



INFRASTRUCTURE  
PARTNERSHIPS  
AUSTRALIA

BUILDING AUSTRALIA TOGETHER

**Submission to the *Special  
Commission of Inquiry into  
the electricity transactions***

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## **About Infrastructure Partnerships Australia**

Infrastructure Partnerships Australia is the nation's peak infrastructure body.

Our mission is to advocate the best solutions to Australia's infrastructure challenges, equipping the nation with the infrastructure assets and services needed to secure enduring economic growth and key social objectives.

Infrastructure is about more than balance sheets and building sites. Infrastructure is the key to how Australia does business, how we meet the needs of a prosperous economy and growing population and how we sustain a cohesive and inclusive society.

Infrastructure Partnerships Australia seeks to ensure governments have the maximum choice of options to procure key infrastructure. We believe that the use of public or private finance should be assessed on a case-by-case basis. IPA also recognises the enhanced innovation and cost discipline that private sector project management and finance can deliver, especially with large and complex projects.

Our membership comprises the most senior industry leaders across the spectrum of the infrastructure sector, including financiers, constructors, operators and advisors. Importantly, a significant portion of our membership is comprised of government agencies.

Infrastructure Partnerships Australia draws together the public and private sectors in a genuine partnership to debate the policies and priority projects that will build Australia for the challenges ahead.

## Executive Summary

New South Wales is grappling with the twin challenges of funding a substantial increase in infrastructure investment, and reducing the cost of energy for the State's households and businesses.

Without a radical increase in the pace of infrastructure investment in the State's transport, utility and social infrastructure networks, the impact of existing shortfalls will soon become acute. On top of this, the lack of commercial principles and competitive tension in the State's publicly owned electricity generation and network businesses will see prices in NSW continue to escalate at rates well above those in Victoria and South Australia, where full privatisation was completed in 1997 and 2001 respectively. It is no coincidence that in the period since Victoria privatised its electricity market, electricity prices in that State have risen just half the rate of those in NSW.

NSW has a final opportunity to create substantial financial capacity for new infrastructure and to drive down the costs of electricity through the privatisation of the State's electricity generation, distribution and transmission businesses.

Asset valuations undertaken by Infrastructure Partnerships Australia find that full privatisation of these businesses would liberate between \$50 billion and \$58.5 billion in capital and avoided public investment in electricity assets. These figures are made up as follows:

- Distribution and transmission assets worth between \$29.2 and \$34.5 billion;
- Generation assets worth between \$3.3 and \$6.5 billion; and
- \$17.5 billion in forecast government spending on the State's ageing energy infrastructure over the next four years, which would be transferred to the private sector.

This paper argues that the net capital realised from electricity privatisation should be invested in the NSW Government's Restart NSW fund, and be used to close the gap between the infrastructure that the State needs, and what it can currently afford. These investments should be informed by the long-term strategic infrastructure plans being developed by *Infrastructure NSW*.

However, while the opportunities to fund the backlog of infrastructure projects are very important, the arguments in favour of the privatisation of electricity go well beyond the ability to deliver new projects.

Experience in Australia and overseas has shown that an optimally competitive electricity sector is the most enduring means of applying downward pressure to electricity prices – increasing the competitiveness of the business sector, and addressing cost of living pressures for households. In Victoria, market forces are now so effective that retail price caps have been removed completely.

The development of a competitive, efficient and truly national electricity market has long been the aim of Commonwealth, state and territory governments. The 1995 *Competition Policies Agreement* formalised a process of reform across the states to undertake structural reforms to separate contestable retail and generation businesses from natural monopoly network assets, and to take steps toward the development of a contestable National Electricity Market (NEM).

Progress towards the NEM continued throughout the 1990s and 2000s, with the development of national regulatory and management institutions to oversee its development and function. Incorporating Queensland, NSW, Victoria, South Australia and the ACT from December 1998, as well as Tasmania from 2006, the NEM now facilitates over \$10 billion of electricity trade each year, servicing close to nine million end-use consumers (ACCC, 2010).

The early and rapid pace of reform toward a NEM saw the International Energy Agency (IEA) describe Australia as a "pioneer" in energy sector microeconomic reform (IEA 2005). These reforms had a considerable economic impact, with the Australian Bureau of Agricultural and Resource Economics (ABARE) estimating they have added around \$1.5 billion per annum to real GDP (ABARE, 2002).

In spite of these successes, the NEM is yet to reach its full potential, because some states – most notably NSW - have failed to undertake meaningful reform of electricity generation and distribution (ERIG, 2007). The privatisation of electricity businesses is critical, because it introduces a level playing field and commercial discipline into the pricing, investment and operation of electricity businesses. Under current arrangements, public companies account for two-thirds of total generation in the NEM, and more than 90 per cent of generation in NSW (ACCC, 2010).

The process of fundamental electricity market reform has until now, consistently failed in NSW. The current structure of the NSW electricity market is opaque and confusing. The former NSW government undertook a last ditch attempt at reform in 2010, which saw government retailers sold but generation businesses remain in full public ownership, with their output of power contracted to private owners for some (but not other) assets.

This gentrader model was conceived to introduce a degree of competition, while placating public sector unions, because it did not involve the transfer of the underlying assets and their workforces.

Far from achieving a sound outcome, the gentrader model represented the latest in a long line of missed opportunities, saddling taxpayers with risks relating to the electricity market, coal supply and the costs of operating and maintaining generators. In terms of consumers, keeping generation assets in public ownership limits optimal competition on the supply side, and therefore the opportunity to exert downward pressure on energy prices.

While the gentrader transactions failed to deliver either a sound market structure or sufficient capital returns to taxpayers, reversing the transactions is not a viable option. Its reversal would represent sovereign risk and would do considerable damage to NSW's and Australia's reputation with investors. Rather, the State should pursue a well-structured, well executed asset sales process that includes the divestment of all remaining energy network and generation assets, including those subject to a gentrader contract.

Full privatisation of all state-owned electricity assets is the only prudent pathway for getting the NSW electricity sector – and broader state economy – back on track. With NSW accounting for more than a quarter of national energy consumption, privatisation will also remove a longstanding roadblock to the achievement of a truly competitive and efficient national energy market. Specifically, privatisation will:

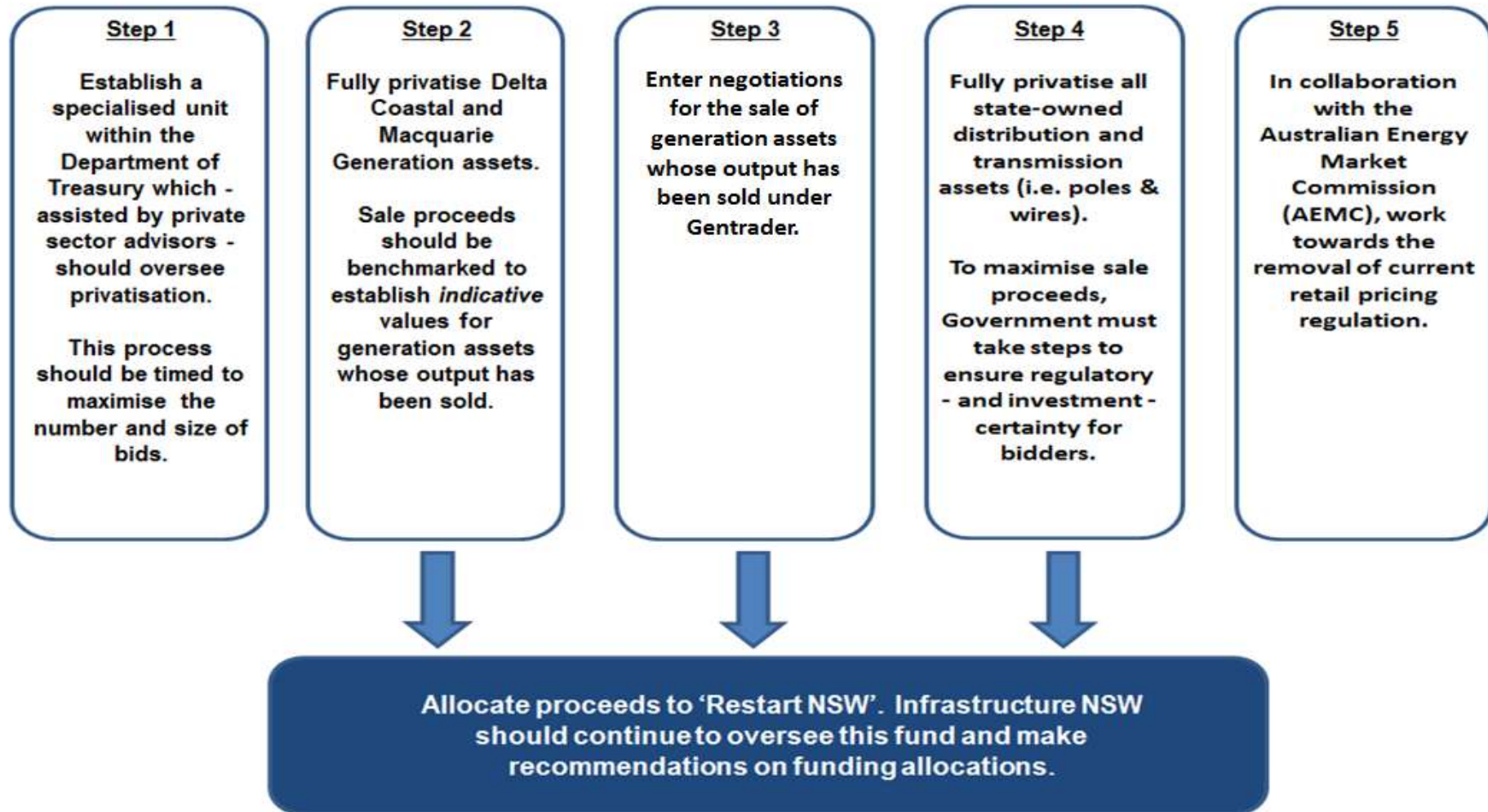
- **Ensure downward pressure on electricity prices** through the creation of a competitive and efficient electricity market on a fully commercial footing.
- **Strengthen the state's longer-term financial position** by removing taxpayer exposure to electricity market risk, investment requirements and realisation of taxpayer equity in these assets. Electricity sector investment currently accounts for 23.6 per cent of the State's capital budget, while in Victoria it accounts for around 1 per cent (ABS, 2011).
- **Buttress government's role in setting overarching strategic objectives** for the electricity sector, by removing the current conflict where government is both a direct market participant and a policymaker/regulator.

The recent election of a new State Government with a significant mandate for reform in NSW should see new progress toward energy reform in this State.

NSW has before it a final opportunity for meaningful reform. The new State Government must take this opportunity and lead the charge for the next round of competition reform, building on the progress made under the National Competition Policy and boosting state and national productivity.

## Recommendations (Summary)

The following five-step reform pathway aims to maximise taxpayer value from the sale of state-owned electricity assets and to remove a long-standing roadblock to the achievement of an optimally competitive and efficient electricity market.



## **Key Points**

1. The privatisation of the New South Wales electricity sector offers a generational opportunity to finally deliver a competitive, contestable electricity sector that will drive lower prices for consumers – and to release tens of billions in taxpayers' money for reinvestment in new infrastructure.
2. Modeling by Infrastructure Partnerships Australia finds that the sale of the distribution and transmission assets in New South Wales would realise between \$29.2 billion and \$34.5 billion for investment in new infrastructure projects. Calculations are attached in Appendix A.
3. Modeling by Infrastructure Partnerships Australia also finds that the sale of generation assets in New South Wales would realise between \$3.3 billion and \$6.5 billion for investment in new infrastructure projects. Calculations are attached in Appendix A.
4. Beyond sale proceeds, the retention of distribution, transmission and generation assets in public hands will require New South Wales taxpayers to shoulder \$17.5 billion in new investment over the next four years alone (NSW Treasury, Budget Paper 4 2010/11).
5. Meaningful reform would strengthen the State's budgetary position by between \$50 billion and \$58.5 billion (avoided debt + capital), allowing for significant additional capacity for addressing the State's infrastructure backlog.
6. The proceeds of asset sales should be sequestered in the *Restart NSW* fund, and invested in new infrastructure projects. Investment decisions should be informed by the long-term infrastructure plan being prepared by *Infrastructure NSW*.
7. Full privatisation will also provide opportunities to significantly strengthen the State's fiscal position. Energy privatisation enabled Victoria to reduce its net debt ratio from 26.7 per cent of Gross State Product (GSP) in 1994-95, to just 3.1 per cent by 1999-2000. Similarly, South Australia reduced its net debt from 29.5 per cent of GSP in 1998 to 12.5 per cent in 2005.
8. The failure of successive governments to undertake bold structural reform is borne by the State's consumers in the form of higher electricity prices. Between 1995 and 2010, retail electricity prices rose by around 70 per cent in New South Wales, compared to 44 per cent nationally. In Victoria, prices rose by just 34 per cent over the same period, in the context of a competitive market.
9. Under a business-as-usual scenario, New South Wales energy consumers will continue to pay more for power than their counterparts interstate. Retail prices in New South Wales are projected to increase 39 per cent between July 2010 and June 2013, compared to 30 per cent nationally (AEMC, 2011).
10. A lack of supply-side competition – coupled with the limited capacity of interstate transmission links – is leading to opportunistic pricing by state-owned generators. The ACCC's 2010 *State of the Energy Market Report* said opportunistic bidding by state-owned generators saw 14 days in NSW in 2009-10 when prices exceeded \$300 per MWh for one or more trading intervals (ACCC, 2010).
11. Privatisation and associated regulatory reforms would have a considerable positive impact on the State and national economy. The Energy Reform Implementation Group (ERIG) estimated privatisation and associated reforms would increase (real) GDP by about \$400 million per year, and would reduce retail energy prices by around 2 per cent (ERIG, 2007).



## 1. **Gentrader – A missed opportunity for reform**

The gentrader reforms undertaken by the former New South Wales Government represent a poor outcome for taxpayers and consumers in NSW. The sale of the output of the State's generation businesses – but not the underlying asset – fails to deliver an optimally competitive market structure or to achieve sufficient value for money or risk transfer. Specifically, the gentrader model:

- **Did not represent value for money for taxpayers or consumers:**

The complexity of the gentrader reforms means that the State realised proceeds of some \$3.272 billion for assets previously valued at up to \$15 billion in 2007.

- **Encumbers taxpayers with significant supply and maintenance risks**

The gentrader reforms have saddled NSW taxpayers with significant risks relating to the electricity market, coal supply and the costs of operating and maintaining generators.

The costs of mitigating these risks are already starting to eventuate; including the \$1.8 billion commitment to retain ownership of the Cobbora coalmine, and the \$500 million upgrade of the Munmorah Power Station.

The NSW Parliamentary Inquiry into the gentrader transactions – in reference to future generation maintenance costs - stated:

*“The decision to set maintenance payments for the life of the gentrader contracts, subject only to certain fixed escalations, exposes the public sector to significant and unmeasurable risks associated with an unexpected decline in the condition of the generating plant. The decision to place all of the risk for unexpected maintenance costs in the hands of the generators is unusual and not in the best interests of the people of New South Wales.”*

- **Fails to deliver optimal competition or create downward pressure on energy prices:**

Competition concerns arose early in the conception of the gentrader process, but were largely ignored by the government of the day. The current structure leaves a confused and opaque structure, with some generators subject to gentrader contracts, while others are not. This remains a significant barrier to optimal supply side competition. The current structure also means that taxpayers retain exposure to generating 95 per cent of the State's current total capacity.

