

SENATE ECONOMICS REFERENCES COMMITTEE

SUBMISSION BY MR PETER EMERY, PARADISE, SOUTH AUSTRALIA

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Terms of Reference

In October last year the Senate referred this matter to the Senate Economics References Committee:-

“Incentives to privatise State or Territory assets and recycle the proceeds into new infrastructure, with particular reference to:

- (a) The role of the Commonwealth in working with States and Territories to fund nation-building infrastructure, including:
 - (1) The appropriateness of the Commonwealth providing funding, and
 - (2) The capacity of the Commonwealth to contribute an additional 15 percent or alternative amounts, of reinvested sale proceeds;
- (b) The economics of incentives to privatise assets;
- (c) What safeguards would be necessary to ensure any privatisations were in the interests of the State or Territory, the Commonwealth and the public;
- (d) The process for evaluating potential projects and for making recommendations about grants payments, including the application of cost-benefit analyses and measurement of productivity and other benefits;
- (e) parliamentary scrutiny;
- (f) alternative mechanisms for funding infrastructure development in States and Territories;
- (g) equity impacts between States and Territories arising from Commonwealth incentives for future asset sales, and
- (h) any related matter.”

The Senate is to be thanked and congratulated for referring this matter to a Committee for detailed enquiry and report. The topic is an important one, potentially having major implications for decades to come.

Nature of this Submission and its author

This Submission is presented on my own behalf. It is not on behalf of any organisation or interest group: the views expressed based only on my consideration of what is in the long term interest of the Australian community. I have never been and am not now a member of any political party though I am interested in politics and Government as an observer and a voter.

I spent about three decades of my working life as an officer of the Commonwealth Treasury and then the South Australian Treasury including a period as CEO of the latter. I have also worked in relevant areas as a consultant. A considerable part of my work has been in public finance including in Commonwealth-State-Local financial relationships in particular.

I have chosen to express my views in this Submission in a very straightforward way and briefly. Although a more complex exposition would be possible the key issues seem to me to be reasonably simple.

The overall public finance context

I agree with the view of the current Commonwealth Government that the finances of the Commonwealth public sector are in poor shape – the debt and deficits problem currently and in prospect for years ahead. I suggest that the picture would not be different if we were looking at the Australian public sector as a whole.

The problems being faced will be overcome only through a sustained program of what I would term intelligent pragmatism extending probably over five to ten years.

I would not consider the proposal now under consideration by the Committee as fitting this description. I believe it is based on a mixture of ideology and untested assumptions.

It seems to me that if the Commonwealth is to provide an incentive for State and Territory Governments to undertake activities which the Commonwealth believes to be desirable it would be appropriate for the following conditions to be met:-

1. for the Commonwealth to demonstrate that the activities it desires to see undertaken are, in principle, in the public interest;
2. for the Commonwealth to satisfy itself in detail that where these activities have already been undertaken by a State or Territory Government that they have

been proven to be in the public interest so far as that State or Territory is concerned;

3. for the Commonwealth to have a firm commitment to testing that a specific activity put forward by a State or Territory Government is clearly in the public interest;
4. for the Commonwealth, State and Territory Governments to put in place procedures for **full** disclosure of the details of the proposed activities and the analysis of their financial and other implications.

My view is that these conditions are not met so far as the Commonwealth Government's proposals on privatisation are concerned.

Has it been established that privatisations at the State and Territory level are desirable in principle

I suggest that the answer to this question is 'no'. None of the material presented publicly by the Commonwealth Government on this matter has made a case to establish that privatisations at this level are desirable in principle.

I note that this issue has been explored by the Productivity Commission and that it did not recommend that the approach now under consideration be pursued. No doubt the Commission's examination will be studied by the Committee.

I observe that work already undertaken by the Senate at Committee level has demonstrated that incentive or bonus schemes do not always work well. I am referring here to the disaster in the Commonwealth Bank of Australia in relation to poor investments made as a result of advice from its financial advisory services group the staff of which were indeed provided with strong incentives through bonus arrangements. The Senate is to be much commended for this work. It obviously needs to probe the proposals now under consideration with the same level of rigour and intensity.

Examination of previous privatisations by State and Territory Governments

Many privatisations (or other transactions which can be usefully placed under this heading) have already been undertaken at the State level. South Australia has been amongst the earliest and most active in this field but of course there are also numerous examples from other States.

Certainly so far as South Australia is concerned (and I suspect the other States as well) the degree of disclosure of the detail of the transactions entered into between the Government, the intermediaries concerned and the buyers of assets and the details of the financial analysis undertaken by the Government and its advisers to justify the transactions has been very low indeed. There is virtually nothing significant in terms of detail on the public record.

Surely if the Commonwealth is to justify adding to its deficit by making incentive payments to the State for privatising it should first examine how well previous privatisations have been justified and how well they have worked out in practice.

The essence of a privatisation transaction is normally that a Government is, in effect, foregoing a future stream of income accruing to a public enterprise for a 'once off' amount of cash as proceeds from the sale of the enterprise. In analysing whether previous privatisations have been justified in financial terms the following questions are amongst those to be considered:-

1. Has care been taken to include all the income of the enterprise concerned including that which is retained and not distributed to the State Government?
2. What rates of discount are used to bring future income flows back to a present value to compare with the cash received from the sale?
3. In dealing with the uncertainties facing the future if a public enterprise were to continue as such is adequate weight given to potential income upside as well as any perceived risks?
4. Is adequate attention given to additional costs which will accrue if the enterprise is privatised – just to cite one example if an electricity enterprise is sold are the costs of price and other regulation which will then be necessary taken fully into account? In the case of the sale of South Australia's electricity

assets the costs of the independent regulator (Essential Services Commission of South Australia) have been considerable.

