Chapter 5

Regulation of state government-owned network companies

5.1 The terms of reference for this inquiry contained specific statements about the actions of state government-owned network companies, such as how they have calculated their weighted average cost of capital (WACC).

5.2 As some of the issues are relevant to all network companies, whether publicly or privately owned, the discussion in other chapters of the report is generally applicable to both. This chapter differs in that it deals with some particular issues that either clearly are, or were considered by submitters to be, unique to government-owned network companies. Specifically, this chapter considers the evidence received about:

- the relative efficiency of government-owned networks compared to the privately-owned networks;
- the application of competitive neutrality principles that require government-owned companies to be compared to a benchmark efficient entity;
- how inaccurate revenue determinations can provide a lucrative source of revenue for state governments; and
- past inefficient expenditure and calls for asset write-downs, particularly in the context of privatisation proposals.

Efficiency of state government-owned networks

5.3 Mr Bruce Mountain argued that analysts have 'long recognised', and the AER has also accepted in its latest benchmarking report, that the government-owned distribution network companies are less efficient than the privately-owned companies in terms of operating expenditure.[1] Indeed, it is evident that this issue has been considered thoroughly elsewhere. When the Productivity Commission (PC) recommended in 2013 that state and territory governments should privatise their government-owned network businesses, it stated that:

> State-owned network businesses appear to be less efficient than their private sector peers. This is not surprising given their multiple objectives, political intervention and the imposition of non-commercial restrictions.[2]

5.4 Mr Mountain provided some charts to illustrate the higher costs associated with state government-owned networks (Figure 5.1 and Figure 5.2)

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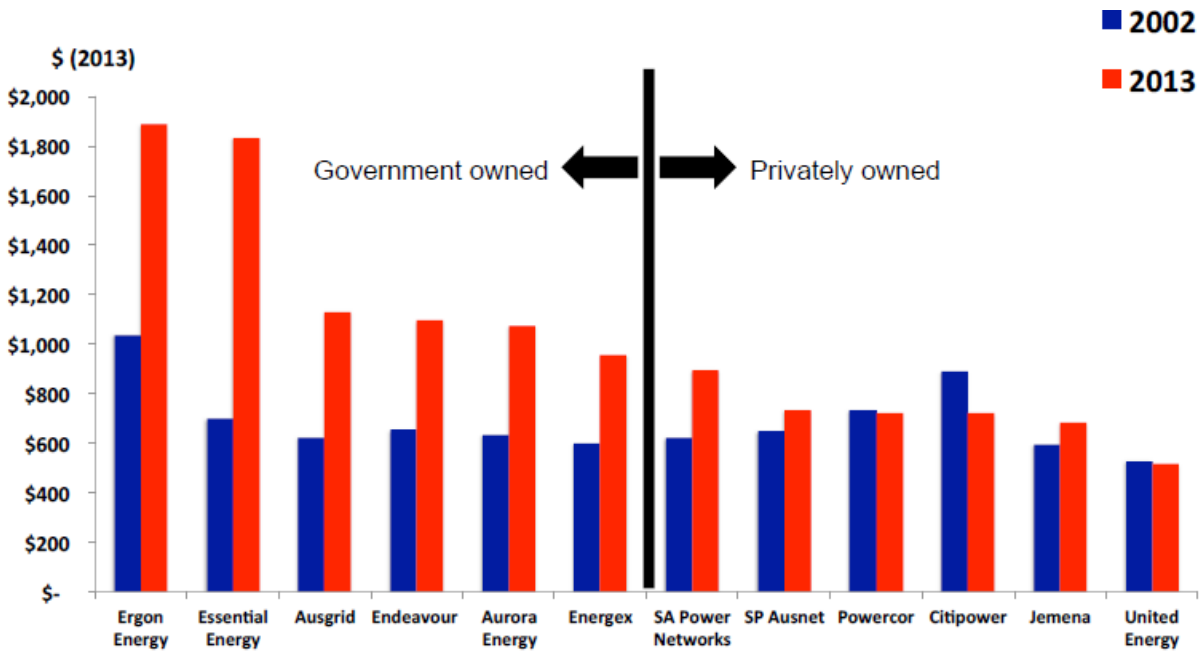
1 Mr Bruce Mountain, *Submission 19*, pp. 15–16.