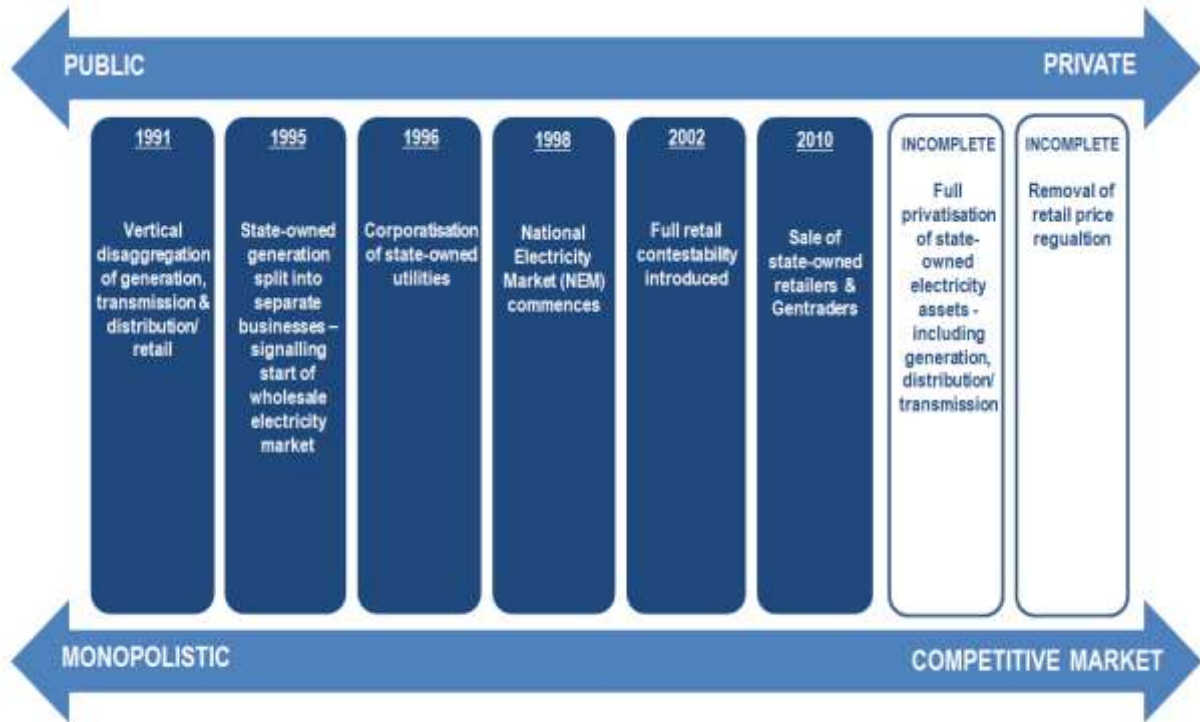
Notwithstanding the adverse impacts outlined above, rescinding the gentrader agreements is not an option that should be entertained, because it would result in significant compensation costs to bidders and would constitute sovereign risk, undermining private sector confidence in future divestitures.

Full privatisation of all state-owned electricity assets is the only prudent pathway for getting the NSW electricity sector back on track and - with NSW accounting for over a quarter of national energy consumption - will remove a long-standing roadblock to the achievement of a truly competitive and efficient national energy market.

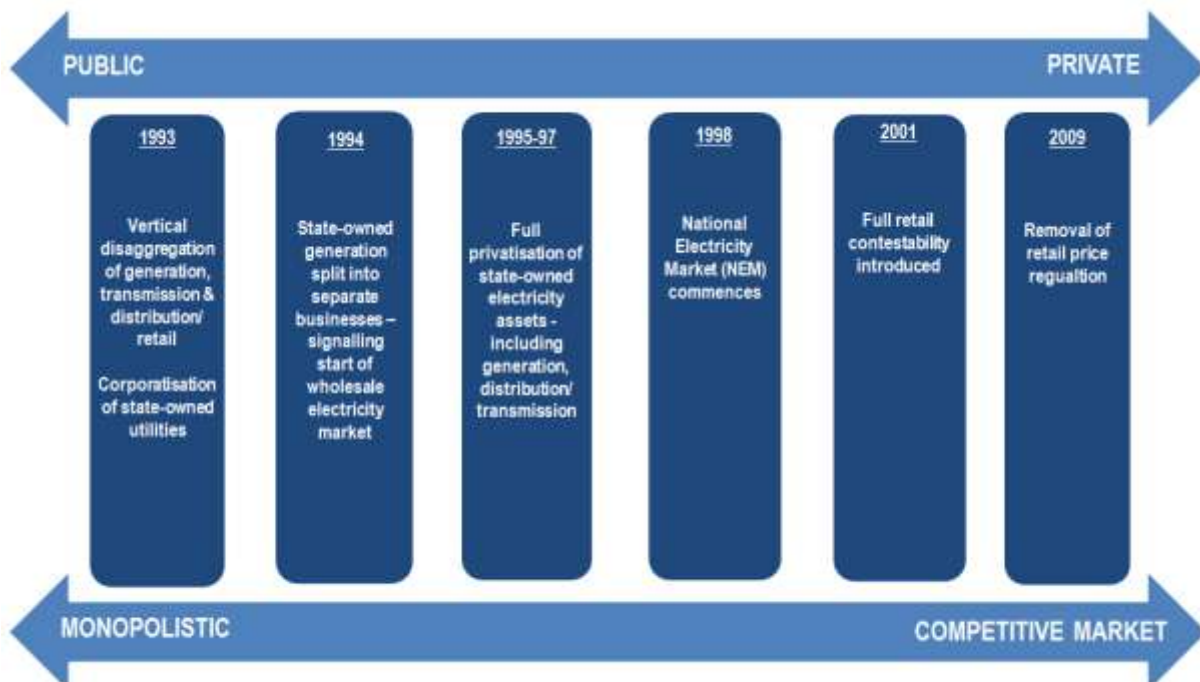


## Electricity sector reform in New South Wales and Victoria, 1991 to present

**New South Wales** has seen no real progress since the introduction of full retail contestability in 2002. Key requirements of an optimally efficient and competitive national energy market – privatisation of state-owned electricity businesses and deregulation of retail prices – remain incomplete.



**Victoria** enjoys a competitive and efficient electricity sector, having successfully completed a fundamental overhaul of public ownership between 1995 and 1997. The success of the Victorian reforms was confirmed by the removal of retail price regulation in January 2009, on the recommendation of the Australian Energy Market Commission (AEMC).



## 2. Getting back on track

### The Case for Privatisation

The case for electricity sector privatisation has been long established in Australia, having been a key recommendation of a 1991 Industry Commission Inquiry into energy generation and distribution.

The commission, whose report became a blueprint for reform in Victoria and subsequently, South Australia, cited the formidable barriers to achieving full competition and recommended the sale of publicly-owned generation assets “to remove ongoing constraints associated with public ownership”, and “to permit faster rationalisation of management and work practices”.

Privatisation was put firmly back on the reform agenda in 2007 when the Energy Reform Implementation Group (ERIG) - appointed by COAG to provide advice on energy sector reform - made privatisation of electricity assets across the NEM its key recommendation.

ERIG quantified that privatisation – and associated regulatory reform – would increase real GDP by about \$400 million a year (in 2007 dollars) and reduce retail prices by 2 per cent.

Later that year, these findings were reinforced by the Owen Inquiry into electricity supply, which found the New South Wales government would have to borrow more, raise taxes or reprioritise other expenditure to meet a \$15 billion investment task for its electricity businesses over 10 to 15 years (Owen, 2007).

More recently, the OECD has added its voice to calls for privatisation in the electricity sector, including in its 2010 *Review of regulatory reform in Australia* (OECD, 2010).

Victoria and South Australia have proved the case for electricity privatisation, showing there are considerable gains to be made. As well as increasing competition and lifting sector productivity, both states were able to significantly strengthen their budgetary positions.

This experience has shown that privatisation of the NSW electricity sector will:

- **Ensure downward pressure on electricity prices** through the creation of a competitive and efficient electricity market on a fully commercial footing.
- **Strengthen the State’s longer-term financial position** by removing taxpayer exposure to electricity market risk, investment requirements and realisation of taxpayer equity in these assets.
- **Buttress government’s leadership role in setting overarching strategic objectives** for the electricity sector, by removing the current conflict where government is both a direct market participant and a policymaker/regulator.

Each of these benefits has been outlined in greater detail in this submission.

