

# Privatising Electricity Assets and New South Wales' AAA Credit Rating

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LateralEconomics

CAPABLE, INNOVATIVE, RIGOROUS

## **I. An opinion about the proposed privatisation of NSW Electricity Assets and the retention of NSW's AAA credit rating**

The author of this statement considers that economic reform in Australia has been a triumphant success. Though it has not been the only factor, it has been a major factor in turning around Australia's economic fortunes from a country sliding down the ladder of relative economic prosperity in the world to one that has stopped and then reversed that decline.

One of the strengths of economic reform has been the way in which we have built on simple and compelling principles, even where they affronted the economic 'commonsense' of many. Thus many people thought that tariff cuts would reduce employment in Australia, but though employment has fallen in the industries that have been subject to tariff reform – by somewhat more than the very substantial amount it otherwise would have – employment across the economy has boomed.

It is a matter of concern and indeed sadness that at a time when an informed economic framework has triumphed in the framing and evaluation of economic reform generally, in one area policies have been driven by simple but plausible fallacies. Having made so many strides towards the light and away from the economic populism of the Australian settlement, in one area governments have expended substantial efforts to take public understanding backwards. This is what has happened in the area of the economics of public debt.

Though this mentality has been a bipartisan one, it has been championed strongly by the ALP, a party that claims to be committed to the role of a strong and prosperous government sector in a mixed economy. Yet just as arbitrary debt restrictions imposed upon a household would be a recipe for its long term impoverishment (at least relative to what it might otherwise achieve) so this is true of the public sector.

Unfortunately fiscal conservatism (which I would strongly support) is being wilfully confused with arbitrary restrictions on debt based on plausible but fundamentally misguided reasoning. If it means anything, fiscal conservatism should mean one or all of the following commitments.

- to run budgets with operating results which are at least balanced over the cycle, though if surpluses can be generated that will generally be a good thing in building a strong public sector.



- to build the net worth of the public sector
- to do this at acceptable risk.

It will be noted that this is broadly the way public companies are run as well as households. In an environment in which assets typically enjoy a rate of return well above the cost of borrowing, borrowing should be encouraged up to the point at which further borrowing would constitute an unacceptable risk.

This is at a time when the state is groaning under the weight of a widely recognised infrastructure crisis <sup>1</sup> and shortly after it has been mired in controversy for its having shifted the costs of infrastructure development off its books – with disastrous effect as in the case of the cross city tunnel. As the table below indicates, NSW's growth performance has been disappointing. It seems likely that underinvestment in infrastructure is amongst the causes. This is the result of managing the state in order to minimise debt rather than to optimise economic outcomes.

**Table One: GSP growth since 1996-7**

<b>GSP, Chain volume measures - 2006-07</b>	<b>Annual growth (%)</b>	<b>Average annual compound growth rates (1996-97 to 2006-07) (%)</b>
New South Wales	1.8	2.9
Victoria	2.7	3.4
Queensland	4.9	4.8
South Australia	0.8	2.7
Western Australia	6.3	4.4
Tasmania	2.1	2.7
Northern Territory	5.6	4.3
Australian Capital Territory	5	3.6
Australia(a)	3.2	3.5

(a) Gross domestic product.

Source: 5220.0 - Australian National Accounts: State Accounts, 2006-07 available at <http://tinyurl.com/2wrgfv>

<sup>1</sup> See for instance Duffy, Michael, "A city on the edge of a nervous breakdown? Let me count the ways", Sydney Morning Herald, February 2, 2008 at <http://tinyurl.com/ywdyln>



This submission does not oppose the privatisation which has been proposed by the Owen Report. We have not investigated the question of whether the assets can be managed more productively in private hands. There are clearly some persuasive arguments that this may be the case, but there are others that suggest otherwise, at least for some time while Australia's and the world's carbon abatement regime is bedded down – a process that may take considerable time – and while the capital markets remain in their current turmoil. The former consideration was mentioned in the Owen Report whilst the latter was given additional urgency by recent analysis from Standard and Poors.

We do disagree with two propositions which appear to be presumed in many discussions of the future of NSW's electricity assets. Those propositions are that:

1. keeping the electricity industry in public hands will compromise the state's AAA credit rating.
2. we should do whatever is necessary to retain NSW's AAA rating as a matter of principle rather than seeking to obtain the best credit rating we can whilst optimising economic outcomes for the state.

These two propositions are considered in the next two sections of this advice.

## **II. Maintaining the assets in public ownership is very unlikely to prejudice the State's AAA rating**

As the rating agencies make clear, credit ratings for sub-national governments – like credit ratings more generally – are based on a wide range of criteria. At the level of highest generality, the criteria set out by Standard and Poors – which are materially very similar to the criteria used by competitors of theirs such as Moodys – are set out in the box below.



