Chapter 2

Linking infrastructure funding to privatisation

2.1 During this inquiry the committee focussed its attention on the link between infrastructure funding and privatisation under the Asset Recycling Initiative, which provides states and territories with financial incentives if they sell assets and recycle the capital into additional infrastructure.[1]

2.2 While the committee was aware of some support for the Asset Recycling Initiative,[2] the majority of submitters and witnesses identified a range of concerns and did not support the Initiative. This chapter discusses the issues that may arise from binding infrastructure funding to privatisation under the Asset Recycling Initiative, with a specific focus on the:

- potential distortion of state and territory decisions on privatisation and infrastructure funding;
- possibility that privatisation decisions will be rushed, leading to poor processes, poor consultation and poor regulatory safeguards; and
- potential unfairness and inequity between the states and territories.

Distortion of decisions

2.3 The committee has considered evidence that binding infrastructure funding with privatisation has the potential to distort state and territory decisions on privatisation and infrastructure funding. The potentially undesirable outcomes of this distortion may include:

- privatisation of assets that would not otherwise be privatised;
- negative impact on states and territory revenues by selling revenue earning assets to purchase loss making infrastructure; and
- distorting the consideration of a range of more appropriate infrastructure funding mechanisms by states and territories.

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1 Department of Infrastructure and Regional Development, *The Asset Recycling Initiative*, http://investment.infrastructure.gov.au/publications/reports/pdf/factsheets2014/Factsheet_The_Asset_Recycling_Initiative.pdf, (accessed 3 March 2014).

2 Australia Logistics Council, *Submission 12,* pp 4–6; Australian Chamber of Commerce and Industry, *Submission 13,* p. 7; Association of Superannuation Funds of Australia, *Submission 11,* p. 2.

Distortion of privatisation decisions

2.4 Economist Mr Stephen Koukoulas informed the committee that in his view, the Asset Recycling Initiative introduces a market distortion that could lead to poor privatisation decisions:

> …it is interesting that none of these assets have been sold until this bonus, or incentive…has been offered. Presumably all of a sudden these assets are not more valuable—arguably, in a low inflation environment with a very subdued rate of economic growth, they are worth less today than they were some time ago.
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> …if anybody offered me 15 per cent more for anything, I would be very tempted to sell it whether I wanted to or not because I know I would be able to do something else with the money.[3]

2.5 Professor John Quiggin informed the committee that the Asset Recycling Initiative could distort both privatisation decisions and infrastructure investment decisions:

> The implication is that that (a) privatisation decision must be marginal. Obviously, if we were in a situation where state government had an asset which it held as a substantial premium product it would not need the subsidy program to make that decision. So, what we are seeing, as with most subsidies, is bad decisions. In this case, bad privatisation decisions are being encouraged by the presence of the subsidy. The fact that you cannot get it for a privatisation that makes such strong economic sense and for which you do not need the subsidy is an indication of exactly how things are being distorted on both sides of the decision. Regarding both the assets originally for sale and secondary investments, this program distorts both of those decisions.[4]

2.6 Mr Mark Lennon, Secretary of Unions NSW and Mr Adam Kerslake, of the 'Stop the Sell Off' campaign supported the view that the Asset Recycling Initiative was distorting the market.[5] Professor Quiggin asserted that policy should be based on cost-benefit analysis of projects and should not be driven by the Asset Recycling Initiative.[6]

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3 Mr Stephen Koukoulas, Managing Director, Market Economics, *Committee Hansard,* 18 February 2015, p. 9.

4 Professor John Quiggin, *Committee Hansard,* 18 February 2015, p. 23.

5 Mr Mark Lennon, Secretary of Unions NSW, *Committee Hansard,* 18 February 2015, p. 32; Mr Adam Kerslake, Director, Stop the Sell Off campaign, *Committee Hansard,* 18 February 2015, p. 35.

6 Professor John Quiggin, Australian Research Council Laureate Fellow, University of Queensland, *Committee Hansard,* 18 February 2015, p. 23.

2.7 The distorting effect of the Asset Recycling Initiative was confirmed by the Treasury submission which indicates that states and territories are required to show that the decision to divest an asset must have been significantly influenced by the Initiative in order to qualify for incentive payments.[7]

2.8 In its May 2014 report on Public Infrastructure, the Productivity Commission offered this blunt comment on binding privatisation with new infrastructure projects through capital recycling:

> Privatisation has been raised by participants in this inquiry mainly in the context of 'capital recycling' — that is, selling existing infrastructure assets and using the proceeds to finance new infrastructure projects. The Commission's view is that privatisation should only occur when it is in the community's interests in its own right, as a tool to improve efficiency. What is done with the proceeds is essentially a separate issue. Linking the two issues through capital recycling may help to build community support for privatisation, but there are also risks.[8]

2.9 The Productivity Commission also confirmed that one of the greatest risks from the capital recycling model is the potential for it to distort infrastructure funding decisions. The Productivity Commission argued that:

