homestart's loans are mortgage loss insured, the guarantee fee appears reasonable.

The concessional nature of the lending schemes operated by Homestart Finance means that the organisation performs Community Service Obligations. The cost of performing Community Service Obligations under the HomeStart scheme was estimated at \$3 million in 1996-97. This amount is not offset by any payment from government. In evaluating privatisation, it is important to consider whether, and how, these Community Service Obligations will be preserved.

For purposes of future evaluation, the flow of income to SA taxpayers is taken to comprise items (i)-(iii) and (v), totalling \$17.5 million in 1996-97.

Profit risk

Unlike most other government business enterprises being considered for privatisation in South Australia, Homestart is exposed primarily to commercial, rather than regulatory risk. In effect, the price charged by Homestart and other mortgage lenders is the margin between the general market rate of interest and the rate charged by Homestart for mortgages. A decline in this margin, arising for example from the entry of new mortgage providers to the market, would reduce Homestart's profitability.

Evaluation of HomeStart is also complicated by the fact that the volume of mortgages outstanding is currently declining, primarily because no new loans are being made under the Home Ownership Made Easy (HOME) scheme. It is unclear whether this decline will continue.

Estimates of the fiscal impact of privatisation

Unlike most other SA government enterprises being considered for privatisation, it

appears likely that the privatisation of Homestart Finance would be approximately fiscally neutral. The current income flow of \$17.5 million per year could service a debt of \$290 million. In view of the possibility of declining income in the future, it may be appropriate to add a risk premium to the discount rate used in evaluating future income flows. At a rate of 8 per cent, the present value of future income would be \$218 million. Hence, the value of Homestart in public ownership may be estimated at between \$200 million and \$300 million.

HomeStart's primary asset is its mortgage portfolio, with a current book value of \$1218 million, which must be set against borrowings of \$1060 million. Minor assets and liabilities approximately cancel out, leaving net assets of \$160 million.