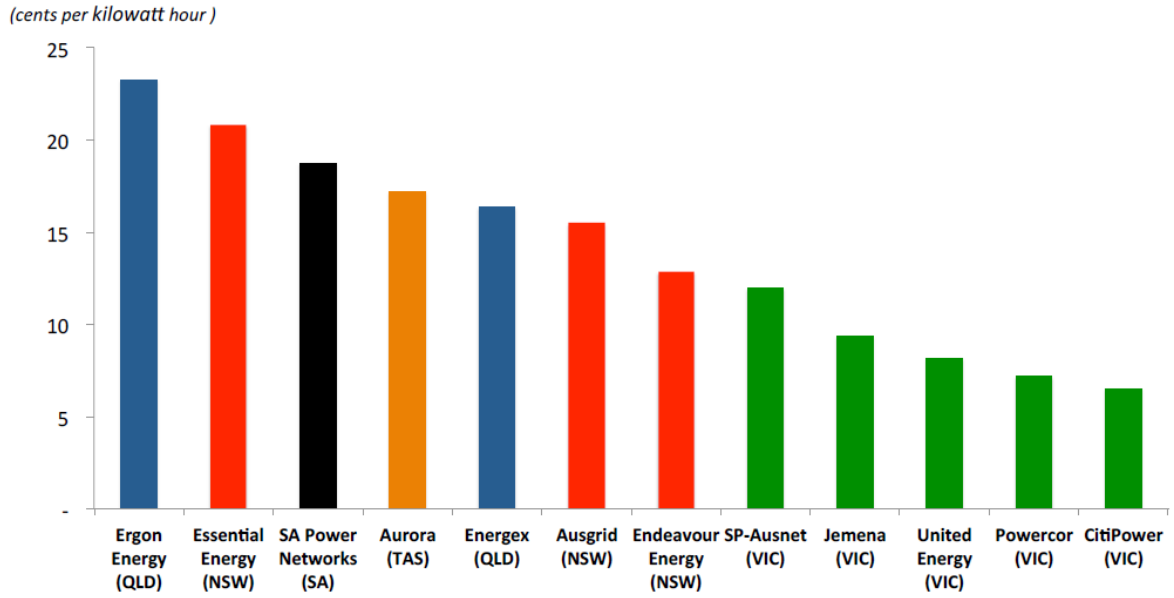
2 Productivity Commission (PC), *Electricity networks regulatory frameworks*, vo1. 1, April 2013, p. 287

Figure 5.1: Regulated revenue of distributors per connection ($2013)



Source: Mr Bruce Mountain, *Submission 19*, p. 4.

Figure 5.2: Average electricity network services prices per household for distribution network service provider in 2014



Source: Mr Bruce Mountain, *Submission 19*, p. 6.

5.5 Government-owned network companies were questioned about their efficiency. When asked why Ergon was identified by both an independent Queensland government review and the PC as the most inefficient network in Australia, Mr Ian McLeod, Ergon's chief executive officer, responded that Ergon's customer profile and geographic coverage means 'simple maths' will make it the highest cost network in the country. He advised that Ergon distributes to 44 per cent of the NEM's geographic

area, but only to seven per cent of the NEM's customers. To put it another way, Ergon serves 170,000 customers in an area of 160,000 square kilometres.[3] However, Mr McLeod contended that Ergon was not the most inefficient network. He provided the following explanation:

> We have done multimodels of productivity. From a customer perspective, we certainly look inefficient. You can look at it from an actual asset perspective and you will see that makes us look efficient compared to the others. We can look at it from a load perspective. Our customers use more load than any others—mines and those sorts of things. That makes us look efficient. We have quite a substantial amount of generation connected to the grid, which does not pay towards the grid costs. So that is also a challenge. We have done a multifactor productivity analysis and, whichever inputs you put in and whichever model you use, it drives a different outcome. However, on top of that, we think it is a challenging network. The integration of technology is part of the solution. We have certainly been leaders in that space. We have a huge amount of distributor generation in solar PV. We are more advanced on batteries, we have more demand under control than any other network. I think it drives innovation in Ergon. We do not think we are at the efficient frontier. We think we can get there, though, and will aim to get there. Are we the most inefficient? I would argue we are not.[4]