> …an arrangement where the proceeds of sale are automatically hypothecated to investment in new infrastructure projects may create risks for over-investment in new greenfields infrastructure which, by its nature, typically involves significant risks in the early construction and operational phases.[9]

2.10 Another problem with capital recycling identified by the Productivity Commission is that it could possibly create a public perception that the only time an asset should be privatised is if there is some new infrastructure project in which to invest.[10]

Compensation for tax equivalent payments

2.11 The Water Services Association of Australia noted that corporatised government owned businesses contribute two revenue streams to state and territory governments. The first revenue stream that state and territory governments receive is dividends from the profits made by the business. The second revenue stream is the tax equivalent payments under the National Tax Equivalence Regime, which are the income tax payments that an equivalent private company would pay to the Commonwealth government. If such a corporatised entity or its assets are sold by a

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7 Treasury, *Submission 28*, p. 15.

8 Productivity Commission, *Public Infrastructure*, Inquiry report, No. 71, May 2014, p. 88.

9 Productivity Commission, *Public Infrastructure*, Inquiry report, No. 71, May 2014, p. 262.

10 Productivity Commission, *Public Infrastructure*, Inquiry report, No. 71, May 2014, p. 262.

state or territory government, that government will no longer receive either revenue stream.[11]

2.12 The committee heard evidence that the Initiative could be considered as a way of compensating states and territories for the possible loss of revenues from tax equivalent payments.[12] This was dismissed by Treasury, with Mr Chris Legg stating that the 15 per cent payment 'is an incentive, and that is all it is. It is a figure that emerged from negotiations with the states. It is high enough to be seen as meaningful to them and low enough for us to see it as an economical way of achieving the desired outcome.'[13]

2.13 However the Productivity Commission questioned whether there was a need to offer any incentives at all to the states and territories:

> Whether the State and Territory Governments have a financial disincentive to privatise their infrastructure assets that needs to be compensated by the Australian Government is debatable. Several factors, such as dividend imputation and productivity gains from privatisation could offset the loss of notional income tax payments. Specifically, if dividend imputation is complete and the purchaser of the enterprise can obtain full compensation of company tax through franking credits, a State Government would not lose from privatisation. Furthermore, if the purchaser is able to operate the enterprise more productively, the price they pay would reflect some of that gain. The State Government would then receive a premium over the (capitalised) revenue stream that would have vested with the government, if the asset stayed in public hands.[14]

Impact on revenues

2.14 This section discusses the committee's consideration of concerns raised about the potential impact of the Asset Recycling Initiative on revenues to governments that decide to sell income-generating assets to fund infrastructure that will *not* generate income.[15]

2.15 Asset recycling could involve using proceeds from the sale of existing income generating assets to fund new income generating infrastructure. However, it is entirely possible that a state or territory could divest itself of a revenue generating asset and use the proceeds on activities that do not generate income. Professor John Quiggin advised the committee that:

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11 Water Services Association of Australia, *Submission 10,* p. 4.

12 Water Service Association of Australia, *Submission 10,* p. 5; Association of Superannuation Funds of Australia, *Submission 11,* p. 2.

13 Mr Chris Legg, Chief Adviser, Industries and Infrastructure Division, Department of the Treasury, *Committee Hansard,* 20 February 2015, p. 42.

14 Productivity Commission, *Public Infrastructure*, Inquiry report, No. 71, May 2014, p. 263.

15 Community and Public Sector Union, *Submission 2,* p. 1; Stop the Sell Off, *Submission 23,* p. 2.

> Income-generating assets are valuable precisely because they generate income. Selling the assets and spending the proceeds on current or capital items that generate no flow of income, and cannot be justified by ordinary cost-benefit analysis is not, in any meaningful sense, recycling.[16]

2.16 The Community and Public Sector Union (CPSU) and representatives from the 'Stop the Sell Off' campaign raised concerns that if income generating assets such as electricity networks are sold and the proceeds are used to fund non-income generating assets such as roads, the reduction in long-term income will make it harder to raise the revenue necessary to sustainably fund additional infrastructure and public services in the future.[17]

2.17 The committee understands that the NSW government is proposing to sell the state's electricity transmission and distribution assets. The McKell Institute report notes that these make significant, stable, and low-risk contributions to annual state revenues:

> The $1.7B that the NSW Government earned from the network last year was equal to over 25% of payroll tax, 30% of transfer duties, and nearly 90% of taxes on gambling and betting.[18]

2.18 The committee does not intend to conduct a financial analysis of the proposed sale of 49 per cent the NSW electricity transmission networks. However, the committee notes that the predicted sale price of $20B proposed by the NSW government has been questioned by experts who have suggested that a more likely value for the transaction is $11B.[19]

2.19 Submitters and witnesses noted that federal, state and territory governments are presently operating under significant fiscal constraints.[20]

2.20 Mr Koukoulas advised the committee that in his view, retaining income generating assets can make an important contribution to government budgets:

> …you do run into the problem that, having had a look at the score sheet of asset sales over the last 20-something years…You can only sell these assets once, of course, and in the meantime you have got to rely on other sources

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16 Professor John Quiggin, *Submission 21,* p. 8.