**Box One: The criteria according to which credit ratings are assessed.**

### **Economy**

The economic strength of a region or locality is among the most critical determinants of its creditworthiness. Fiscal solvency is intimately linked to economic prosperity, growth prospects, and economic diversification.

### **System support and predictability**

The supportiveness and predictability of the public sector system offers a positive contribution to the rating if the institutional arrangements and environment give confidence in the local or regional government's (LRG's) long-term financial capacity.

### **Management capacity and institutional legitimacy**

In weak institutional environments, fiscal frameworks tend to be focused on short-term technical issues, using low-quality financial information and weak incentives for efficiency, which can be a negative factor in assessing a rating.

### **Financial flexibility**

Financial flexibility is particularly important during periods of external pressure on government finances. If the LRG has high financial flexibility, it is likely to be able to effectively adjust in the face of external shocks on the LRG.

### **Budgetary performance**

Budgetary performance is a central part of the financial analysis of LRGs. Currently, Standard & Poor's analysis of budgetary performance mainly rests on cash-based ratios and available accrual information.

### **Liquidity and debt management**

Analysis of LRG credit quality places a large emphasis on liquidity and debt management issues, such as the appropriateness of debt and liquidity management policies and the level of internal liquidity.

### **Debt burden**

Debt burdens are measured in various ways by comparing annual charges and stocks with available resources to service debt. Debt owed directly by the central government and debt owed by its agencies are both relevant as are the capital and revenue resources available to both government and its agencies.

### **Off-balance-sheet liabilities**

The size and quality of non-debt contingent liabilities can have a material impact on the creditworthiness of an LRG. These include the financial situation of public enterprises and quasi-government insolvent programs.

It will be seen that only one of eight of these criteria is directly in point. Indeed, as reported in the Owen Report, and as Standard and Poor's



have indicated, “the biggest risk to New South Wales’ rating is its operating performance”.<sup>2</sup>

Obviously large increases in debt in NSW can increase the risk to the state – certainly in the short term. But when invested in assets that earn a commercial return they are unlikely to compromise total operating returns (with the possible exception of the very short term when assets are being built) and they can be expected to strengthen operating returns immediately assets commence operation.

It is for this reason that Tony Harris, the former NSW Auditor General observed as recently as last Tuesday that

A large additional investment in NSW’s generation and distribution sectors is pressing. But even with recent interest rate increases, needed investments can earn sufficient gross profit to service borrowings. And such borrowings, made outside of the general government sector, would not affect the government’s budget. Still less would they imperil the state’s AAA status.<sup>3</sup>

Indeed as Mr Harris pointed out, the State’s aggressive dividend policies have ensured that it has received exceptional commercial returns from its electricity assets.<sup>4</sup>

Moreover, while retaining the electricity industry in public hands would obviously increase the gross debt burden on the state, greater investment in infrastructure generally would have a very positive impact on some of the other criteria by which credit ratings are assessed.

Providing it were invested according to sound financial principles, it would

1. increase productivity and economic growth in NSW
2. reduce off balance sheet liabilities – particularly by reducing exposure to PPP type liabilities and

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<sup>2</sup> Cited in the Owen Report, p. 6-16.

<sup>3</sup> Australian Financial Review, 19<sup>th</sup> February, 2008.

<sup>4</sup> Using Productivity Commission data, the Audit Office reported that NSW generators, transmitters and distributors collectively recorded a 15 per cent return on equity for 2006 and 2007. In the last three financial years, NSW’s three electricity generating businesses recorded an average pre-tax annual return on equity of nearly 20 per cent. Earnings on assets were around 10 per cent. These are sterling returns for humdrum utility businesses.

*Ibid.*



3. if investment were in assets with yielded commercial returns which were likely to exceed the cost of capital, it would, over time improve financial flexibility net worth, and budget performance on the operating account.

These benefits would come through relatively quickly as infrastructure was built as in the case of (1) and (2) and over time regarding (3). In fact the Owen Report argues that some of the borrowing to fund new investments in the electricity sector would be on budget. But this is in return for equity in an asset which pays dividends back to the state and which would appreciate through time.

While it does not appear factually inaccurate, the Owen Report appears to downplay the benefits of keeping the industry in public hands and to emphasise risks that would seem relatively manageable given NSW's strong balance sheet. Consider for instance the language it uses in discussing the relative cash flows involved in borrowing to invest in electricity assets. The Owen Report points out that the "[i]ncreased dividend and tax equivalent payments *should at least offset increased finance costs* as the Government should receive a return on its equity investment *at least equal to the Government's cost of debt*" (emphasis added) (p. 6-20). Thus the investment *improves* the bottom line – considered simply in operating terms.