5.6 The privately-owned Victorian distribution businesses argued that their ownership structure was a key reason for their lower network costs and stronger records of reliability. Mr Alistair Parker, the general manager of asset management at AusNet Services, a privately-owned transmission and distribution network service provider in Victoria, discussed the relative performance of the Victorian businesses compared to those in other states, particularly Queensland. He recognised that Queensland businesses face particular challenges, such as cyclones and difficult topography. Nevertheless, he argued that the AER takes this into account as part of its benchmarking process and, even then, the privatised distributors 'remain the most efficient networks on average'.[5] Mr Parker explained why he attributes this disparity in performance to the different ownership structure:

> [The privately-owned businesses] aim to spend less to get the same outcomes. We have investors, and I use that term very carefully. We do not have owners; we have investors, and we have investors like superannuation funds and so on, who demand a return from us. Our commercial view is that, while there is potentially an incentive to increase your RAB—to

3 Mr Ian McLeod, Chief Executive, Ergon Energy, *Proof Committee Hansard*, 16 February 2015, p. 18. However, the utility of figures based on customer density per square kilometre was questioned. Mr Bruce Mountain argued that these figures make 'little sense as a basis for comparison, since a large part of the surface area of each state is not inhabited, and neither does electricity infrastructure cover it' (*Submission 19*, p. 12).

4 Mr Ian McLeod, Ergon Energy, *Proof Committee Hansard*, 16 February 2015, p. 18.

5 Mr Alistair Parker, General Manager Asset Management, AusNet Services, *Proof Committee Hansard*, 18 February 2015, p. 32.

> increase your asset base—we make more money by responding to the AER's efficiency incentive schemes. So we do better by spending less. We do better over the long run by spending less, by finding cheaper alternatives to deliver good outcomes. And we need to innovate, and we need to really have a culture that is seeking to do that at all times to get to that point.[6]

5.7 Mr Parker noted another key difference between the privately-owned business in Victoria and others that arises from the use of 'probabilistic investment'. He provided the following explanation of how the adoption of probabilistic investment affects how his company approaches investment decisions:

> …what we do is we look at the value that we believe customers and the Australian Energy Market Operator place on reliability, we look at the probability of having a problem on our network, and we only invest if there is not an alternative solution like demand management and if the economic value of the loss of supply outweighs the cost of doing something about it. This means, in practical terms, we invest later than somebody in New South Wales will. We are currently doing, as a transmission company, a huge redevelopment of the CBD supply in Melbourne. My guess—it is not accurate—is that we are doing that four or five years later than somebody in New South Wales would do it, and we look at that all the time to check: if we can avoid the investment, we will avoid the investment. It means we have to do some things in terms of contingency plans, but if we can avoid an investment we will.[7]

Application of competitive neutrality principles

5.8 The current framework is designed so that state government-owned networks are treated as if they are privately owned. This section examines the rationale for this and the evidence received about whether this is appropriate and in the long-term best interests of consumers.

Overview of competitive neutrality

5.9 The current regulatory treatment of government-owned companies follows the development of a national competition policy. The 1993 report on the subject chaired by Professor Fred Hilmer (known as the Hilmer Report) called for pro-competitive structural reform of public monopolies so that natural monopoly elements were no longer integrated with potentially competitive activities.[8] To facilitate this, the Hilmer Report proposed several principles that Commonwealth, state and territory

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6 Mr Alistair Parker, AusNet Services, *Proof Committee Hansard*, 18 February 2015, p. 33.

7 Mr Alistair Parker, AusNet Services, *Proof Committee Hansard*, 18 February 2015, p. 33.

8 A relevant example given was that the natural monopoly of electricity transmission was integrated with electricity generation, an activity that was potentially competitive. Independent Committee of Inquiry into Competition Policy, *National Competition Policy*, August 1993, p. 218.

governments would abide by. The Council of Australian Governments' (COAG) Competition Principles Agreement, which was entered into in 1995, contained the final principles the governments adopted and required COAG members to issue a policy statement on competitive neutrality. The following objective is contained in the Agreement:

> The objective of competitive neutrality policy is the elimination of resource allocation distortions arising out of the public ownership of entities engaged in significant business activities: Government businesses should not enjoy any net competitive advantage simply as a result of their public sector ownership. These principles only apply to the business activities of publicly owned entities, not to the non-business, non-profit activities of these entities.[9]

5.10 Among other things, the Competition Principles Agreement requires that the following are imposed on government-owned businesses:

- full Commonwealth, State and Territory taxes or tax equivalent systems;
- debt guarantee fees directed towards offsetting the competitive advantages provided by government guarantees; and
- on an equivalent basis as private companies, regulations to which private sector businesses are normally subject to, such as planning and environmental regulations.

