# 7 Ownership

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| Key points |
| * While governments have a legitimate role in owning and operating many services in Australia, the rationale for government-ownership of electricity network businesses no longer holds. * This reflects the development of sophisticated incentive regulations that function best when the regulated businesses have strong profit motives. * Government ownership produces perverse interactions with the existing Rules, which are likely to lead to overinvestment and ineffective cost controls. * State governments often impose multiple constraints on state-owned corporations that are incompatible with their central purpose of maximising returns to their shareholders. These constraints include: * social and environmental obligations * requirements to procure locally * requirements to reduce returns to restrain prices * requirements to limit capital spending when governments are concerned about debt levels * employee benefits and job security for employees are out of kilter with those associated with most businesses * poor governance. * The evidence appears to suggest that state-owned enterprises are less efficient than their private sector peers. * The best remedy is privatisation. However, in the event that governments do not privatise their state-owned network businesses, the original intent that they act as truly independent corporate entities should be reinstated, with their governance and statutes changed to give effect to this clearer role. * The process of privatisation requires clear communication and explanation to the community and other stakeholders, oversight, accountability, clear milestones and timetables, and early regulatory reform. But realistically it should be capable of being achieved over a two year period. |
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Governments have a justifiably central role in the direct supply of many services in Australia. This chapter explains why this no longer holds for the provision of electricity network services. Yet, Australian governments currently own about 75 per cent of electricity network assets in the National Electricity Market (NEM) and a greater share for Australia as a whole (chapter 2).

Section 7.1 sets out a simple framework for making coherent choices about ownership, and explains why the circumstances that would justify government ownership are no longer present for electricity networks.

The regulatory incentive arrangements for the NEM were designed to encourage cost minimisation by profit-maximising businesses. The implicit assumption was that corporatised state-owned businesses resembled private entities and that they would behave the same way. That does not appear to have occurred. Drawing on chapter 5, section 7.2 explains why incentive regulation is more compatible with privately-owned enterprises.

Notwithstanding the removal of state-owned electricity network businesses from direct government control, as shareholders, governments still have mixed incentives. They have imposed a range of non-commercial objectives on their businesses. These increase the costs of those businesses and, in some cases, send mixed messages to managers about their priorities. Section 7.3 considers such mixed objectives, as well as examining some of the government constraints and poor governance arrangements in state-owned corporations (SOCs) antithetical to desirable commercial practices, and to the delivery of the National Electricity Objective — efficient operation of, and investment by network businesses for the long‑term benefit of consumers.

An important question is whether the deficiencies in governance and weaker incentives for cost minimisation are revealed in lower productivity rates or in other performance measures. Section 7.4 examines this question, drawing on the findings of chapter 6, some recent judgments by other reviews, and the findings of the international literature on the effects of government ownership.

Some parties argue that privatisation involves many risks — an issue considered in section 7.5.

Section 7.6 discusses the Commission’s overall view about privatisation and other governance reforms, while section 7.7 examines the appropriate transition to the sale of state-owned network assets.

## 7.1 A framework for considering ownership

Australian governments ‘own’ many organisations responsible for producing goods and services. They play a dominant role in parts of the economy where people do not pay directly for the services — defence, policing, courts, customs, foreign embassies, policy formation, the tax office, government schools and public hospitals. On the other hand, governments have largely relinquished their role in many other activities funded by customer charges, such as banking, telecommunications, airlines, airports, publishing, manufacturing (and in the more distant past, fish and butcher’s shops, building workshops and brickworks — Goot 2010).

Nevertheless, they still own and operate some activities where users pay at least some of the costs of the service, such as public transport and housing. And — relevant to this inquiry — governments are still often owners of utilities, such as water and electricity networks.

In this case, the main challenge is to determine where it is appropriate for governments to act as owners of anything, and then to assess whether these circumstances apply to electricity networks. The strongest (sound) rationale for government ownership is where governments find it difficult to write good contracts with private businesses or to regulate them effectively and where those contractual problems can be effectively overcome through government ownership.[[1]](#footnote-1) This may occur in several circumstances:

1. Businesses may sometimes produce social goods or bads, as well as the goods they sell on markets. From the community’s perspective, the goal should be to maximise the net value of the private and social goods (King and Pitchford 1998). For example, a national park earns market income from entry fees, but they also have major non-economic roles, such as preserving species. In theory, a government could contract these non-market activities to private businesses, or regulate the businesses so that they are obliged to provide them. However, it may be hard to verify whether the business has fulfilled its side of the bargain given the difficulties of measuring the outputs. In that case, a private business has an incentive to make higher profits by producing less than the desirable amount of the non-market output. A government-owned business does not have any such incentive, since it does not keep any surplus as a private return.
2. Government ownership may be preferred to procurement from private parties if it is difficult to write a contract that realises government’s preferences and priorities. This is similar to the considerations of private businesses when deciding how much to outsource an activity or undertake in in-house.
3. Quality and performance may be higher where an employee has a motivation beyond their pay and conditions to achieve a goal common with the objective of the organisation. For example, this may be a solider fighting for his or her country (Besley and Ghatak 2005).
4. There may be intrinsic conflicts of interest in private ownership. One United States economist posed the question of whether a private business could run the US State Department. The answer was (obviously) no, but as Dixit (2002) explores in some detail, the fundamental reason centres on the difficulties in creating appropriate incentives, monitoring performance, ensuring probity and motivating employees.
5. Government ownership might be an alternative to regulated private enterprises — especially in the provision of essential services — if it is difficult to construct effective regulations. In that instance, government ownership might result in outcomes closer to the competitive ideal (Goot 2010 and Yarrow 2012a, p. 3).[[2]](#footnote-2)

In the case of electricity networks, it is less clear that (i) to (iv) has ever applied as a legitimate basis for government ownership of electricity networks. However, a good case could be made that (v) was relevant prior to the development of sophisticated competition regulation. There is also a view that government ownership was important to achieve social goals that were fluid and implicit.

However, circumstances have changed with several major developments.

* Australia has an elaborate system of regulatory arrangements for controlling prices and ensuring quality of services in network businesses, underpinned by independent regulators. Ownership can no longer be seen as a substitute for regulation.
* All the state-owned businesses have now been corporatised, so that they are at much greater arm’s length from government than they were in the past (though, as discussed later, not as distant as desirable). In that case, to the extent that they ever existed, rationales (i) to (iv) can no longer apply, since the contractual difficulties between government and a corporatised entity are similar to those between a government and a private entity.

Accordingly, the rationale for government ownership of electricity networks has now disappeared. That might not matter much if corporatisation of government owned businesses had created sufficient incentives for cost-minimisation. If corporatised entities behaved like private businesses, then even if their ownership status were no longer justified, the transactions costs of privatisation might mean that they should remain publicly-owned. However, as the remainder of this chapter shows, the premise that they do or can behave like private businesses is doubtful.

## 7.2 Incentive regulation and state-owned corporations

Incentive-regulations are built on a simple premise. Where the regulatory rewards to the business are (at least significantly) separated from their actual costs, profit-motivated businesses face strong incentives to cost minimise in any given period. Over time, the regulator can rein in the rents this creates by raising the performance benchmark.

However, as discussed in chapter 5, the investment incentives for state-owned corporations are more complex than for privately owned businesses, and can work against the cost minimising incentives in the regulatory regime. Without repeating the analysis in that chapter, this reflects several factors.

* Finance appears to be easier to access for SOCs than private businesses (certainly over recent times). The consequence is that, in comparison with private businesses, the weighted average cost of capital (WACC) actually facing SOCs is more likely to be lower than the regulated WACC. The larger the gap between the ‘true’ and the regulated WACC, the weaker is the penalty from overspending. Indeed, a large enough gap can make it profitable to overspend. This effect is accentuated by the fact that state and territory governments are effectively able to receive a pre-tax rate of return on their SOC investments because they receive the company taxes that would otherwise have gone to the Australian Government. This could weaken the usual incentives of shareholders to constrain overinvestment. It would also mean that setting a higher reliability standard (with its associated requirements for additional investment) could produce positive financial returns.
* Financial market accountability is concentrated in just one party (the government). In contrast, private businesses must typically secure their equity or debt from multiple parties, all of which monitor the performance and potential risks of the business when deciding whether to provide finance. The consequences of poor management by a private network business— and the reputational effects that ensue — are likely to have enduring effects on the capacity of the business to obtain further capital (and on the cost of that capital).
* Insolvency is effectively impossible.
* Governments have non-commercial incentives that constrain their SOCs — an issue examined further in section 7.3.
* Governance arrangements may not encourage tough-minded management (also considered further in section 7.3).