*“ERIG has been struck by the consistent refrain that ‘government’, particularly some state governments, are a barrier to private sector entry into energy markets. Government policy and government ownership of competing businesses are the two sources of such barriers.”*

*“In NSW, the dominance of government-owned energy businesses, plus evidence of intermittent but persistent market power, plus the failure to attract new private sector entry despite price signals for it, suggests private investment may be delayed or prevented compared with what would occur in a fully contestable market.”*

**ERIG (2007)**

## 2.1 Ensuring downward pressure on electricity prices

Public ownership of electricity businesses – particularly in the generation sector – is a key factor limiting greater supply-side competition and efficiency gains, keeping prices much higher than they need to be.

In particular, the dominance of publicly owned companies raises serious concerns about competitive neutrality and potentially predatory behaviours within the market. Private investors feel there is no level playing field, directly threatening full market contestability (ERIG, 2007).

Barriers to supply-side competition are especially pronounced in NSW, with more than 90 per cent of generation capacity publicly owned (ACCC, 2010).

The failure of successive NSW governments to introduce supply-side competition has ultimately flowed through to the state's energy consumers in the form of higher electricity prices. The OECD observed this impact in the most recent Review of regulatory reform in Australia, saying:

*“Since the creation of the NEM, prices have risen faster in New South Wales, where there is still a public monopoly, than in other states in eastern and south-eastern Australia, yet productivity gains have been smaller” (OECD, 2010).*

The link between the lack of supply-side competition and rising electricity prices was also clearly illustrated in the ACCC's 2010 *State of the Energy Market Report*, which stated:

*“In 2009-10, NSW recorded 21 price events above \$5000 per MWh, which was the second highest number for any region. At least 11 of these events featured an interplay of factors aggravated by opportunistic generator rebidding....A number of generators, including Delta Electricity, rebid capacity to higher prices to take advantage of the tight market....These events contributed to NSW experiencing 14 days in 2009 – 10 when prices exceeded \$300 per MWh for one or more trading intervals” (ACCC, 2010).*

Structural reforms undertaken in NSW in the 1990s including vertical separation and corporatisation have had a positive impact on the state's energy sector. However, the reality is that these reforms alone cannot lift sector performance to the fullest extent possible.

The limited capacity of structural reforms was a key finding of the 1991 Industry Commission Inquiry into energy generation and distribution. The commission found that structural reform, while necessary, does not directly address the formidable barriers that existing suppliers pose to the new market entrants, in turn limiting market contestability. The final report said:

*“Administrative reform also ignores gains which can be achieved by transferring ownership to the private sector. Private ownership brings with it the disciplines of the share and capital markets, the sanctions provided by the possibility of takeover and the risk of insolvency” (IC, 1991).*

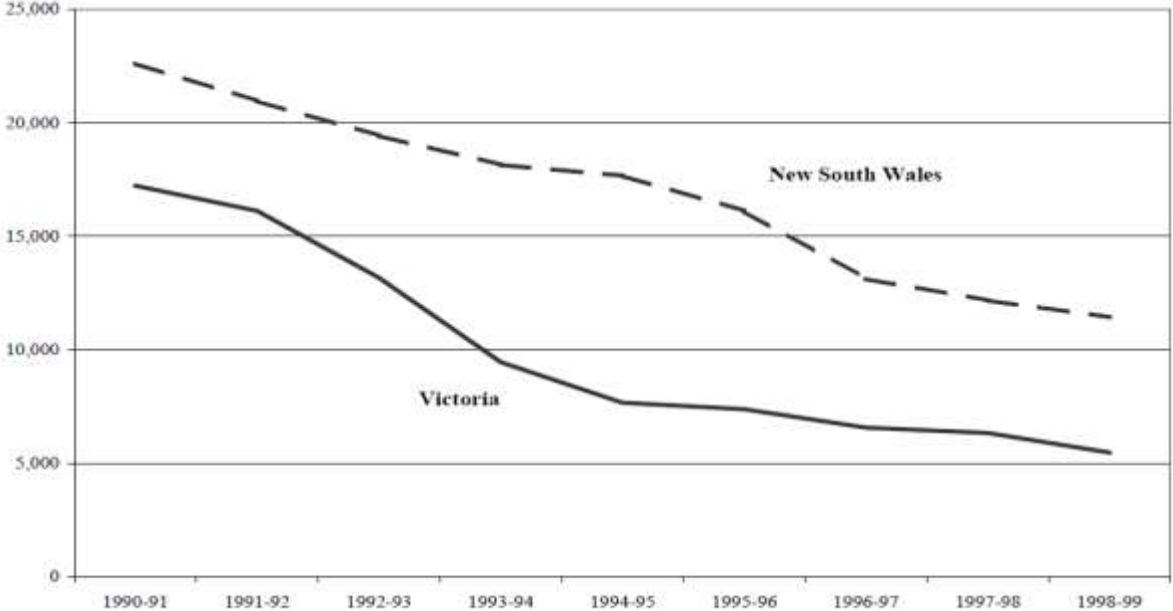
Disciplines applying to private, but not public enterprises include:

- The ability of private shareholders to trade in equity capital;
- The requirements to compete for debt on economic terms;
- The exposure of investment and/or borrowing programs to continual monitoring by capital/share markets;
- The sanctions of takeover or merger for inferior performance arising from the under-utilisation of capital; and
- The risk of insolvency.

**‘Energy Generation and Distribution’  
Industry Commission (1991)**

These findings – in particular the benefits of privatisation – were subsequently borne out by the Victorian electricity sector following the privatisation of state-owned assets between 1995 and 1997. As shown in Figure 4 below, the Victorian electricity sector experienced a marked lift in efficiency in the years following privatisation, with productivity growing at almost twice the rate of NSW (see Figure 1).

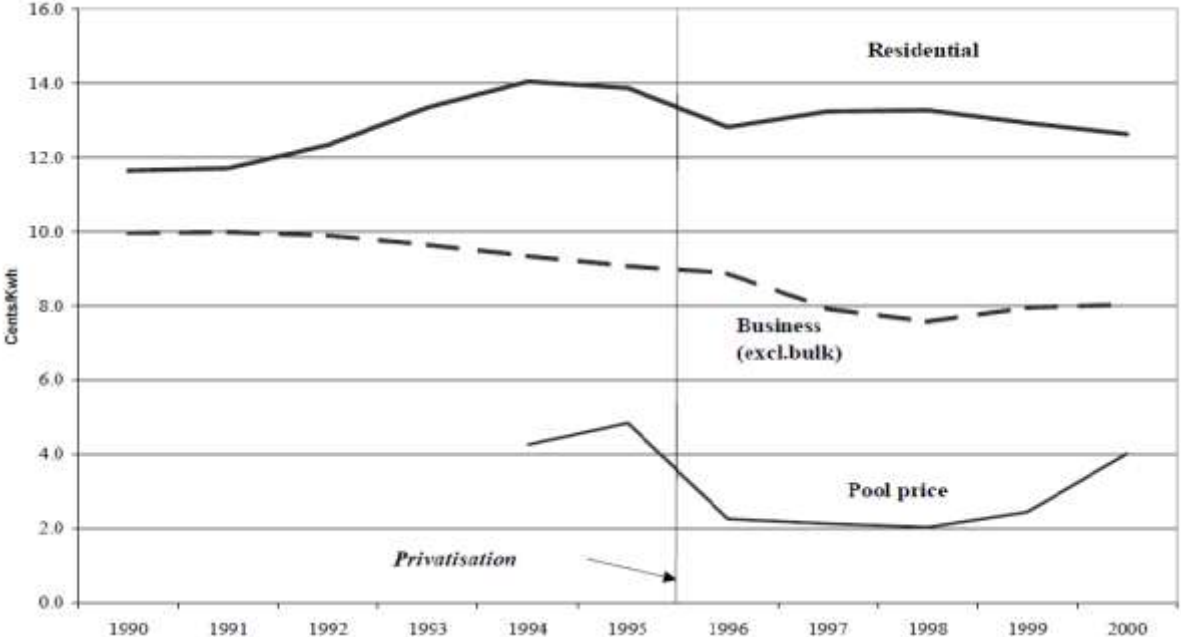
**Figure 1 –Electricity sector labour productivity (\$'000/employee) - Victoria & New South Wales**



Source: Access Economics, 2001<sup>1</sup>

Victoria also provided a first-hand illustration of the direct correlation between increasing sector efficiency and electricity prices. As shown in Figure 2 below, average real electricity prices fell by 8.9 per cent for households, and 11.4 per cent for businesses in the period immediately following privatisation (Access Economics, 2001).