5.11 Following the competition reforms, governments separated the generation, transmission, distribution and retail components of electricity supply. The new generation and retail businesses were opened up to competition,[10] whereas the transmission and distribution businesses were regulated as monopolies.

Application of competitive neutrality principles to electricity networks

5.12 Evidence taken by the committee considered what effect the competition neutrality principles have had on electricity prices. The principles underpin the current framework and have informed both the AEMC's and AER's decisions. For example, the AEMC has decided against proposed rule changes on the basis that the rule would be inconsistent with the concept of competitive neutrality.[11] The AER's determinations do not take into account that state governments have a stronger credit rating than that used for the benchmark efficient entity. As Energex noted, the AER's

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9 *Competition Principles Agreement*, 11 April 1995 (as amended to 13 April 2007), http://ncp.ncc.gov.au/docs/Competition%20Principles%20Agreement,%2011%20April%201995%20as%20amended%202007.pdf (accessed 19 March 2015).

10 Since the 1990s vertical re-integration of some retailers and generators has occurred to form what are known as 'gentailer' structures. See Australian Energy Regulator (AER), *State of the energy market 2014*, p. 40.

11 See Energy Users Association of Australia (EUAA), *Submission 17*, p. 11.

method of determining the rate of return by reference to a benchmark efficient entity means the ownership structure of a network company 'should be irrelevant'.[12]

5.13 However, the Energy Users Association of Australia (EUAA) questioned the AEMC's and AER's application of the Competitive Principles Agreement to electricity network businesses. The EUAA argued that the Agreement was 'designed to apply to businesses that operate in competitive markets—not to regulated monopolies'.[13] A similar point was made by Mr Bruce Mountain; he noted that the Competition Principles Agreement makes no provision for the principles to apply to monopolies. He described competitive neutrality principles applied to a monopoly as 'an oxymoron'.[14] The EUAA stated that requiring the regulator to ignore 'that government owned networks are funded by low cost state government debt' and providing the companies 'with "theoretical" debt and equity raising costs that they do not incur' was an approach that is unique to Australia.[15]

5.14 Submitters that argued against the application of the Competitive Principles Agreement to government-owned network companies highlighted what they consider are adverse outcomes from this practice. Mr Mountain argued that the treatment of government-owned networks as if they are a private company has 'had a significant impact on incentives to invest'. Mr Mountain pointed to borrowing costs as an example:

> …over the last five years state government borrowing costs were typically in the range from 3% to 5%. Under the current revenue/price controls however they have been allowed to charge consumers a rate of around 8.8%. A conservative estimate of the excess above reasonable costs would be around 300 basis points. The regulated asset base of government-owned distributors (in the NEM) in 2013 was $42.8bn. A 300 basis point excess translates into a revenue premium of $0.8bn per year (only 60% of the asset base is assumed to [be] financed through debt).[16]

5.15 Submitters suggested that the benchmarking framework is far removed from the actual outcomes. The Agriculture Industries Electricity Taskforce argued that debt and equity raising allowances given to state government-owned network companies do not correspond with reality. This is because the government-owned networks do not incur equity raising costs and state treasuries do not incur many of the debt raising costs network companies seek to recover.[17] A similar argument was made by the EUAA, which used the experience in New South Wales to demonstrate its point. The EUAA claimed that in 2010 the New South Wales government received an

12 Energex, *Submission 14*, p. 5.

13 EUAA, *Submission 17*, p. 11.

14 Mr Bruce Mountain, *Submission 19*, p. 20.

15 EUAA, *Submission 17*, p. 11.

16 Mr Bruce Mountain, *Submission 19*, p. 20.

17 Agriculture Industries Electricity Taskforce, *Submission 21*, p. 8.

effective rate of return of around 29 per cent on its electricity networks, which was around three times higher than that allowed by the AER's determinations. The EUAA explained this higher return was due, in large part, to:

- the New South Wales government's ability to collect both the profits and tax on profits delivered by the networks it owns; and
- the margin added by the New South Wales government to the cost of debt that it provides to the network companies.[18]