As I say we do not have the information to be able to check how well this work has been done but I believe that these points need to be looked into in detail.

In relation to point 2 and again in the case of South Australia an official document known as the Treasurer's Instructions at one stage gave a range of discount rates to be used in this and other areas as high as 10 percent, noting that this was in "real" terms – that is not including the effects of inflation; this is relevant in comparing these rates with the "normal" interest rates with which we are all familiar. I mention that some time ago I wrote to the South Australian Treasury requesting information as to what discount rates were used in connection with which transactions but this request was not met.

I emphasise that the point I am making here is not that the relevant financial analyses have been wrong but that we simply don't know. What follows from this, I suggest, is that the Committee should do either or both of two things. First, as part of its current investigations it should undertake detailed checks of selected transactions in terms of the financial analyses which were undertaken and in terms of the contracts which were entered into between the Government, intermediaries and purchasers of the assets. I believe that South Australia would be a good test case in this regard given the variety of transactions undertaken and that they have been undertaken by both Liberal and Labor Governments. Second, the Committee should recommend that, if the Commonwealth Government does proceed with its proposals no State should be eligible for consideration under the program unless it provides full disclosure of the details of its past privatisation transactions including, but not confined to, the kinds of matters referred to above. As a further condition there should be made available information which enables a proper assessment to be made of how the privatisations have worked out in practice compared with the analyses undertaken.

Having made these initial points I now turn to comment briefly on the specific matters referred to in the Committee's Terms of Reference.

- (a) The role of the Commonwealth in working with States and Territories to fund nation-building infrastructure, including:-
(1) The appropriateness of the Commonwealth providing funding, and
(2) The capacity of the Commonwealth to contribute an additional 15 percent or alternative amounts, of reinvested sale proceeds.

The answer to the first part depends on one's views about the general structure of Commonwealth-State relationships. My own view is that the Commonwealth has over-reached in becoming so much involved in matters which are essentially the responsibility of State Parliaments and Governments. It could hardly be said that in recent times the Commonwealth has done such a marvellous job in its own direct areas of responsibility that it is obvious that it should be extending the range of its activities.

In terms of the "capacity" of the Commonwealth it seems obvious to say that given its current debt and deficits problem it does not have the financial capacity to be indulging in further areas of expenditure where its responsibilities are, at best, indirect.

- (b) The economics of incentives to privatise assets

Incentives by the Commonwealth to the States will be justified if it can, in a particular case, establish that in the absence of incentives the States would fail to enter into privatisations which were justified on the basis of correct financial analysis. At this stage there is no reason to believe that this is so.

- (c) What safeguards would be necessary to ensure any privatisations were in the interests of the State or Territory, the Commonwealth and the public

The comments above are highly relevant to this. Basically the safeguards would be in terms of full disclosure of financial analysis and the terms of the relevant contracts.

A related safeguard would be that a participating State, if the program does proceed, would have to demonstrate that privatisations entered into in the past have been fully justified financially and have proved effective with the benefit of hindsight.

- (d) The process for evaluating potential projects and for making recommendations about grants payments, including the application of cost-benefit analyses and measurement of productivity and other benefits

The key ingredient here will be full disclosure not only to the Commonwealth but also to interested observers and commentators generally.

- (e) parliamentary scrutiny

It would clearly be appropriate for a Committee of the Senate to have the opportunity to examine the full details of any proposal which might be advanced before it was endorsed and any grants paid.

- (f) alternative mechanisms for funding infrastructure development in States and Territories

The main alternatives are obvious and have been the common methods used over the many decades since the States were first established as Colonies – namely the generation of surpluses on current account to finance capital spending and the use of borrowings through the issue of State-guaranteed securities. The fact that in recent times Governments have tended to find it difficult to generate adequate current account surpluses is more a comment on the ability of those Governments than on the principles involved. Any suggestion that adequate infrastructure cannot be put in place by State Governments without a privatisation incentive is simply not justified.

If the Commonwealth believes that it is able to provide incentives to State Governments for particular financial outcomes it would be better and simpler for it to base an incentive on the achievement of current account surpluses – e.g. a grant of x percent of a current account surplus above a minimum of y based on officially accepted accounting procedures. I emphasise that I am not advocating this but it would make more sense than the current proposal.

- (g) equity impacts between States and Territories arising from Commonwealth incentives for future asset sales

There are several aspects to this issue. One of them is that some States have fewer enterprises available for sale because they have already been very active in this respect. South Australia is a good example of this. There is a strong likelihood that any new privatisations which might be brought forward as a result of an incentives program would be more difficult to justify than the privatisations which have already taken place.

(h) any related matter

There are a number of matters which I believe warrant the attention of the Committee and its staff which are not specifically referred to in the Committee's Terms of Reference or in this document.

An important example is the methodology of the credit rating agencies. Although discredited in the United States for their role in home lending finance which led to the global financial crisis these agencies still exert considerable influence. What needs to be examined is whether the ratios on which they rely in relation to the public sector might have a perverse effect on decision making in relation to public enterprises by over-emphasising the level of debt as against the ongoing financial benefits which can accrue from profitable public enterprises. I would recommend that this matter be put to detailed study by the Committee.

Another matter which would deserve study is the earlier program of grants provided to the States in relation to privatisation including, in particular, why that grant program was discontinued.

Concluding comments

I am very well aware that this Submission amounts to little more than a broad sketch of some of the main issues.

The Committee has a tremendous responsibility to ensure that not only the Senate but the Commonwealth Government and the community generally are fully advised

on this matter. What matters is not so much theory but detailed analysis including, as I have tried to emphasise, detailed analysis of what has happened to date in the privatisation of State Government assets.

If I can provide any help to the Committee in the further exploration of these matters I would be very glad to do so.