The Commission’s diagnosis on the above is not new, with many others having identified the mismatch between incentive regulation and government-ownership of electricity network businesses.[[3]](#footnote-3) The most recent consideration of these issues concluded that the current regulatory regime is essentially incompatible with state-owned businesses:

The NER [National Electricity Rules] and NGR [National Gas Rules] are based upon an economic approach developed for the regulation of *privately owned* utilities. Whilst the approach can, and has, been applied to state owned entities international experience tends to indicate that it is more difficult to get to work effectively. Underlying issues include a relative lack of incentives to reduce costs in publicly owned monopolies, and intra-government conflicts relating to the supervision of publicly owned monopolies (most typically between that part of government responsible for performing shareholder functions and the regulatory authorities). (Yarrow et al. 2012a, p. 12)

More generally, Yarrow (2012) has emphasised that while the interactions of incentive regulations with private utilities are relatively predictable, this does not hold for state-owned network businesses. In commenting on the problems apparently besetting the National Electricity Rules, Yarrow drew some parallels to the experiences of the Island of Guernsey to provide a lucid illustration of the difficulties in this area (box 7.1).

Collectively, these factors suggest weaker incentives for cost controls in state-owned businesses, a position endorsed by some privately-owned businesses:

The Businesses believe that privately-owned businesses have stronger drivers to operate efficiently and to respond to the incentive arrangements provided in the current Rules than publicly-owned businesses given the nature of private shareholder requirements. This has been borne out by the experiences of privatisation in Victoria and South Australia. … The Businesses support the privatisation of the publicly-owned DNSPs [Distribution Network Service Providers] in New South Wales, Queensland and Tasmania and believe that it presents significant opportunities to achieve efficiency savings, which will be beneficial to end customers through lower distribution prices. (ETSA Utilities et al., sub. 6, pp. 41‑2).

Recent changes to the National Electricity Rules (AEMC 2012r) — broadly in line with those recommended by the Productivity Commission in its draft report — partly address some of the above concerns. For example, the new Rules give the Australian Energy Regulator (AER) a capacity for ex post scrutiny and potential rejection of capex overspending by network businesses. While not its explicit purpose, this is likely to apply mainly to SOCs (where overspending has been more common — chapter 6). The creation of an Efficiency Benefit Sharing Scheme and adjustments to incentives schemes affecting demand management should also address some of the present biases against opex and non-network solutions (chapters 5 and 12).

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| Box 7.1 Lessons from the Island of Guernsey |
| In a detailed micro study of competition regulation on the Island of Guernsey, two leading competition economists found that standard incentive regulation worked reasonably well for the privately‑owned telco sector, but poorly for the publicly-owned postal and electricity sector. In the latter instance, the problems centred on:   * a relatively inactive shareholder * the capacity for the business to retain earnings for discretionary investment at a time of its choosing * a flawed appeal mechanism * perhaps most oddly, the fact that there were implicitly two incompatible regulatory systems sitting next to each other. On the one hand, there was an independent regulator charged with the usual responsibilities for setting efficient prices. On the other, the electricity business had, in effect, its own regulatory charter. It was obliged to balance its commercial objectives against the effect on the community of any increase in its charges.   Guernsey is an interesting case study of the importance of the confusions that arise when a regulatory regime intended for profit-minded managers is applied to a business that has non-commercial objectives — which clearly has a resonance in the Australian context.[[4]](#footnote-4) |
| *Source*: Yarrow and Decker (2010). |
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Moreover, if adopted, the Commission’s recommended reliability framework will reduce the tendency for network businesses in some states to build to excessive reliability levels, while independent scrutiny of large projects outside the incentive regulation regime should constrain overspending for those projects (chapters 14 to 17).

However, as noted in chapter 5, other measures that might target some of the unbalanced incentives facing state-owned corporations, such as applying a lower regulated WACC for state-owned rather than private businesses, are not practically feasible or desirable. It is not sensible to craft new Rules whose purpose is to address the distortions created by government ownership of some utilities.

## 7.3 Non-commercial imperatives and interference

As indicated above, in contrast to privately owned businesses, state-owned businesses are exposed to many government requirements, including non-commercial goals, ministerial directions, and obligations for local procurement and greater employment benefits. Arrangements vary by jurisdiction.