**Figure 2 - Victoria: Real average electricity prices (year 2000 prices)**



Source: Access Economics, 2001

<sup>1</sup> Impact on Victoria of the privatisation of the State's Electricity and Gas Assets, Access Economics, 2001

A comparison of price rises in Victoria to both the NSW and the national average further illustrates the positive impact of privatisation in applying downward pressure on electricity prices.

As shown in Figures 3 and 4 below, between 1980 to 1995 (real) electricity price rises in Victoria and NSW tracked fairly closely, rising 35 per cent in Sydney and 34 per cent in Melbourne.

But from 1995, there is a marked divergence in real price rises, with prices in Victoria rising at just half the rate of those in NSW, and at around two-thirds the national rate of increase (see Figures 3 & 4).

The experience of lower prices in Victoria is a direct result of increased supply-side competition. In NSW, the three largest state-owned power companies generate close to 80 per cent of total capacity. In comparison, the three largest (and privately owned) generation companies in Victoria account for only 63 per cent of total capacity (ACCC, 2010).

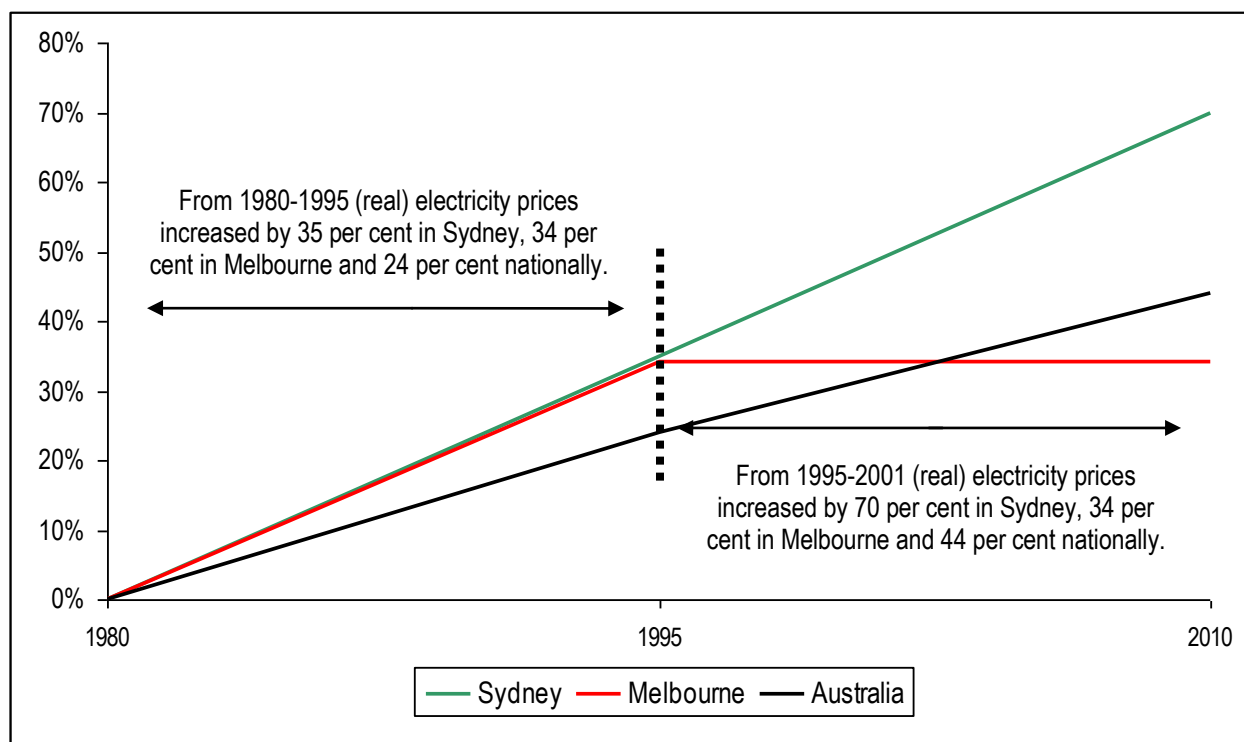
**Figure 3 - Real electricity price rises, 1980 to 2010**



Source: IPA analysis based on ABS 6401.0 Consumer Price Index

(Figure 4 overleaf)

**Figure 4 - Real electricity price rises, 1980 to 1995 and 1995 to 2010**



Source: IPA analysis based on ABS 6401.0 Consumer Price Index

In the absence of an overhaul in ownership, the trend of above-average price rises is set to continue. The AEMC estimates that retail electricity prices in NSW will increase by 39 per cent between 1 July 2010 and 30 June 2013. This will be the second highest increase of any state or territory and 50 per cent higher than the forecast increase nationally (see Figure 5).

**Figure 5 - Retail electricity price forecasts (1 July 2010 to 30 June 2013)**

State	Nominal Increase	Ownership
Western Australia	45%	Majority public
New South Wales	39%	Majority public
Queensland	32%	Majority public
South Australia	31%	Private
Victoria	27%	Private
AUSTRALIA-WIDE	30%	n/a

Source: AEMC Retail electricity price forecasts<sup>2</sup>

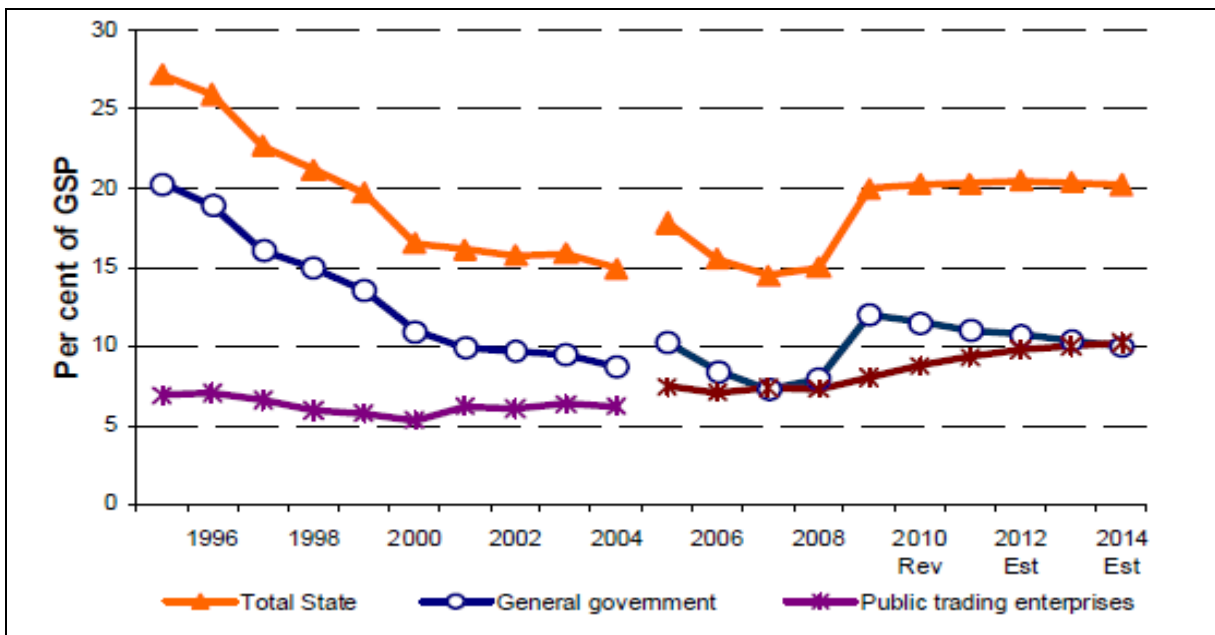
<sup>2</sup> <http://www.aemc.gov.au/Media/docs/Information%20sheet-9110c5bf-385f-4ed4-8642-f9569133e97e-0.pdf>

## 2.2 Strengthening the state's long-term financial position

Aside from achieving an optimally efficient and competitive national energy market, privatisation of state-owned electricity businesses provides considerable fiscal and economic benefits.