The report then moves on to discussing the effect of this option on the NSW Government's finances. Regarding improving the operating result the report says that "on average this may be case over the life of the investment [it would be more informative to say that this is likely or highly likely], dividends will vary from year to year and hence a degree of increased volatility will be introduced to the General Government Budget Result." This is obviously true. But the upside is that over any appreciable period the assets will appreciate and that that appreciation will boost the net worth of the NSW public sector by a similar amount. This prospect is minimised in the Owen Report. At rates of return several percentage points above the cost of debt, the returns will compound strongly over time.

The Owen report concludes that, even with the more expansive capital investment program that the government has in mind in the next ten years, the electricity sector could continue in public ownership, and meet the need for a \$12 billion expansion program and retain a debt to GSP ratio which is still around the level at which it was in the early 1990s during which NSW retained its AAA rating.

The Owen Report observes that the debt to GSP ratio would climb to around the level it was when NSW retained its rating but did weather a 'credit watch' on its AAA rating. It neglects to mention the difference in



the two scenarios. In 1991 when NSW was placed on credit watch, the country was in its deepest downturn since the great depression, a large amount of the investment was turning out to have been excessive and the underlying budget result was a deficit of nearly 1% of GSP (a record for the period). These very different circumstances are barely mentioned in the Owen Report but, as Tony Harris was suggesting in his column in the AFR, other things being equal, a similar debt to GSP ratio in the absence of these kinds of circumstances is very unlikely to trigger credit watch, let alone a credit downgrade.

Further, the Owen Report tends to consider the issue of ownership of existing assets and public investment in future electricity assets as largely conjoined. There is some merit in this approach if Owen's argument is correct that it would be more difficult to secure private investment on favourable terms in an industry dominated by public assets. But it should be possible to introduce regulatory arrangements that would minimise private concerns with such a scenario. This would enable private participation in building additional assets in the industry whilst minimising any risks to fair treatment for private participants. Certainly one of the major risks that the Owen Report warns of – the risk of overinvestment by public sector agencies – would be obviated by a commitment by governments not to build more capacity or to only do so after independent analysis indicated it was warranted.

And it would also be possible to ensure that public ownership and additional public investment was made at the same time as ensuring that regulatory and other administrative arrangements were made such that the industry or appropriate parts of it were prepared for privatisation if and when this ever became necessary to shore up the NSW Public Sector's capital position.

### **Some Counterfactuals**

The relevance of such considerations are starkly underlined by considering what might have happened in the past when similar debates have occurred. Box two outlines some back of the envelope calculations by Professor John Quiggin.



### **Box 2: Some back of the envelope calculations from John Quiggin**

One problem here is that we need to assess what would have happened in the absence of a sale. Fortunately, for NSW electricity, that is not such a problem. We can look at the 1997 sale proposal, which was expected to raise around \$20 billion, and compare the actual outcome under continued public ownership.

Assuming (over-optimistically) that all the sale proceeds were used to repay public debt, and that the resulting interest savings were compounded at 6.5 per cent, the \$20 billion would have a 2007 present value of \$40 billion.

By holding on to the assets, the government received dividend and tax equivalent payments averaging around \$1 billion a year. In addition, a capital restructure yielded around \$5 billion in equity repayments. Converting these flows to 2007 present values yields about \$20 billion.

If the estimated sale price of \$15 billion for the generation and retail assets is right, that leaves the NSW public with about \$4 billion more debt than they would have had if the 1997 privatisation had gone ahead. But the distribution sector, still in public ownership, is worth at least \$10 billion and probably \$15 billion. So, the rejection of privatisation in 1997 saved the NSW public between \$5 and \$10 billion.

John Quiggin, *lemma's power failure*, Australian Financial Review.<sup>5</sup>

Likewise one might ask what if some or all of the privately funded roads in NSW had been funded by State borrowing with tolls equivalent to those that obtained under private stewardship?

We have not attempted to calculate the precise answer but, given the truly extraordinary capital gains that many of them have produced, it is certain that the NSW State Government would today have a net worth which was greater than it is by many billions of dollars. If its debts were greater (and this is by no means clear given the extent to which cash flows would have exceeded debt servicing) its assets and revenues would be far greater. The Government would now be in a position such that if it needed to, it could sell or lease some of these roads – restoring them to the private ownership they are in today – eliminate debt and end up with residual assets that it does not own, and a higher net worth than it has today! There is nothing surprising about this. As the then Auditor

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<sup>5</sup> And also see <http://johnquiggin.com/index.php/archives/2007/12/12/nsw-electricity-privatisation-a-quick-look/>



General warned in the 1990s, borrowing to fund the roads would have been more consistent with the principles of sound public policy and economic efficiency.