17 Community and Public Sector Union, *Submission 2,* p. 1; Stop the Sell Off, *Submission 23,* p. 2.

18 Stephen Koukoulas and Thomas Devlin, The McKell Institute, *Nothing to gain, plenty to lose: Why the government, households and businesses could end up paying a high price for electricity privatisation,* December 2014, p. 6.

19 Stephen Koukoulas and Thomas Devlin, The McKell Institute, *Nothing to gain, plenty to lose: Why the government, households and businesses could end up paying a high price for electricity privatisation,* December 2014, pp 16, 54.

20 Australian Chamber of Commerce and Industry, *Submission 13,* p. 8; Australian Services Union, *Submission 15,* p. 5; Business Council of Australia, *Submission 22,* p. 3; Mr Chris Legg, Chief Adviser, Industries and Infrastructure Division, Department of the Treasury, *Committee Hansard,* 18 February 2015, p. 43.

> of revenue. Again, this has arguably been the problem over the last five to 10 years. We are having a debate about, dare I say it, the GST, Medicare co-payments and all these things that are designed to get towards a balanced budget, because there is nothing much else that is generating the revenue. It is a bit more complex than that, but that is the broad sense of it. So we do need some income generating assets for the government sector to be able to get close to balancing its budget.[21]

2.21 The Productivity Commission noted that the net impact of capital recycling on the government's balance sheet remains unclear, and may even create additional long term liabilities:

> In effect, a government would be swapping ownership of a mature asset (with known demand and cost characteristics), with ownership of a new (and potentially more risky) greenfields asset (with often unknown demand and cost characteristics). While government is receiving revenue from the asset sale and avoiding future liabilities (including any contingent liabilities), it would also lose access to the future revenue stream from that asset (be it from dividends or otherwise) and be exposed to a new set of assets and liabilities with less reliable estimates of dividends and other revenue.
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> Ultimately, poorly conceived decisions to link asset sales to new infrastructure investments could in fact have a negative future balance sheet impact and create long term additional liabilities for government.[22]

Greenfield versus brownfield assets

2.22 Some submitters argued in favour of the Asset Recycling Initiative on the basis that while government is often better placed to manage the demand risks associated with the early stages of greenfield projects, the private sector is often better placed to efficiently operate brownfield[23] assets that have a steady revenue stream.[24] The implication of the above being that mature brownfield assets should be sold and the money invested into new greenfield infrastructure.

2.23 In his submission to the Productivity Commission inquiry into Public Infrastructure, Professor Henry Ergas argued that the same factors that lead to private investors being risk averse towards major new projects with substantial cost and demand uncertainty should also lead the public sector to be wary of those projects.

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21 Mr Stephen Koukoulas, Managing Director, Market Economics, *Committee Hansard*, 18 February 2015, p. 12.

22 Productivity Commission, *Public Infrastructure*, Inquiry report, No. 71, May 2014, p. 264.

23 A 'brownfield' investment opportunity is one that involves the sale or re-development of an asset which already has an operating history. This is in contrast to a 'greenfield' project, which involves the development of a new project without an operating history and which typically also involves construction risk, http://www.herbertsmithfreehills.com/insights/legal-briefings/new-or-recycled-predicting-the-pipeline-of-super-investment-in-infrastructure, (accessed 11 March 2015).

24 Business Council of Australia, *Submission 22*, p. 3; Treasury, *Submission 28*, p. 10.

> In short, 'asset recycling' should not be used as an excuse to inefficiently shift risk on to taxpayers. If projects are inherently risky – because their cost and demand characteristics are uncertain in ways that cannot be hedged through diversification, and/or their likely net returns fluctuate with aggregate incomes – then transferring their funding to the public sector cannot in itself eliminate that risk or reduce its costs. That makes it all the more important to ensure proper project evaluation, along with the other safeguards discussed above.[25]

Alternative funding mechanisms

2.24 The committee considered evidence on whether binding privatisation with infrastructure funding may distort the way states and territories consider other forms of funding including taxes, borrowing, user charges, and Commonwealth grants.

2.25 Mr Koukoulas made the following observations, questioning the appropriateness of binding infrastructure funding with privatisation under the Asset Recycling Initiative:

- if the private sector thought it was profitable within the existing regulatory environment for them to build infrastructure, they would do it; and
- if it is worthwhile undertaking public infrastructure spending, it should be done regardless of whether there is asset recycling or whether interest rates are high or low; it should be based on need and not any other incentive.[26]

2.26 The Productivity Commission noted that a further potential risk is that the availability of funds from privatisation may mute or distort the incentives for state governments to properly consider how user charges could be used to fund new infrastructure. It also noted that capital recycling could prevent funds from being directed to higher value uses, which may not necessarily be new infrastructure investment.[27]

2.27 Many witnesses noted that public sector debt is currently relatively inexpensive and suggested that governments should take advantage of current low borrowing rates for infrastructure funding.[28] In his submission to the Productivity Commission inquiry into Public Infrastructure, Professor Henry Ergas argued that the public sector cost of debt does not reflect the cost to tax payers of making funding available:

> …current bond rates do not reflect an unusually low social cost of risk but rather the opposite: individual savers demand a higher than usual premium

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25 Professor Henry Ergas, Productivity Commission *Public Infrastructure* inquiry, *Submission 87*, p. 17.