### Multiple and conflicting objectives affect some businesses

Several jurisdictions explicitly include multiple objectives in the Acts governing the conduct of their SOCs. For instance, in New South Wales, s. 8 of the *State Owned Corporations Act 1989* (NSW),[[5]](#footnote-5) requires state-owned corporations to give equal weight to commercial success, social responsibility, ecological sustainability, and a sense of responsibility towards regional development and decentralisation. Some participants in this inquiry saw this as appropriate. For example, the Australian Services Union (ASU) noted:

… a state-owned corporation has got responsibilities to balance out environmental concerns, regional employment and some other government operations, as well as the cost of charges. It's also under a bit of political pressure to make sure there are jobs created in those towns, apprenticeships and employment numbers ... (trans, p. 325)

The legislation for ACT-owned corporations appears to be modelled on the New South Wales Act, with requirements for management to give equal weight to a range of commercial and non-commercial obligations.[[6]](#footnote-6)

The statutes for Queensland’s SOCs appear to be less in conflict with commercial behaviour. Commercial success is the prime goal, and as a principle, businesses must not have conflicting goals.[[7]](#footnote-7) Any community service obligations (CSOs) of the business must be clearly identified in the business’s statement of corporate intent and separately costed (with the business to be ‘appropriately compensated for its community service obligations and any funding will be made apparent’). One of the advantages of explicit budget-funded CSOs is that they increase shareholder pressures for business performance. The Queensland Commission of Audit (2012, p. 165) noted that the CSO for Ergon Energy (the regional distribution business in Queensland):

… represents a significant funding risk to the State which highlights the need for appropriate incentives for Ergon to contain costs and manage its business appropriately in order to limit the State’s financial exposure.

The virtues of transparency aside, the Queensland Commission of Audit (2012, p. 159) noted the Queensland Government still has the potential to issue non-commercial directives (discussed further below). It also found 23 other policies and guidelines for SOCs that were outside the Government Owned Corporations Act and the Australia-wide Corporations Act, indicating the challenges for management in running their business on a purely commercial basis.

In Tasmania’s case, SOCs must, on the one hand, operate in accordance with sound commercial practices and as efficiently as possible, yet also ‘have regard’ to the economic and social objectives of the State.[[8]](#footnote-8) The treasurer has the power to specify the economic and social objectives of the state relevant to any SOC (but must do so transparently by gazette).

There is some evidence of tensions between these commercial and non-commercial objectives. The final report of the Independent Review of the Tasmanian Electricity Supply Industry (Electricity Supply Industry Expert Panel 2012), noted:

Stakeholders from the SOEBs [state-owned electricity businesses] indicated that they have difficulties in resolving the inherent tension between their obligations under legislative and other instruments to act commercially on the one hand, and the expectations that the Shareholders may or may not have explicitly stated with regard to delivering broader policy objectives (for example reducing the impact on cost of living for customers or the retention of members of the local Tasmanian workforce as employees of the businesses). (p. 47)

Interestingly, that report also observed:

The CSO [Community Service Obligation] process is a key component in minimising the potential disconnect between directors’ duties and the legislative framework on the one hand and the delivery of broader policy objectives on the other. (2012, p. 60)

But that process often fails:

The Panel has observed other examples where the CSO framework has not been deployed where it would have been appropriate to do so. For instance, in 2009 the Government wrote to Aurora Energy to express a desire for tariff increases charged under the Aurora Energy Pay as You Go (APAYG) billing system to be effectively ‘capped’ for concession cardholders at a rate below that at which Aurora Energy was intending to charge. (2012, p. 61)

Sims (2012b), chair of the ACCC, summarised the dilemma:

We still have key network businesses in Government hands in Tasmania, Queensland, New South Wales and Western Australia. Good regulatory policy is important, but regulation is not a substitute for good governance. The incentives of Government shareholders are unavoidably mixed and complicated by multiple and disparate objectives. (pp. 4‑5)

If state-owned businesses are not privatised, the original intent of corporatisation should be re-instated, with the businesses purely oriented to commercial purposes. This does not mean that governments need relinquish any social or community goals that they best see delivered through electricity network businesses. These decisions are reasonably those of government. However, any non-commercial objectives of government should be separated from ownership, and independently financed.

If such objectives are maintained, they should be prioritised and the business given guidance on their application. Given the tendency for weak or changeable shareholder disciplines, it would be appropriate to specify expectations of equity and dividend returns that the boards and management of the state-owned enterprises were expected to achieve, commensurate with those considered acceptable by an independent investor for a comparable business.

### Procurement policies

SOCs face several obligations to meet procurement guidelines set down by their governments.

The New South Wales Government’s procurement policy — the Local Jobs First Plan — includes two mandatory components to address industry development for purchases made by New South Wales Government agencies, including SOCs (NSW Government 2009). Consistent with the New South Wales Government’s international obligations, such as Free Trade Agreements, the beneficiaries are limited to small and medium enterprises (NSW Government 2009, p. 4). This suggests that the agreements are seen as risking violating the principles of free trade.