5.16 The treatment of tax was delved into further by Mr Mountain. He noted that the government-owned network companies are 'in effect exempt from income taxes', as although a tax allowance payment is calculated, the payment is collected by the shareholder anyway.[19] Mr Mountain provided the following example that not only illustrated his argument about the flaws in this arrangement, but also showed how the AER can use resources defending decisions based on unrealistic benchmarking:

> In 2011 the two Queensland distributors successfully appealed against the AER's decision on dividend imputation in the calculation of income tax allowances. Their argument was based on the imputation of dividends paid by privately owned companies and ignored the fact that these distributors' profits are effectively untaxed (because the Queensland Government collects the income tax).[20]

5.17 Mr Mountain advised that the successful appeal meant the distribution businesses were entitled to recover additional revenues of around $400 million. However, following the appeal, the Queensland government 'instructed its distributors not to raise their revenues by the additional amount'.[21] The AER was, nevertheless, left with over $1.2 million in costs that it incurred defending its decision.[22]

Response to concern about the competitive neutrality principles

5.18 As noted above, it was argued that the approach of regulating state government-owned electricity network companies as if they were private companies is unique to Australia. However, the AER suggested that a mix of public and private-owned network companies was a situation unique to Australia anyway. AER officials gave the following evidence on this subject:

> Typically in…overseas jurisdictions they tend to be either fully government or fully private, so it is a little bit unusual to have the mix of the two. If you look at the UK and the US, they are all private and in Europe it is mostly all

18 EUAA, *Submission 17*, p. 11.

19 Mr Bruce Mountain, *Submission 19*, p. 18.

20 Mr Bruce Mountain, *Submission 19*, p. 18.

21 Mr Bruce Mountain, *Submission 19*, p. 18.

22 This figure does not include the cost of AER officers or in-house lawyers. AER, *Answers to questions on notice 8*, received 10 April 2015, p. 10.

> government. So we tend to have, if you like, a one-zero scenario. I cannot think of another jurisdiction which has such a clear mix as us.[23]
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> While [New Zealand has]…a mix of privately owned, you would characterise it as more municipally owned. They are government owned businesses but they are quite often community trusts or the equivalent of local government…The US and Canada are regulated on a state basis. A lot of municipally owned businesses are community trusts, so they are probably more akin to government ownership than to private sector, but they are a slightly different model. In Australia we do not have the municipally, local government, owned business sector.[24]

5.19 The AEMC argued that if consumers paid the state borrowing rate rather than the benchmarked efficient costs of a stand-alone network business, decisions about investment would be distorted.[25] The AEMC also observed that such a framework would allow network businesses in some states to offer pricing that was lower than what is 'reflective of the true stand-alone costs of providing those network service'.[26] Mr Matthew Warren, the chief executive officer of the Energy Supply Association of Australia (ESAA) expanded on this; he noted that the competitive neutrality principles prevent state governments that own utilities (or other businesses) from utilising their influence 'to unfairly compete with or attract businesses from other states'.[27]

5.20 The committee notes that a review of competition policy was recently completed. The review, which was chaired by Professor Ian Harper, released its final report on 31 March 2015. In the report, the Harper Review expressed support for the principle of competitive neutrality, although it noted that 'competitive neutrality policies benefit consumers in markets where both governments and other providers deliver services'. Among other recommendations, the draft report suggested that all Australian governments should review and update their competitive neutrality policies.[28]

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23 Mr Sebastian Roberts, General Manager, Networks, AER, *Proof Committee Hansard*, 18 February 2015, p. 4.

24 Ms Michelle Groves, Chief Executive Officer, AER, *Proof Committee Hansard*, 18 February 2015, p. 4.

25 Mr Paul Smith, Chief Executive, Australian Energy Market Commission (AEMC), *Proof Committee Hansard*, 17 February 2015, p. 9.

26 Mr Paul Smith, Chief Executive, AEMC, *Proof Committee Hansard*, 17 February 2015, p. 9.

27 Mr Matthew Warren, Chief Executive Officer, Energy Supply Association of Australia (ESAA), *Proof Committee Hansard*, 18 February 2015, p. 27.