26 Mr Stephen Koukoulas, Managing Director, Market Economics, *Committee Hansard*, 18 February 2015, pp 8–11.

27 Productivity Commission, *Public Infrastructure*, Inquiry report, No. 71, May 2014, p. 262.

28 Mr David Richardson, Senior Research Fellow, The Australia Institute, *Committee Hansard*, 18 February 2015, p. 5; Mr Stephen Koukoulas, Managing Director, Market Economics, *Committee Hansard*, 18 February 2015, p. 11.

> to bear risk. There is no reason to believe taxpayers differ from savers in that respect.[29]
>
> …it is the cost to taxpayers of making funding available, not the public sector cost of debt, that must be used. That cost to taxpayers is unlikely to be below the private sector cost of capital, except where the public sector has access to risk-pooling opportunities unavailable to the private sector. Moreover, because taxes distort economic activity, the cost of those distortions must be fully accounted for in assessing the projects that are being considered for funding.[30]

Rushed privatisation

2.28 This section discusses the committee's consideration of the potential for binding infrastructure funding and privatisation to create incentives to needlessly rush decisions without establishing appropriate corporate structures, safeguards and regulatory arrangements, or undertaking public consultation or cost-benefit analysis.

2.29 In its inquiry into Public Infrastructure the Productivity Commission commented on Australia's experience with privatisation. These comments highlight some of the important steps for privatisation to be successful:

> As in many countries, Australia’s experience with privatisation has been mixed. A key lesson is that the structure of the industry and relevant markets should be well defined prior to any privatisation, and the method chosen to privatise assets should be designed to maximise net benefits to the community. Practices designed to reach inflated sale prices are rarely successful, can disadvantage further efforts at privatisation and lead to an overall net cost to the community over the long term.[31]
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> Above all, privatisation should be undertaken not for its own sake, but to achieve a more efficient outcome for the community at large.[32]

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29 Professor Henry Ergas, Productivity Commission *Public Infrastructure* inquiry, *Submission 87,* p. 17.

30 Professor Henry Ergas, Productivity Commission *Public Infrastructure* inquiry, *Submission 87,* p. 17.

31 Productivity Commission, *Public Infrastructure*, Inquiry report, No. 71, May 2014, p. 63.

32 Productivity Commission, *Public Infrastructure*, Inquiry report, No. 71, May 2014, p. 64.

Consultation and public disclosure

2.30 A common concern identified by many submitters and witnesses was the lack of public disclosure of the benefits and costs of privatisation, including transaction costs, retained liabilities and regulatory costs associated with privatisation.[33]

2.31 In the Northern Territory, the committee repeatedly heard concerns about a lack of public consultation in relation to the privatisation of the Territory Insurance Office (TIO) and other assets in the Northern Territory.[34] The Northern Territory opposition raised concerns about privatisation of assets being rushed and the lack of public debate that occurred about the sale when compared to other jurisdictions.[35]

2.32 The Hon Delia Lawrie MLA asserted that TIO was sold without public consultation on the merits of the sale and with a lack of real scrutiny.[36] United Voice NT raised related concerns in its submission.[37] Independent MLA Mr Gerry Wood informed the committee that:

> In the Territory, unfortunately, I think the big issue in relation to the sale of assets has been (1) the lack of consultation with the people and (2) the lack of consultation even with parliament. A classic example would be the recent sale of TIO.
>
> …the real issue was that the government did not take the issue to the people to put their case in an open way so people could at least hear the arguments for it.[38]

2.33 Officials from the Northern Territory government did provide evidence of some recent attempts at public consultation,[39] but the committee notes that this may not have provided the community with an adequate level of information, or enough time to consider a response.

2.34 The Transport Workers Union also identified concerns regarding the lack of consultation around the sale of the Darwin bus service:

> This decision was made on the last day of parliamentary sittings, and was therefore met with limited parliamentary scrutiny. Public transport plays a

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33 Mr Peter Emery, *Submission 14,* P. 5; Emeritus Professor Bob Walker and Dr Betty Con Walker, *Submission 30,* p. 8; Australian Workers Union, *Submission 32,* p. 7.

34 Northern Territory Opposition, *Submission 33,* p. 1; United Voice NT, *Submission 27,* p. 2. Ms Kay Densley, Northern Territory Regional Director, Community and Public Sector Union, *Committee Hansard,* 16 February 2015, p. 11.

35 Northern Territory Opposition, *Submission 33,* pp 1–2.

36 The Hon Delia Lawrie MLA, Leader of the Opposition in the Northern Territory, *Committee Hansard,* 16 February 2015, p. 1.