The plan includes various price preferences.

* The Country Industries Preference Scheme is applied to support approved manufacturing industries in country New South Wales by adding margins of 2.5 per cent or 5 per cent only to the prices of other New South Wales suppliers.
* The Australia and New Zealand (ANZ) Price Preference Margin provides for a 20 per cent price discount to be applied to that part of the tendered price related to the ANZ content of goods and services offered in a tender response.

It also requires tenderers to draw up industry participation plans. As part of this process, tenderers must estimate the various consequences of winning any contract tender over $4 million. This includes consequences for existing and new employees engaged in delivering the contract and their location; the number of local suppliers that will win work as a result of the contract and their employment numbers; the number of apprentices and trainees supported by the contract; and the regional economic impact, skills enhancement and technology transfer that will result.

Queensland state-owned network businesses are subject to similar provisions as part of the government’s *A Fair Go for Local Industry* policy (Queensland Government 2008, 2011). For example,

… as part of value for money due consideration in the tender evaluation is given not only to price but also to environmental sustainability, quality and delivery, whole-of-life costs and/or administrative and risk mitigation advantages *and the advancement of the priorities of Government arising from local sourcing* [italics added for emphasis]. (Queensland Government 2011, p. 5)

Less intrusive procurement policies appear to be in place in the ACT and Tasmania.

Such procurement arrangements increase input costs and create compliance burdens for state-owned network businesses. In this regard, it was notable that the Ausgrid board assessed their obligations under the Local Jobs First Plan as non-commercial, noting that:

The costs of complying with that policy have not been separately funded, although the direction was given to implement the plan by the Minister (Ausgrid 2011b, p. 10).

EnergyAustralia (the predecessor to Ausgrid) estimated that complying with the Plan would cost them $6 million in 2011‑12, rising to $50 million per annum by 2015‑16 (Industry and Investment 2010, p. 25). These costs will not be reflected in electricity bills since they do not meet the AER’s guidelines, but they will affect dividends to the New South Wales Government. They are indicative of the problematic links between state-owned corporations and government.

### Employment policies

Employment policies of the state-owned utilities have several distinct features. First, they appear to pay higher wage rates than private utilities (chapter 2).[[9]](#footnote-9)

Second, employment policies appear to involve more generous non-wage conditions. In its submission to the Senate Select Committee on Electricity Prices, the New South Wales Government observed:

It is important to note that inefficient work practices have been occurring across the energy industry and have been allowed to become part of the expected wage structure within network and generation businesses. Examples include:

* Excessive overtime payments because rostering arrangements do not take into account that electricity networks operate 24 hours a day, 7 days a week;
* Generous long service leave provisions providing additional leave for long‑term employees;
* Employer contributions to superannuation well above standard level for some employees;
* Bonuses paid to permanent employees just to allow contractors to undertake capital projects;
* Planned night work is paid at double time with employees then stood down the next day effectively receiving triple time for the shift;
* Income supplements that can double or triple the base level income of regular employees. (NSW Government 2012b, p. 3)

Particular concerns have been raised about the use of overtime. The New South Wales Government’s economic development agency, Industry and Investment (2010, p. 50), observed that overtime levels were projected to rise significantly (and over 100 per cent in a single year for one business). It identified this as an area for possible cost containment.

The New South Wales Auditor-General (2012) found that over one million hours of overtime was paid by Ausgrid in 2011‑12; the highest overtime amount paid to an individual was just over $180 000, representing nearly twice the person’s annual salary; and that in 2011‑12, 865 employees were paid 50 per cent or more of their annual salary in overtime. He noted that:

Management attribute the high levels of overtime to the nature of Ausgrid’s operations requiring some work to be completed outside of employees’ scheduled operating hours. Risks from excessive overtime include work, health and safety issues and less than optimal staff resourcing. The level of overtime is high and needs close monitoring to ensure business needs are met efficiently. (NSW Auditor-General 2012, p. 26)

There have also been concerns about overtime levels in the Queensland network businesses. The independent review panel examining the source of network cost pressures in Queensland (IRPNC 2012, pp. 21ff), found that across the three network businesses, 647 employees earned in excess of 1.5 times their base pay and in many cases twice their base pay**.** The panel considered that this was highly undesirable and likely to weaken incentives for productivity.