28 Competition Policy Review, *Final report*, March 2015, p. 50.

Revenue raising via electricity companies

5.21 State governments collect significant amounts of revenue from the network companies they own. This revenue is in the form of dividends received as shareholders, fees associated with the provision of finance and the income tax allowances that are calculated. Examples of these payments were provided by submitters. Mr Bruce Robertson reported that in New South Wales, the combined dividends paid by the network companies totalled $872 million, with a further $829 million collected from income tax equivalent payments.[29]

5.22 It is also evident that at least some state governments have been enjoying increasing payments. A community group that opposes a certain network investment proposal, VETO, advised that its inspection of the Queensland distributor Energex's annual financial reports revealed that Energex's dividends paid to the state government have increased from $103 million in 2009 to $406 million in 2014. Over that same period, the tax equivalent payments that the state government collects increased from $47 million to $215 million.[30]

5.23 It has been suggested the state governments that own electricity network companies benefit from the current regulatory arrangements as the money collected from high revenue determinations effectively act as a hidden tax on consumers. As a result, it is argued that the state governments have a conflict of interest when it comes to electricity regulation. The potential benefits of a system where a Commonwealth regulator determines the revenue of a state government-owned network company based on rules put in place by state governments are evident when regulatory decisions are made. For example, the Australian Sugar Industry Alliance considered that Ergon and its owner, the Queensland government, 'misrepresent the binding nature of the AER's decision around the regulation of revenue'. The Alliance explained:

> The AER sets the maximum revenue that a network operator can recover. The regulated amount is not a mandated recovery amount and it is not a minimum revenue recovery amount. Some state governments, with network ownership, have foregone the maximum allowable revenue determined by AER for their particular network, to reduce the financial strain on the dependant customer base. In Queensland, the government continues to argue that it has been directed by the AER to collect this level of revenue.[31]

29 Mr Bruce Robertson, *Submission 16*, p. 3.

30 VETO, *Submission 55*, p. 7.

31 Australian Sugar Industry Alliance, *Submission 32*, p. 3.

5.24 Submitters called for greater transparency of what they consider is a tax:

> We are a developed, rich country and international policy, government policy, is absolutely unanimous on not hiding our taxes, being transparent, and having accountability at suitable levels. I do not believe that we should have the arrangement that we have. I do not believe it constitutes transparent and good government. It is a right of the states, in answer to their voters, to do what they choose. If they seek to tax electricity supply to meet other objectives, I think that is their decision. But I think those things should be made clear…[32]

5.25 Mr Robert Mackenzie from Canegrowers Isis suggested that the government-owned distribution network companies, and therefore the government, are enjoying rent for the assets they own. Although addressing this would affect the state government's revenue, he argued this should not be the main consideration:

> Governments raise revenue by a variety of means. They should not be raising it through electricity. It acts as a tax on doing business. It stifles business. It stifles GDP. It stifles activity. It is just a bad way of raising revenue, in my opinion. We should be looking at other ways. We should be taxing outputs rather than inputs.[33]

5.26 The equity implications of state governments raising revenue from electricity prices were also noted. Mr Oliver Derum from the Public Interest Advocacy Centre argued that such practices were regressive as low-income people use a greater percentage of their income to pay their electricity bills.[34]

5.27 Mr Mountain similarly argued that a tax on electricity is 'highly regressive' for low-income consumers and inefficient as taxes should tax outputs and not inputs. Mr Mountain concluded:

> From an efficiency and fairness perspective, the current arrangement seems to be the worst of all words: a regressive input tax that misallocates resources and results in stranded assets.[35]

5.28 Nevertheless, the view that state governments with their own networks have a conflict of interest in relation to electricity prices was not shared by all stakeholders. The ESAA maintained that state governments would either need to raise the money from electricity prices by some other means or cut expenditure. A general manager at the ESAA stated:

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32 Mr Bruce Mountain, *Proof Committee Hansard*, 18 February 2015, pp. 62–63.

33 Mr Robert Mackenzie, Director, Canegrowers Isis, *Proof Committee Hansard*, 16 February 2015, p. 28.

34 Mr Oliver Derum, Senior Policy Officer, Energy and Water Consumers' Advocacy Program, Public Interest Advocacy Centre, *Proof Committee Hansard*, 17 February 2015, p. 15.