37 United Voice NT, *Submission 27,* p. 2.

38 Mr Gerry Wood MLA, Northern Territory Parliament, *Committee Hansard,* 16 February 2015, p. 37.

39 Mr Richard Harding, Former CEO, Territory Insurance Office, *Committee Hansard,* 16 February 2015, p. 50.

> critical role in Northern Territory life. Every day, members of our community rely solely on a safe, cost-effective and efficient public transport system. There was no pre-election commitment to privatise the Darwin bus service. There was no meaningful consultation with the community, the union or employees over the decision to privatise the Darwin bus service.[40]

2.35 Similar concerns have been raised about public consultation in relation to the proposed leasing of the Darwin Port.[41] The committee notes that a Northern Territory parliamentary committee was established in relation to the leasing of the Darwin Port.[42]

Disclosure of transaction and regulatory costs of privatisation

2.36 The committee heard concerns relating to the disclosure of transaction and regulatory costs associated with privatisation. Mr Peter Emery submitted that in his view, transparency around the sale of state owned assets in South Australia had been insufficient to allow the community to make informed decisions about whether the privatisation was beneficial. He submitted that the degree of disclosure and detail of financial analysis and transactions entered into between the South Australian government, intermediaries and the buyers of assets had been very low, and that there was no significant detail on the public record. [43]

2.37 Some submitters raised concerns about the possible lack of disclosure of liabilities that are retained by governments when assets are privatised. Emeritus Professor Bob Walker and Dr Betty Con Walker submitted that in their view, the privatisation of the State Bank of NSW in 1995 did not properly account for risks relating to bad debts that were retained by the NSW government.[44] The NSW Greens submitted that in their view, lack of disclosure of liabilities associated with the 50 year lease of the NSW desalination plant did not permit an open public debate on the lease.[45]

2.38 Other potential costs are feasibility or scoping studies, cost-benefit analyses, corporate restructuring, and the structural separation of monopoly and competitive elements. Emeritus Professor Walker informed the committee that he estimates transactions costs are approximately six per cent of the transaction value, without including the cost of feasibility studies.[46]

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40 Ms Elise McLay, Northern Territory Organiser, Transport Workers Union, *Committee Hansard*, 16 February 2015, p. 11.

41 Northern Territory Opposition, *Submission 33,* p. 2.

42 Mr Gary Barnes, Coordinator-General of Major Projects and Investments, Northern Territory Government, *Committee Hansard*, 16 February 2015, p. 46.

43 Mr Peter Emery, *Submission 14*, p. 5.

44 Emeritus Professor Bob Walker and Dr Betty Con Walker, *Submission 30*, p. 13.

45 NSW Greens, *Submission 34,* pp 5–6.

46 Emeritus Professor Bob Walker, private capacity, *Committee Hansard*, 18 February 2015, p. 14.

2.39 The Northern Territory government noted that for relatively small projects, such as those that are likely to occur in less developed or regional and remote areas of Australia, a substantial amount of the Commonwealth contribution under the Assets Recycling Initiative would be likely to be consumed by the transaction costs associated with the privatisation process.[47]

2.40 Some submitters suggested the cost of regulating privatised functions should be included when assessing the total costs of a privatisation. These costs could include the cost of establishing a relevant regulatory body, as well as the costs of compliance for the private entities involved. Mr David Richardson informed the committee that:

> …you are also going to need a good regulatory environment. That is a costly thing. If you look at Telstra, for example, the Commonwealth sold that but had already corporatised it and, having corporatised it, you then need to set up a regulatory structure. So now you have the position where you have an army of people in the ACCC regulating Telstra and you have an army of people in Telstra providing information to the ACCC. This is a crazy resource cost that is usually not factored in. In each state you have a similar thing. Now that the electricity authorities have been corporatised, we have a bureaucracy that monitors those state authorities, and they employ a significant number of people putting together facts and figures to satisfy the regulators.[48]

2.41 In its report on Public Infrastructure the Productivity Commission noted that private sector involvement in infrastructure development and/or financing would only deliver efficiency gains with careful planning and implementation. Government guarantees and tax concessions still involve both risks and costs, and ultimately, it is the users and/or taxpayers who will absorb these.[49] The transition to privatisation involves a range of activities, including effective communication with the community, which requires careful management and leadership.[50]

The value of future earnings

2.42 Submitters raised concerns about the disclosure of discount rates used to estimate the value of future earnings.[51] The value of the potential sale relative to the future earnings of the entity to be privatised is an important consideration. The sale and the future earnings will happen in different timeframes, and adjustments should evaluate the possible changing value over time:

> This involves forecasting the future cash profits a business will generate, and discounting these back to the present day at the Weighted Average Cost

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47 Northern Territory Government, *Submission 31*, p. 2.