In particular, full privatisation of the state's electricity businesses would enable the government to significantly reduce its net financial liabilities. Liabilities are forecast to increase markedly over the forward estimates, rising from \$85 billion to just under \$108 billion over the four years to June 2014, an increase of 27 per cent (see Figure 6).

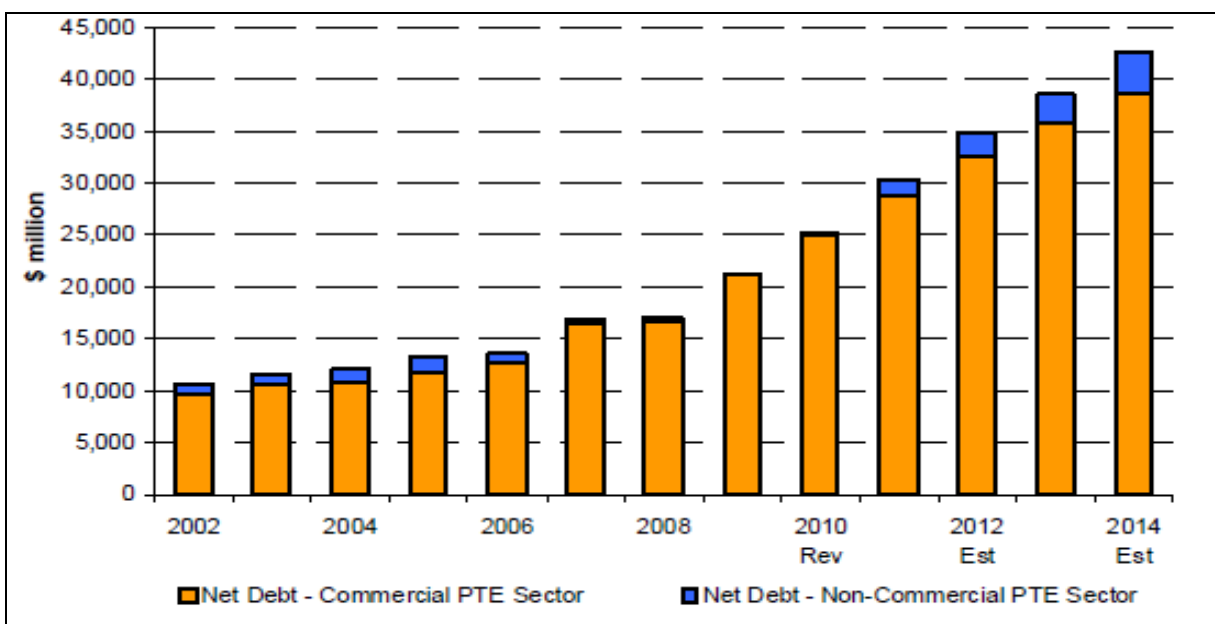
**Figure 6 – New South Wales Net financial liabilities by sector**



Source: *New South Wales Budget, 2010-11, Budget Paper No.2, Chapter 7*

This increase is largely due to the growth in gross debt, which is forecast to rise by \$23 billion. Around 80 per cent of this increase will be borne by public trading enterprises, whose net debt is forecast to rise by \$17.8 billion (see Figure 7).

**Figure 7 – New South Wales Public trading enterprise sector – net debt**



Source: *New South Wales Budget, 2010-11, Budget Paper No.2, Chapter 7*



## *Victoria & South Australia*

Privatisation of energy in Victoria and South Australia illustrates a successful reform pathway that could be applied in NSW. In particular, both states were able to improve their long-term financial position through a significant reduction in their net debt levels.

Victoria, having raised almost \$20 billion - \$28.7 billion in today's dollars - from the privatisation of its electricity businesses, was able to reduce its net debt ratio from 26.7 per cent in 1994-95, to just 3.1 per cent by 1999-2000.

In 2001, South Australia was able to raise more than \$5.3 billion from privatisation of its electricity assets - \$6.8 billion in today's dollars. The majority of proceeds were subsequently applied to debt reduction, reducing net debt as a proportion of GSP from 29.5 per cent as of 30 June 1998 to just 12.5 per cent by 30 June 2005.

Privatisation of electricity businesses in South Australia was credited with the state regaining its AA+ credit rating, with the 2001-02 budget papers saying stating the government "*no longer has to bear the risk of operating in the National Electricity Market and has been able to significantly reduce State debt*".<sup>3</sup> Electricity privatisation was also credited with South Australia regaining its AAA credit rating in 2004.

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<sup>3</sup>[http://www.treasury.sa.gov.au/dtf/budget/publications\\_and\\_downloads/previous\\_budgets/state\\_budget\\_2001\\_02/budget\\_overview\\_0102.jsp?](http://www.treasury.sa.gov.au/dtf/budget/publications_and_downloads/previous_budgets/state_budget_2001_02/budget_overview_0102.jsp?)

## Tackling the Infrastructure Backlog

There is clear evidence of significant infrastructure shortfalls in NSW. Overcrowding of public transport during peak periods sometimes exceeds 130 per cent and congestion costs Sydney's economy more than \$5 billion each year. Significant issues also exist in terms of the quality and capacity of key public services, including social housing, public health and education.

The size of the infrastructure backlog is enormous. The former state government's transport blueprint, which was never formally released, contained projects estimated to be worth more than \$150 billion.

On top of these existing challenges, NSW is facing significant and sustained population growth. The State's population will surge from around 7.2 million people to more than 9.1 million by 2036. This will place the government under significant pressure to invest in new and upgraded social infrastructure and public services, particularly in health, education and justice facilities.

In recent times, the state's infrastructure strategy has been subjected to a regrettable shifting in priorities. This has resulted in a lack of progress in terms of new projects, and has damaged the reputation of the state as a place to do business.

The sale of state-owned electricity assets in NSW will be a generational opportunity to tackle the state's growing infrastructure backlog, by bringing high-priority projects forward and boosting productivity. In Victoria, the sale of state-owned electricity businesses raised almost \$30 billion (in 1997 prices) while in South Australia sale proceeds totaled over \$5.3 billion (in 2001 prices).

The following are examples of infrastructure projects that could be funded by the proceeds of the sale of state-owned electricity assets in NSW.

### North West Rail Link

**\$7-10 billion**

Construction of a new heavy-rail link from Cheltenham to Rouse Hill to service the North-West growth corridor.

### M5 East Duplication

**\$5.2 billion**

Duplication of the M5 East, including a new 4-lane tunnel parallel to the M5 tunnel 3.

### Northern Beaches Hospital

**\$600 million+**

A new hospital & health precinct at Frenchs Forest to service population growth in Sydney's North.

### M4 East

**\$10 billion+**

Construction of a road link from the M4 at Strathfield to the City West Link at Anzac Bridge; as well as a 13 km tunnel to link the M4 to the Port precinct at Port Botany.

### F3 Connection

**\$4.5 billion**

Construction of a motorway link between the F3 to M2

### Pacific Highway Upgrades

**\$7.6 billion**

Completion of a 4 lane dual carriageway through the central coast and northern NSW.

## 2.3 Buttressing government's leadership role

Government has an essential and unique role in setting an overarching strategic direction for the electricity sector, as it does with other essential utilities.

Fully divesting state-owned electricity businesses will further enhance this role by removing the inherent conflict of interest whereby government is both a direct market participant and an objective policymaker.

This conflict of interest was observed by the OECD in its 2010 *Review of regulatory reform in Australia*. The review recommended privatisation not just as a means to enhance competition, but 'to ensure that governments don't use their price control powers to support other policy objectives'.

Full privatisation is the next logical step in a long-term process of ensuring an optimal operating environment and procedural framework is in place. In turn, this will enable market participants to meet demand at prices that recover the reasonably efficient cost of supply.