### **Tomorrow's credit rating is partly a function of how well we manage our finances today**

A corollary of these examples is that there is a dynamic relationship between AAA ratings today and AAA ratings tomorrow. Too excessive, and arbitrary focus on reducing debt today can not just compromise economic growth, but also the State's revenues, operating result and net worth and through that it's credit rating in the future. Accordingly prudence requires that decisions on today's debt levels be made on well informed and thought out financial grounds, rather than according to arbitrary formulas or phobias.

### **III. How important is a triple AAA rating?**

*There is no doubt that there is a substantial amount of funds available to finance infrastructure type investments. A significant component of the investor base finds high-yield, low-volatility assets to be an attractive class of investment. . . .*

*But these funds are attracted by the nature of the assets being borrowed against, not the particular identity of the borrower. There is no external reason that the government could not tap the same pool of funds to finance an infrastructure asset. One reason that has been proposed in this regard is the reluctance of governments to increase borrowings on their balance sheets. If this prevents government from financing infrastructure development itself, then it should be recognized that the use of private sector financing is the result of a blanket government policy, rather than a proper financial assessment.*

Professor Stephen Gray <sup>6</sup>

The Government has indicated that a AAA credit rating is a very high priority. As we have argued above, it is not necessary to question this to question the argument that the AAA rating requires sale of the State's electricity assets.

Obviously other things being equal, AAA is a worthwhile thing for the state to have. Indeed, for as long as the State is in debt, the AAA credit

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<sup>6</sup> Professor Stephen Gray, "Financing Infrastructure: Public versus Private" in CEDA, 2007, Sustainable Queensland, Information Paper No 88, p. 13.



rating will generally be bankable in the form of a lower cost of debt capital. In addition, as the State Government points out, there may be external benefits from having such a rating – for instance the AAA rating may offer some fillip to confidence in NSW domiciled firms, though this would likely be at the margin.

But the world is full of tradeoffs. As the passage from Stephen Gray quoted above suggests, it is best to make such tradeoffs by deliberation rather than arbitrarily, by adherence to a policy that has been determined without regard to careful financial analysis. As Professor John Quiggin puts it:

[A] government will generally improve its credit rating by forgoing investment opportunities, even if the investments have an expected rate of return well above the cost of capital. The same is true for corporations, and it is one reason why very few corporations now seek to maintain a AAA rating - the cost in terms of foregone investments exceeds the benefits.<sup>7</sup>

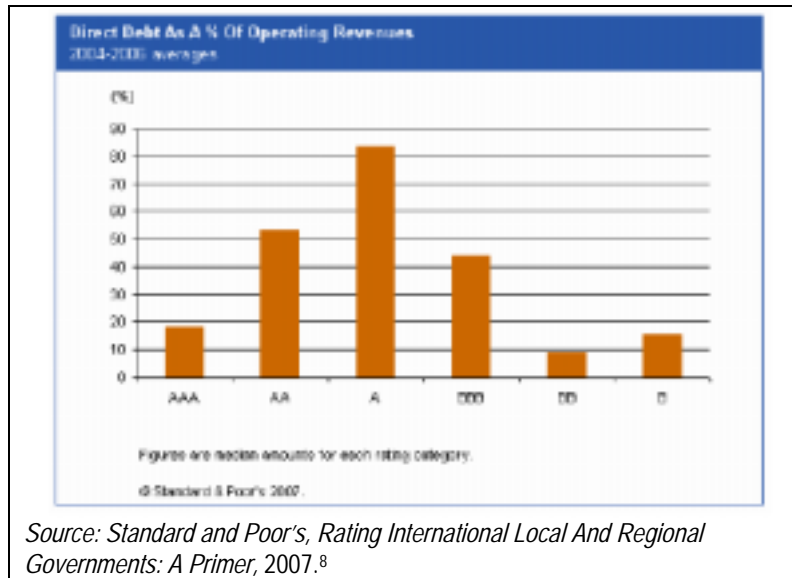
We are unaware of any financial analysis according to which the NSW Government has analysed the costs and benefits of having a AAA rating and chosen its course according to that analysis.

The funds available to the government from being prepared to countenance a move from AAA to a AA rating are very substantial. We can get an approximate idea of this by comparing the average amount of debt of AAA rated Local and Regional Governments (LRGs) and AA rated LRGs. AAA LRGs average direct debt is approximately 18%. But the average for LRGs with a AA rating is around three times higher at 53%.