35 Mr Bruce Mountain, *Submission 19*, p. 20.

> …while I understand those frustrations about the way that competitive neutrality payment is applied, the money that those state governments receive is money they would either have to raise from other forms of taxation or they would have to reduce spending. Whilst you could make a change to that rule, it would just be moving money around between the people of New South Wales and Queensland as electricity consumers and essentially the same people as taxpayers. It is really just moving money around, whereas in terms of really driving down their power bills going forward, the obvious point to tackle is the future efficiency of operating and capital expenditure.[36]

Asset write-downs and privatisation proposals

5.29 Whether the value of inefficient and underutilised assets included in the regulatory asset base should be written down is an issue that was considered generally in Chapter 4. Evidence taken by the committee, however, indicated there were distinct considerations when the assets belong to government-owned network service providers. Some submitters added that the correct value of assets is also relevant to proposals for privatising these businesses. This section considers these issues.

Revaluing the assets of state government-owned network companies

5.30 As discussed in Chapter 4, one of the arguments used to counter asset write-down proposals is that such action may actually lead to higher electricity prices for consumers as higher sovereign or regulatory risk would need to be taken into account in the future. Although he considered it would be 'problematic' to revalue privately-owned assets, Mr Bruce Mountain submitted that, for government-owned businesses, the sovereign risk argument does not apply. He argued that 'governments are not able to expose themselves to sovereign risk, to suggest otherwise is just nonsense'.[37]

5.31 State governments are also not normal shareholders. While they may seek returns from their assets, other political and economic considerations also influence their decisions regarding how their assets should be used. This tension was highlighted by the Public Interest Advocacy Centre. Using New South Wales as an example, the Centre argued that if the state government decided to write-down the assets of a government-owned network business, it follows that the 'asset belonging to the people of New South Wales would, according to its book value, be worth less'. However, the Centre argued that this would be offset by consumers paying less for their electricity.[38]

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36 Mr Kieran Donoghue, General Manager, Policy, ESAA, *Proof Committee Hansard*, 18 February 2015, p. 27.

37 Mr Bruce Mountain, *Proof Committee Hansard*, 18 February 2015, p. 63.

38 Mr Oliver Derum, Public Interest Advocacy Centre, *Proof Committee Hansard*, 17 February 2015, p. 15.

5.32 EnergyAustralia acknowledged that governments, like businesses, do not like to write down the value of assets. Nevertheless, it argued that the fall in electricity demand and low growth forecasted by the AEMO compels the government to take such action. EnergyAustralia argued the alternative option would be a continuation of 'the "death spiral" which will only increase hardship cases for those that remain connected to the network'. [39]

5.33 However, another witness speculated that a state government may be reluctant to write-down assets as doing so may have implications for a government's future capital raising activities:

> Write-downs of the asset values would cause difficulties with the government raising capital in the capital markets. If the assets were written down to their true level, Queensland Treasury and the Queensland Treasury Corporation may find some embarrassment when they are looking to be raising capital.[40]

Asset write-downs in the context of privatisation

5.34 Proposals for leasing publicly-owned electricity assets to private sector companies were key issues at the January 2015 Queensland election and the March 2015 New South Wales election. As a consequence, submitters also considered the re-valuation of assets in that context.

5.35 Some submitters were nervous that privatisation proposals would threaten efforts to reform the regulatory system and cause the less than optimal outcomes achieved for consumers under the current system to be locked in for the future. The Agriculture Industries Electricity Taskforce argued that the New South Wales Government appears to be prioritising the sale of its network assets above any possible reform. The Taskforce suggested this was evidenced by that government's opposition to the AER's draft determinations for New South Wales distribution networks.[41] Unless 'credible regulatory arrangements are established', the Taskforce feared that leasing or privatisation will mean:

> …a government monopoly will be replaced by a private monopoly but with continued inadequate regulation. Regulatory reform in the context of private ownership will be even more difficult since it will raise the prospect of sovereign risk for the new private investors. It is essential that the regulatory challenges are dealt with now as a priority, before privatisation.[42]

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39 EnergyAustralia, *Submission 23*, p. 5.

40 Mr Warren Males, Head, Economics, Canegrowers; and Chairman, Sugarcane Gene Technology Group, Australian Sugar Industry Alliance, *Proof Committee Hansard*, 16 February 2015, p. 23.