48 Mr David Richardson, Senior Research Fellow, The Australia Institute, *Committee Hansard*, 18 February 2015, pp 3–4.

49 Productivity Commission, *Public Infrastructure*, Inquiry report, No. 71, 27 May 2014, p. 2.

50 Productivity Commission, *Public Infrastructure*, Inquiry report, No. 71, May 2014, p. 2, 89.

51 Mr Peter Emery, *Submission 14*, P. 6; Emeritus Professor Bob Walker and Dr Betty Con Walker, *Submission 30*, pp 13–14;

of Capital. The cash flows are discounted to reflect the time value of money, where $1 today is worth more than $1 tomorrow due to the returns that could be made by investing the $1.[52]

2.43 Emeritus Professor Bob Walker and Dr Betty Con Walker submitted that in their view, the privatisation of the State Bank of NSW in 1995 led to a poor financial outcome for the State of NSW, with the sale price being a fraction of what the bank was worth. Central to this concern was the very high 18.9 per cent discount rate used.[53]

Committee comment

2.44 The committee is concerned about the possibility that incentives under the Asset Recycling Initiative may encourage privatisation without effective public consultation and communication strategies, and without appropriate consideration or analysis of future costs. The committee strongly encourages governments to conduct proper, rigorous analysis of the all current and future costs associated with privatisation projects. In addition, thorough and appropriate public consultation should be always be undertaken, including consultation around transactions costs and the cost of creating an appropriate regulatory environment and compliance with those arrangements.

Recommendation 1

2.45 The committee recommends that proper and rigorous analysis of total costs associated with privatisation projects be conducted when privatisation is proposed by governments at any level. In addition, appropriate public consultation should be undertaken, including consultation around transactions costs and the cost of creating an appropriate regulatory environment and compliance with those arrangements.

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52 Stephen Koukoulas and Thomas Devlin, The McKell Institute, *Nothing to gain, plenty to lose: Why the government, households and businesses could end up paying a high price for electricity privatisation*, December 2014, p. 53.

53 Emeritus Professor Bob Walker and Dr Betty Con Walker, *Submission 30*, pp 12, 13–14.

Public safeguards and the regulatory environment

2.46 This section addresses concerns raised about public safeguards and regulatory arrangements.[54] Submitters and witnesses identified the importance of ensuring that these were put in place before privatisation occurred, particularly in relation to natural monopolies.[55]

2.47 The Australian Competition and Consumer Commission (ACCC) indicated that the benefits of privatisation could be at risk if actions to maximise the sale price limit competition or inhibit appropriate regulation. These concerns are increased where, in the case of the Asset Recycling Initiative, the Commonwealth proposes to provide incentive payments of 15 per cent of the sale proceeds.[56] The ACCC indicated that:

- it is important not only for competition reasons but also important for bidders in terms of ensuring certainty about the regulatory regime when they bid in the sale process; and
- not having a mechanism that ensures appropriate up-front regulatory arrangements are reached may be distorting incentives.[57]

2.48 The ACCC had previously raised concerns in its June 2014 submission to the government's competition policy review noting Australian governments are focusing on short term budget goals without sufficient regard to longer term competition. The ACCC indicated that anti-competitive provisions have been included in contracts between the states and potential acquirers that effectively impose a tax on future generations and hinder Australia's competitiveness in the global market.[58]

2.49 To highlight these concerns the ACCC provided the committee with the example of the right of first refusal that was provided to the acquirer of Sydney Airport to operate a second airport:

> The right of first refusal, along with certain provisions of the *Airports Act 1996*, confers on the operator of Sydney Airport a potential monopoly over the supply of aeronautical services for international and most domestic flights in the Sydney Basin, with the real prospect that the potential for competition between Sydney Airport and an independent operator of a

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54 Emeritus Professor Bob Walker, Private Capacity, *Committee Hansard*, 18 February 2015, p. 14; ACCC, *Submission 8,* p. 3; Community and Public Sector Union, *Submission 2,* p. 2; Australian Services Union, *Submission 15,* pp 24–25; Business Council of Australia, *Submission 22,* pp 8–9; Maritime Union of Australia, *Submission 36,* pp 28–29; Dr Penny Howard, National Research Officer, National Office, Maritime Union of Australia, *Committee Hansard,*18 February 2015, p. 37.

55 ACCC, *Submission 8*, p. 3; Australian Sugar Industry Alliance, *Submission 18,* p. 1; Northern Territory Government, *Submission 31,* p. 3.

56 ACCC, *Submission 8*, p. 3.

57 Mr Michael Cosgrave, Executive General Manager, Infrastructure Regulation Division, Australian Competition and Consumer Commission, *Committee Hansard*, p. 44.

58 ACCC, *Submission 8*, pp 5–6.

> second airport will be foreclosed. Indeed, the National Audit Office has found that the sale price for Sydney Airport was higher than a number of possible valuation benchmarks, including the government's own estimate of the sale price in the 2001-02 budget.[59]

2.50 The ACCC went on to recommend that:

> …the Commonwealth require the states and territories to demonstrate that appropriate market structure and/or access and pricing arrangements have been put in place as part of the privatisation process, and link this requirement to any payments made under the Commonwealth Government's proposed incentive scheme for privatisations (the Asset Recycling Initiative).[60]

2.51 This view was confirmed by the Productivity Commission, who emphasised the importance of addressing structural arrangements and regulation prior to privatisation, including separating natural monopoly components from competitive components. The Productivity Commission noted that:

> Structural separation can bring benefits because it can make it easier to achieve effective competition in those components where competition is possible. This is because a vertically-integrated firm with a monopoly over network infrastructure has an incentive to discriminate against competing firms that need to access this infrastructure. Regulating against such discrimination, for example in the telecommunications sector, can be difficult.[61]

2.52 The Productivity Commission also suggested that the highest priority for the sale of government owned assets is not to secure the highest price, but to first ensure that:

- economic efficiency is achieved;
- the risks to consumers and other public interests are managed;
- the market structure is amenable to the privatisation; and
- the sale is conducted efficiently, ethically and transparently.[62]

2.53 The Business Council of Australia (BCA) supported introducing appropriate pricing and access arrangements prior to privatisation, even if those arrangements may reduce the sale price of the asset.[63] The BCA submitted that:

> These regulatory arrangements will enable potential investors to have a clear understanding of the terms under which the asset will be permitted to operate, and should allow customers to raise any issues or concerns they

59 ACCC, *Submission 8*, pp 5–6.

60 ACCC, *Submission 8*, p. 3.

61 Productivity Commission, *Public Infrastructure*, Inquiry report, No. 71, May 2014, p. 85.

62 Productivity Commission, *Public Infrastructure*, Inquiry report, No. 71, May 2014, p. 18.

63 Business Council of Australia, *Submission 22*, p. 8.

> may have. It minimises the risk of pressure for post-sale regulation in subsequent years that, in turn, would undermine the confidence of investors and their willingness to invest in growing these businesses.[64]

2.54 Treasury indicated that in its view, states and territories are accountable to their constituents for ensuring that the necessary regulatory arrangements are in place. Treasury also submitted that the Commonwealth respects the role of the states and territories to make decisions about appropriate regulatory arrangements within their jurisdiction.[65]

2.55 The committee did not receive much evidence on parliamentary scrutiny of privatisation. However, the Northern Territory government submitted that in its view, the current levels of parliamentary scrutiny and other regulatory and legislative safeguards are sufficient to ensure an appropriate balance between maintaining the long term interests of the public and allowing sufficient flexibility in achieving the best outcomes for investment in new economic infrastructure.[66]

Committee comment

2.56 The committee considers that appropriate safeguards and regulatory arrangements should be put in place for all asset privatisation, well in advance of the sale process commencing. The committee is concerned about the evidence it has received that the Asset Recycling Initiative may encourage states and territories to take shortcuts on safeguards and regulatory arrangements in order to meet the timeframes established by the Asset Recycling Initiative.

Recommendation 2

2.57 The committee recommends that prior to privatisation of assets, governments at all levels introduce appropriate regulatory arrangements and safeguards, including safeguards against anti-competitive behaviour to ensure that future costs are known and established.

64 Business Council of Australia, *Submission 22*, p. 8.

65 Treasury, *Submission 28*, p. 11.

66 Northern Territory Government, *Submission 31*, p. 3.

Inequity of the initiative across states and territories

2.58 This section discusses the committee's consideration of the possible inequity of the Asset Recycling Initiative across states and territories. Binding infrastructure funding to privatisation may lead to unfairness and inequity across states and territories because it:

- disadvantages those jurisdictions that have already undertaken significant privatisations;
- operates on a 'first in first served' basis, benefiting those jurisdictions with assets to sell or prepared for sale, rather than those jurisdictions most in need of infrastructure funding; and
- the fixed 15 per cent incentive does not correlate to infrastructure need and may be substantially consumed by transaction costs for small projects in small jurisdictions.

2.59 The section also notes that steps have been taken to minimise the impact of the Asset Recycling Initiative on the distribution of GST proceeds.

Some jurisdictions are disadvantaged

2.60 Several submitters and witnesses reminded the committee that those states and territories which have already undertaken significant privatisation activities may be disadvantaged by the Asset Recycling Initiative.[67]

2.61 Some raised concerns about the 'first in first served' nature of the Initiative.[68] The Northern Territory government submitted that:

> …some jurisdictions appear to be at a much more advanced stage of preparation for asset sales and have a large pipeline of potential privatisations. It is foreseeable that the existing pipeline of privatisations in the larger jurisdictions may significantly eat into the pool of funds allocated for incentive payments under the asset recycling initiative.[69]

2.62 The Business Council of Australia suggested that the Asset Recycling Initiative should be designed to prevent one or two states from capturing all of the available $5 billion in funding through large-scale privatisation projects.[70]

2.63 Emeritus Professor Bob Walker and Dr Betty Con Walker also suggested that incentives for privatisation from the Commonwealth may encourage states and

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67 Mr Peter Emery, *Submission 14*, p. 9; Electrical Trades Union, *Submission 19*, p. 9; Business Council of Australia, *Submission 22*, p. 10; Emeritus Professor Bob Walker and Dr Betty Con Walker, *Submission 30*, p. 16; Northern Territory Government, *Submission 31*, p. 5.

68 Business Council of Australia, *Submission 22*, p. 10; Northern Territory Government, *Submission 31*, p. 5; Mr David Richardson, Senior Research Fellow, The Australia Institute, *Committee Hansard*, 18 February 2015, p. 5.