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<sup>7</sup> John Quiggin, February 19, 2003,  
<http://johnquiggin.com/index.php/archives/2003/02/19/aaa/>





Source: Standard and Poor's, *Rating International Local And Regional Governments: A Primer*, 2007.<sup>8</sup>

Now here is Standard and Poor's description of a AA borrower:

An organization rated 'AA' differs from the highest rated obligations only to a small degree. The obligor's capacity to meet its financial commitment is very strong.

Until recently a credit downgrade from AAA to AA would have involved higher funding costs of around 10 basis points. This amounts to a cost on the existing stock of debt of around \$5 million dollars. Recently with the 'flight to quality' in capital markets that penalty has probably blown out to between 20-25 basis points, at least doubling this estimate, though looking forward this probably overestimates the penalty by assuming that the current extreme aversion to risk in the financial sector will last.

Against this penalty, the additional borrowing could be deployed in funding assets at a rate of return considerably in excess of the cost of the borrowing. The typical premium of debt over equity is around 6%.

Now let us imagine that we borrow sufficient funds to fully fund the State's general government unfunded liabilities which the budget papers have running at around \$16 billion dollars. Assuming conservatively that average returns over time exceed the cost of borrowing by 4% per annum this produces excess returns of around \$640 million per year.

<sup>8</sup> At <http://tinyurl.com/28b6ft>



Moreover given the liquidity that the investments in the superannuation fund could have, we find it most implausible that such a strategy would trigger a credit downgrade.

Nevertheless even if it did, the cost of a downgrade would be \$125 million per annum assuming the 2012 forecast of \$50 billion in debt and no improvement in the financial market's appetite for risk. This still leaves the strategy improving the State's net worth by over half a billion dollars per annum. Indeed if the strategy were implemented immediately, by 2012 the State could already expect to be \$2 billion better off than it would otherwise be.

Of course the gains would not come steadily. There would be some years when the costs of borrowing exceeded returns in the portfolio. There could be some years when returns for the portfolio would be negative. But over any reasonable period of time the State would be ahead. And it would be demonstrating that the hard work that it had put into the financial stability it had was not just sitting idle, but prudently building the foundation for stronger finances in the future.

#### IV. Our bottom line

*Reluctance to use the medium term fiscal policy flexibility that governments have earned may prove to be very expensive in time. There is increasing evidence that we are taking more risk to wellbeing in terms of the safety of economic prosperity as well as personal safety of people in the community because of underinvestment in infrastructure. Recent experience in the United States and Canada points to how damaging outcomes can be where pressures exceed capacity for even a short time.*

*Failure to mobilise resources and channel them into urban public infrastructure will constrain economic opportunities and impact on the vibrancy and liveability of our urban areas which are central to competitiveness and sustainability.*

The Allen Consulting Group.<sup>9</sup>

We conclude by repeating that when we were approached to provide an opinion by Working NSW we made it clear that we were not in principle against the privatisation of those assets in the NSW electricity system that can plausibly become competitive privately owned assets.

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<sup>9</sup> The Allen Consulting Group 2004, Financing Public Infrastructure in Victoria: A comparison of approaches, Report to the Property Council of Australia Victorian Division, Sydney, p. 2. Available at <http://tinyurl.com/yuq7of>.



But the overwhelming impression created by the Government's policies on risk and capital is one of a lack of ambition. The State's unreflective conservatism (it cannot be called prudence) has already cost the state dear but as exporters and the city of Sydney groan under the economic weight of inadequate infrastructure, the costs of that lack of ambition appear to be rising.

Even within the arbitrarily chosen target of remaining within the disciplines of a AAA rating, it seems inconceivable that NSW could not retain the electricity assets it has and highly unlikely that it could not expand its investment in the industry, particularly by building assets which could be sold relatively straightforwardly if the need arose.

The truth is that the Government of NSW has a lazy balance sheet. Working it harder would generate substantial benefits for the citizens of NSW with negligible increase in risk.

Further, if it were sufficiently ambitious for the future of the State, there are things the Government could do to reassure rating agencies that would contribute to growth and prosperity much more effectively than reducing its exposure to high returning assets. It could commit to generating higher operating surpluses and other growth promoting policies and it could commit to greater independent scrutiny of its own budget processes – for instance by receiving public advice on its fiscal stance from the Auditor General or to mechanisms to ensure that governments are unable to run deficits or borrow to invest in projects without the imprimatur of some independent agency.

Without this it seems that NSW, a State that hopes to grow strongly into the future will be condemned to face its future with the financial structure of a retired couple.