*"Because private firms' profits and management incomes typically are more closely linked to their performance, they generally respond better to customer demands and price signals."*

**Commonwealth Treasury  
'Economic Roundup' 2007**

This will build on previous reform including the establishment of IPART as an independent economic regulator in 1992, and the corporatisation of state-owned utilities in 1995.

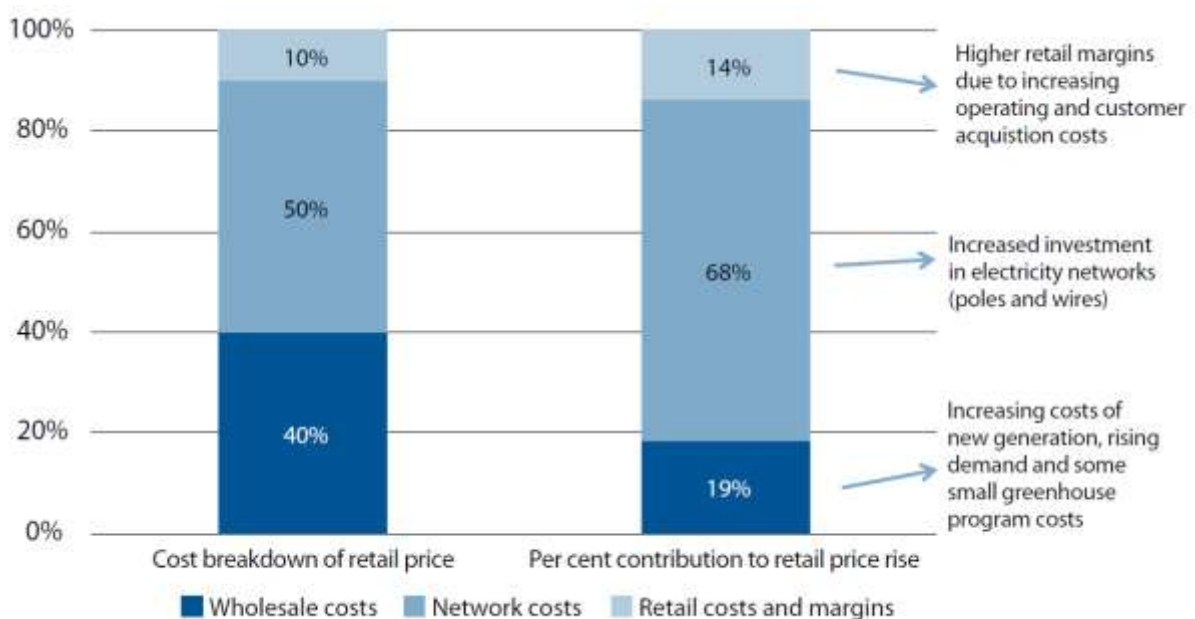
### 3. Next steps for reform

#### 3.1 Privatisation of poles and wires

To maximise downward pressure on electricity prices - through operating efficiencies - and to shift significant required investment onto the private sector, privatisation must include the sale of transmission and distribution assets.

As shown in Figure 8 below, increased levels of investment in transmission and distribution networks has been a major contributor to rising electricity prices in recent years. For the most part, this investment has been entirely necessary. High levels of network investment have been attributed to the need to replace ageing assets, electricity load growth and rising demand, as well as rising peak demand and changed standards in reliability and service requirements.

**Figure 8 - Electricity costs and their contribution to current price rises in 2010**



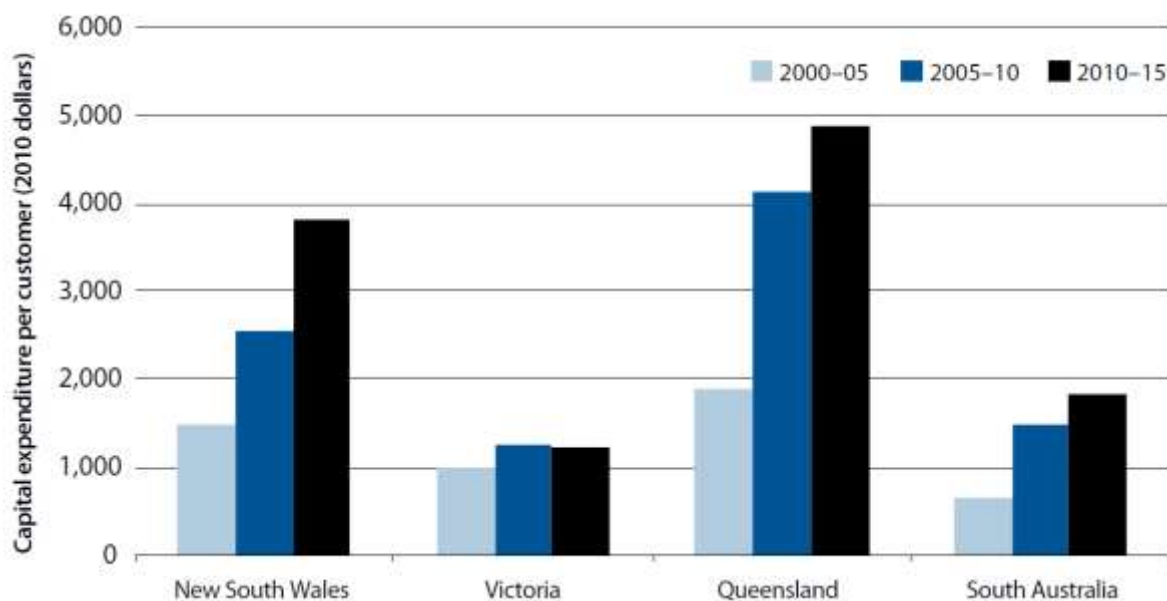
Source: Garnaut Review Final Report, 2011

While the state-based regulatory frameworks in which network companies operate will clearly impact investment levels, there is strong evidence to suggest that network spending is lower, and quality of service higher, where networks are privately owned and operated (ESAA, 2011, Garnaut, 2011).

In light of these efficiencies – as well as the considerable contribution of network costs to retail electricity price rises in New South Wales – privatisation of state-owned network assets will be essential to ensuring that maximum downward pressure is applied to prices.

Victoria and South Australia provide a clear illustration of the benefits flowing from private ownership and operation. As shown in Figure 9 below, network costs per customer in Victoria and South Australia have remained consistently lower than in NSW, where networks remain in public ownership.

**Figure 9 – Real capital expenditure per customer**



Source: Garnaut Review Final Report, 2011

Realisation of efficiency gains from private sector ownership and operation of electricity networks was a factor recognised by the 2011 Garnaut Review, which stated:

*“State government owners have an incentive to overinvest because of their low cost of borrowing and tax allowance arrangements. In addition, political concerns about reliability of the network, and about the ramifications of any failures, reinforce these incentives.”*

While genuine differences between the states explain some of this divergence, ‘it is unlikely that these differences explain the majority of them’ (Garnaut, 2011).

Transmission and distribution is equally important to maximising the fiscal benefits of privatisation. Australia-wide network investment over the current five-year regulatory period is forecast at close to \$40 billion, comprising \$7 billion for transmission and \$32 billion for distribution (Garnaut, 2011).

In New South Wales, the electricity sector consumes 23.6 per cent of the State’s capital budget – with 90 per cent of this capital allocated to networks. Over the next four years alone, NSW taxpayers will be required to shoulder \$15.7 billion in network investment.

Accordingly, the retention of networks in public hands will lock-up the State’s balance sheet and will put at risk its AAA credit rating. Unless price rises continue to be passed directly through to consumers, it will require higher taxes or a reprioritisation of other government expenditure programs, making other commitments critical to the State’s economic and social future extremely difficult to deliver.

In Victoria, the sale of transmission and distribution assets equated to more \$9.3 billion, representing nearly half of the total proceeds from the sale of electricity assets (Access, 2001).

**In NSW, the sale of distribution and transmission assets could realise between \$29.2 billion and \$34.5 billion for the State’s taxpayers.**

## 3.2 Retail price deregulation

Victoria and South Australia have both demonstrated that effective competition between energy producers and retailers will deliver efficient, reliable and safe supplies of energy, as well as maintaining the balance between energy supply and demand over the long term.