41 Agriculture Industries Electricity Taskforce, *Submission 21*, p. 14.

42 Agriculture Industries Electricity Taskforce, *Submission 21*, p. 14.

5.36 Another example of this concern can be found in the evidence given by the Australian Sugar Industry Alliance. One of its representatives told the committee:

> If you are looking at privatisation of a system which is currently flawed and you have excessive tariffs and what we would say are flawed tariffs within that current model, our fear is that you would lock those flawed tariffs and that flawed profit model into some kind of privatised basis. No-one is going to invest in purchasing assets if they are not going to be able to generate a significant profit from that. So the end point is that you have a flawed and abstract profit motivation in the current system, you privatise that and you lock it in, and then it becomes a lot more difficult to deal with that into the future.[43]

5.37 It was also suggested that the Australian Government's asset recycling initiative may also reinforce opposition to asset write-downs. The New South Wales Irrigators' Council considered the asset recycling program provides a 'perverse incentive' for asset values to remain inflated or to be inflated further. It provided the following explanation:

> If the payment from the Asset [Recycling] Scheme, as is suggested in the Federal Government's Energy Green Paper, is a proportion of the value of the asset, then it is an incentive for the State Government to 'inflate' the asset value of the electricity network business in order to increase the amount of payments it receives. However such an inflated asset base (and the return that the network business currently receives on this asset base) will be passed onto consumers in the form of higher network charges.[44]

5.38 Some submitters expressly called for state governments that are seeking to privatise their electricity network assets to examine whether those assets are overvalued and should be written-down prior to privatisation. EnergyAustralia declared that privatisation proposals are 'a unique circuit-breaker', with an opportunity for assets to be written-down to reflect reduced electricity demand before privatisation.[45] The Public Interest Advocacy Centre, which also argued that network assets should be examined before privatisation, provided the following overview of the competing issues at play:

> Higher-valued networks will yield greater proceeds from privatisation, but consumers will, in effect, be funding those proceeds through their electricity bills (as they repay the investment in the RAB through network charges). On the other hand, if network values are written down then electricity bills will be lower, but less funds may be available to governments to fund infrastructure or other programs that benefit the community.[46]

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43 Mr Dominic Nolan, Joint Secretary, Australian Sugar Industry Alliance, *Proof Committee Hansard*, 16 February 2015, p. 23.

44 New South Wales Irrigators' Council, *Submission 5*, p. 8.

45 EnergyAustralia, *Submission 23*, p. 5.

46 Public Interest Advocacy Centre, *Submission 18*, p. 13.

5.39 The Public Interest Advocacy Centre noted that it does not 'have a definitive answer' to the question of whether the assets of New South Wales distribution network companies are over-valued. It also advised it cannot answer whether an asset write-down would ultimately be 'good or bad for the people [of New South Wales]'. Consequently, the Centre called for the state government to consider these issues. However, the Centre advised that a report it commissioned suggested that the writing down of the value of stranded assets 'may provide the best outcome for all parties'. In addition to lower prices for consumers, it was suggested that 'a more accurately priced asset would attract more attention from investors'.[47]

Committee view

5.40 The committee acknowledges that some aspects of the economic regulation applied to government-owned network businesses appear to have led to perverse outcomes. For example, assuming that a government-owned business has debt costs comparable to those of a private company when its debt is secured by a government with a strong credit rating is seemingly odd. It also results in customers living in that state paying more for electricity than they would otherwise need to, at least in the short-term.

5.41 Regardless of the relative merits of the arguments for and against the application of competition neutrality principles to government-owned electricity network businesses, the committee does not envisage a situation where this arrangement would change. For governments that own networks, the payments received as a result of these arrangements are a lucrative source of revenue that, if abolished, would need to be replaced (or alternatively, expenditure would need to be reduced). The governments that do not own networks may be concerned that changes to the current arrangements would see the cost of electricity fall in the states with publicly-owned networks, potentially attracting business to those states away from states with privately-owned networks.

5.42 In any case, while there may be particular issues caused by the regulatory treatment of state government-owned network companies, the committee considers the matter of greatest concern is how the return on capital for all network businesses is determined, as canvassed in Chapter 4.

5.43 In this regard, the committee notes that certain state governments have, or are currently considering, proposals for privatising some of their network assets. The committee considers those governments have a duty to their citizens, and an obligation to potential investors, to demonstrate that the value of the RABs for these businesses are reasonable. As noted in Chapter 4, action taken now to ensure the RABs are accurate may prevent more difficult decisions from being needed in the future.

47 Public Interest Advocacy Centre, *Submission 18*, p. 14.

Recommendation 4

5.44 The committee recommends that state governments seeking to privatise their electricity network assets examine whether those assets are overvalued and if the regulatory asset base should be written down prior to privatisation.