69 Northern Territory Government, *Submission 31*, p. 5.

70 Business Council of Australia, *Submission 22*, p. 10.

territories to sell their most profitable businesses, which are currently providing essential services.[71]

Fifteen per cent incentive

2.64 The committee heard several concerns about the seemingly arbitrary and fixed 15 per cent figure of the Asset Recycling Initiative, and assertions that it may not be a sufficient incentive for some new infrastructure projects.[72] Both the Northern Territory government and Northern Territory opposition shared this concern.[73] The Northern Territory government submitted that:

> There is also inequity in the size of potential Commonwealth contributions due to the fixed 15 per cent contribution rate. As previously noted, a flat rate of 15 per cent represents a significant contribution for larger projects. However, for relatively small projects (under $200 million) such as those that are likely to occur in less developed or regional and remote areas of Australia, a substantial amount of the Commonwealth contribution may be offset by transaction costs.[74]

2.65 Treasury confirmed that the figure of 15 per cent was not a result of economic modelling, but of negotiation between the Commonwealth (seeking to achieve the lowest percentage possible) and the states and territories (seeking to achieve the highest percentage possible).[75]

Impact on GST redistribution

2.66 The committee notes that the Asset Recycling Initiative does acknowledge inequities between the states and territories by exempting the Initiative payments from the GST redistribution treatment undertaken by the Commonwealth Grants Commission:

> If the incentive payments were not fully exempt, an incentive payment to a state or territory would have also resulted in a decreased GST allocation for that jurisdiction over time. The net effect of this would have been to reallocate any incentive payment made across all states and territories according to their respective population shares, irrespective of their commitment to recycle capital into additional infrastructure. This would have greatly diminished the incentive effect of the payments.[76]

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71 Emeritus Professor Bob Walker and Dr Betty Con Walker, *Submission 30*, p. 16.

72 Dr Betty Con Walker, *Committee Hansard*, 18 February 2015, pp 17–18; Professor John Quiggin, *Committee Hansard*, 18 February 2015, pp 23–24.

73 Northern Territory Government, *Submission 31*, p. 5; The Hon Delia Lawrie MLA, Leader of the Opposition in the Northern Territory, *Committee Hansard*, 16 February 2015, p. 5.

74 Northern Territory Government, *Submission 31*, p. 5.

75 Mr Chris Legg, Chief Adviser, Industries and Infrastructure Division, Department of the Treasury, *Committee Hansard*, 18 February 2015, p. 42.

76 Treasury, *Submission 28*, p. 14.

Committee comment on the Asset Recycling Initiative

2.67 The committee has considered a wide range of evidence on the Asset Recycling Initiative and in particular, evidence on the link that the Initiative creates between privatisation and investment in infrastructure.

2.68 The committee notes that in its inquiry into Pubic Infrastructure, the Productivity Commission considered the Asset Recycling Initiative and concluded that on balance:

- the aims of the Asset Recycling Initiative are laudable, but the risks are significant;
- decisions to privatise a state owned asset and procure new infrastructure should be seperate;
- there is a distinct risk that states and territories will take shortcuts to avoid thorough and transparent analysis; and
- governments should avoid creating expectations in the community that privatisation is only acceptable when the proceeds are used for procuring new infrastructure, constraining future governments from optimising their balance sheets in the public interest.[77]

2.69 The committee is very concerned that binding privatisation with investment in infrastructure may lead to several significant problems including:

- potentially distorting decisions by states and territories on infrastructure investment, leading to projects being pursued that would not stand on their own merits;
- potentially distorting decisions leading to privatisation that would not go ahead if they were considered on a case-by-case basis;
- the possibility that privatisation and infrastructure projects will be rushed without:
    - appropriate public consultation and debate leading to poor outcomes; and
    - appropriate safeguards, corporate structures and regulatory arrangements in place; and
- the potential to create inequitable outcomes between states and territories as the Initiative may unfairly benefit those jurisdictions which currently have assets for sale or prepared for sale, rather than those jurisdictions where the infrastructure is most needed.

2.70 For the reasons set out above the link between privatisation and infrastructure funding under the Asset Recycling Initiative should be removed. This would provide an environment where states and territories consider the merits of privatisation on a

77 Productivity Commission, *Public Infrastructure*, Inquiry report, No. 71, May 2014, p. 264.

case by case basis and fund infrastructure projects based on community and economic need. The Commonwealth should contribute funding based on the merits of proposed projects while considering the equitable distribution of funds across states and territories.

Recommendation 3

2.71 The committee recommends that the link between privatisation of assets and infrastructure funding under the Asset Recycling Initiative should be removed. This would provide an environment where:

- **states and territories are encouraged to consider the merits of privatisation on a case by case basis;**
- **decisions to fund infrastructure projects are based on the community and economic need; and**
- **the Commonwealth contributes funding based on the merits of proposed infrastructure projects while considering the equitable distribution of funds across states and territories.**

Senator Sam Dastyari

Chair