In both states, effective competition is fundamentally underpinned by the removal of retail price regulation. The Australian Energy Market Commission (AEMC) has been instrumental in this regard, undertaking comprehensive reviews of the respective energy markets and advising the best path for maximising competition, while continuing to protect the interests of consumers.

In its 2008 *Review of the effectiveness of competition in electricity and gas retail markets in Victoria*, the AEMC stated that:

*“Effective competition in Victoria protects consumers against the exercise of market power as firms strive to deliver goods and services consumers demand at least cost and to improve their products, services and processes.*

*“There is evidence that the majority of customers are benefiting from the competitive process as firms continuously strive for competitive advantage against actual and potential rivals by improving their price and service offering in ways that better meet the preferences of energy consumers.”*

The AEMC report also stated:

*“Removal of retail price regulation in Victoria can further extend the benefits of competition to consumers by enabling them to choose from a wider range of energy products and options (including tariff innovation) than is currently the case.*

*“Where competition is facilitating the delivery of efficient outcomes there is no need for retail price regulation. Indeed, price regulation in an effectively competitive market is costly in terms of administration, compliance and the distortions it imposes on the effective functioning of the market to the detriment of consumers.”*

These recommendations were duly embraced by the Victorian Government, with retail pricing regulation removed on 1 July 2009.

The AEMC’s 2008 *Review of the Effectiveness of Competition in Electricity and Gas Retail Markets in South Australia* was equally upbeat about the impact of privatisation on competition, finding that “competition has been effective in constraining retailers’ prices to reflect real input costs, and that profit margins were at, or below, competitive levels”.

The review also recommended full retail price deregulation in South Australia, including the removal of the regulated standing contract price which was found to be a constraint on the ability of market prices to respond to cost increases.

Pricing reform in Victoria and South Australia has provided important lessons for NSW. In particular, retail price regulation will need to be phased out once privatisation has been fully embedded. This will ensure the maximum benefits of a truly competitive market – such as increased transparency, greater price flexibility and tariff innovation – are passed onto consumers.

## **4. Conclusion**

Experience in Australia and overseas has shown full privatisation of state-owned electricity assets is a fundamental prerequisite to achieving a truly competitive and efficient market.

But while Victoria and more recently South Australia have realised lower energy prices and significant fiscal and economic benefits through energy privatisation, reform in NSW has thus far, failed.

Aside from joining the NEM and introducing contestability in the retail market, NSW has undertaken no major energy sector reform since the corporatisation of state-owned utilities in 1996, other than the deeply flawed gentrader transactions executed in 2010.

The consequences of this failure to reform have ultimately flowed through to the state's energy consumers in the form of higher power prices. Between 1995 and 2010 electricity prices in NSW increased by close to 70 per cent (in real terms) compared to just 44 per cent nationally. In Victoria, prices rose by just 34 per cent over the same period.

As NSW accounts for over a quarter of national energy consumption, its failure to undertake reform means that energy consumers – including those in other states – have yet to realise the maximum potential benefits of a fully functioning NEM.

NSW now has a generational opportunity to put the aim of achieving a truly competitive and efficient national electricity market firmly back on track. The gentrader reforms, completed on 14 December last year, clearly missed this opportunity.

To ensure the new State Government does not repeat these mistakes, it must press ahead with the full privatisation of all state-owned electricity assets – including distribution and transmission.

At a time of historic infrastructure shortfalls we simply cannot afford for scarce capital to be allocated to areas where private capital is available.

A fully privatised structure recognises that private sector participants are inherently more capable of responding rapidly to altered market circumstances than public sector participants, given the right market conditions and appropriate governance arrangements (ERIG, 2007).

Ultimately, full privatisation is the most sensible and proven pathway for getting the NSW electricity sector and NEM back on track.

NSW must now lead the charge for the next round of energy sector reform, building on the progress made under the National Competition Policy and restoring Australia's position as a pioneer in energy sector microeconomic reform.



## APPENDIX A - Estimated Sales Proceeds

### Distribution and transmission

Full privatisation of “poles and wires” could realise between **\$29.2 billion and \$34.5 billion** for NSW taxpayers.

	RAB <sup>1</sup>	Low value (A\$b)	High value (A\$b) <sup>2</sup>
<b><u>Distribution</u></b>			
Country Energy	11.2	12.3	14.6
Energy Australia	5.6	6.1	7.2
Integral Energy	4.7	5.2	6.1
<b>SUBTOTAL</b>	<b>21.5</b>	<b>23.6</b>	<b>27.9</b>
<b><u>Transmission</u></b>			
Transgrid	5.2	5.6	7.2
<b>SUBTOTAL</b>	<b>5.2</b>	<b>5.6</b>	<b>7.2</b>
<b>TOTAL</b>	<b>26.6</b>	<b>29.2</b>	<b>34.5</b>

<sup>1</sup>Regulated Asset Base (RAB) values as at 1 July 2011, based on Australian Energy Regulator (AER) roll forward RABs from the final decisions in 2009.

<sup>2</sup>The low and high multiple values (1.1-1.3x) are consistent with relevant trading and transaction comparables.

A snapshot of recent network company trading and transaction values has been provided below.

Regulated Assets - Trading	Description	EV (\$m)	RABx
DUET	Gas transmission and distribution, electricity distribution	5,524	1.11x
Envestra	Gas distribution	3,071	1.22x
Spark Infrastructure	Electricity distribution	4,408	1.32x
SP AusNet	Electricity transmission and distribution, gas distribution	7,018	1.12x
<b>Average</b>			<b>1.19x</b>

Regulated Assets - Transaction	Year	EV (\$m)	RABx
Northumbrian Water (UK)	2011	7,481	1.30x
WA Gas Networks	2011	1,019	1.20x
Multinet Gas	2011	200	1.13x
NSW Gas Networks	2010	114	1.14x
<b>Average</b>			<b>1.19x</b>

## Generation

Full privatisation of State-owned generation assets could realise between **\$3.3 billion and \$6.5 billion** for NSW taxpayers (see below). The wide range in potential sales proceeds reflects the unknown EBITDA impacts of the Federal Government's proposed carbon tax.

	EBITDA (\$m)	Low (\$bn)	High (\$bn)	Metric
<b>Macquarie Generation</b>	491	2.4	4.9	5-10x EBITDA
<b>Delta Electricity</b>	159	0.793	1.6	5-10x EBITDA
<b>TOTAL</b>	<b>836</b>	<b>3.3</b>	<b>6.5</b>	<b>5-10x EBITDA</b>

*(Notes - EBITDAs have been sourced from FY2010 annual reports. Valuations are expressed as enterprise values, as NSW Treasury Corporation lends to the asset companies. Delta Electricity EBITDA has been discounted by 50 per cent due to gentrader – see below)*

Breakdown of Delta Electricity generation capacity:

	Per Unit (MW)	No. of Units	Total (MW)	Type
Colongra	667	1	667	Gas
Mt Piper	700	2	1400	Coal
Wallewarang	800	2	1600	Coal
Vale Point	660	2	1320	Coal
Mummorah	300	2	600	Coal
<b>Total Capacity</b>			<b>5,587</b>	

Gentrader Volume 3000

Remaining Volume 2587

**Value of EBITDA attributable on installed capacity 46.3%**

A snapshot of recent generation company trading and transaction values has been provided below.

Generators - Trading	Country	EV (A\$m)	EBITDAx
<b>Contact</b>	NZ	6,633	10.1
<b>TrustPower</b>	NZ	4,128	11
<b>Transalta</b>	Canada	9,126	9.2
<b>Cleco</b>	US	3,278	8.1
<b>Portland</b>	US	3,442	6.5
<b>Capital Power</b>	Canada	4,208	8.3
<b>Algonquin</b>	Canada	910	8.9
<b>Average</b>			<b>8.9x</b>

Generators - Transaction	Year	EV (A\$m)	EBITDAx
<b>Transfield Services Infra Fund</b>	2011	813	8.1x
<b>Loy Yang A</b>	2007	n/a	12.6x
<b>Loy Yang B</b>	2006	n/a	10.6x
<b>Average</b>			<b>10.4x</b>