A third feature of employment policies is that they provide greater protection for their workers from structural changes in their businesses. The Queensland Commission of Audit (2012, p. 159) noted that restructures of various government-owned corporations (such as ports and electricity generators) included amendments to enterprise bargaining agreements safeguarding employees from forced redundancies and forced relocations for a period of three years after the restructures. As a result, the Commission of Audit observed that the enterprises were unable to rationalise their workforces in response to changed asset portfolios. Instead, the businesses were required to incorporate excess staff across their respective organisations, with associated inefficiencies. While Queensland’s network businesses have not been re-structured, these other instances reveal that the Queensland Government has placed significant weight on matters that would usually be left to routine industrial relation practices (or otherwise through generic employment assistance measures). In addition, the provision of such safeguards is likely to weaken the incentives for employee efficiency in any of the state-owned corporations.

In New South Wales, Ausgrid is required to provide a five-year employment guarantee to award staff or separate senior contract staff in accordance with their contracts, a requirement that came into play following the removal of the retail arm from Ausgrid (2011b, p. 7).

On a potentially more positive note, the Australian Services Union (ASU, sub. DR57, pp. 5‑6) claimed that state-owned enterprises placed a greater emphasis on technical training than their private sector peers — as suggested by apprenticeship numbers. However, there are significant limitations in the ASU’s data.

* The ASU categorises NT Power and Water, Aurora, ActewAGL and Alinta as private distribution businesses. In fact, the first two are government-owned, the third has split ownership and the fourth is not a distribution business (although Jemena had its origin through an earlier re-structuring of Alinta).
* The ASU under-enumerates apprenticeship numbers and recruitment in the private distribution businesses. It records SP AusNet as recruiting no apprentices in 2010‑11, yet data from SP AusNet (sub. DR102) indicate that 34 new starters joined the existing 128 apprentice, trainees and graduates in that year.[[10]](#footnote-10) The ASU indicated that CitiPower and Powercor recruited about 19 apprentices, yet information from CitiPower and Powercor (2011, p. 20) suggested 37 new apprentices and trainees in 2011 and a stock of 111. Jemena and ETSA Utilities were not included in the ASU’s data. The former took on 39 new apprentices and trainees in 2010 (2011 p. 19), while ETSA Utilities employed 163 apprentices at the end of 2011 (ETSA Utilities 2012c, p. 25) and recruited 30 new apprentices in 2012 (ETSA Utilities 2012d).

Nevertheless, despite these errors and omissions, the available data do suggest that state-owned corporations recruit more apprentices and trainees than the privately-owned network businesses. For example, Ausgrid alone recruited 153 new apprentices in 2010‑11, taking apprentice training numbers to 590 at the end of June 2011 (ASU, sub. DR57, p. 5 and confirmed by data from Ausgrid 2011a, p. 13).

However, while training is critical for sustaining the capabilities of a network business, it is not clear that the private businesses are engaged in too little training. Training is not a good in its own right, but an input into performance. As noted below and in chapter 6, the actual performance of the private networks appears to be superior.

### Sponsorships

While relatively small in scale, sponsorship behaviour provides a revealing window on some of the differences between state-owned and private network businesses.

There are instances where SOCs have provided community sponsorships and donations that appear to be of a magnitude at odds with the goals of most commercially-oriented businesses. It is particularly hard to characterise such sponsorships as building a brand name to attract customers, since customers have no choice but to deal with monopoly network businesses.

For example, in 2010‑11, Ausgrid provided $4.3 million in sponsorship (but including employee payroll contributions) to various community groups, including around $500 000 to the Sydney Symphony Orchestra. The New South Wales Government recently required Ausgrid to terminate this and other sponsorships (Hartcher 2012). The level of sponsorship is relatively large and at odds with the sponsorships generally provided by most other network businesses (as shown below). Moreover, the directive from the relevant minister to cease the sponsorship reveals the capacity for the government to direct the management of ostensibly independent corporations.

The AER rejected Energex’s proposed $9.1 million of sponsorships over the 2010‑11 to 2014‑15 regulatory period, noting:

However, in general the AER considers that sponsorship activities do not represent expenditure required to comply with the opex objectives. The AER considers that sponsorships are generally designed to increase brand awareness or demonstrate community support. Such activities may provide a benefit to the community but do not relate to the provision of standard control services by regulated electricity DNSPs, nor do they relate to the opex objectives. The AER considers that Energex has not demonstrated how its $9.1 million forecast sponsorship expenditure is required to achieve the opex objectives, nor has it outlined how it is relevant to the provision of standard control services. The AER is not satisfied that this forecast level of expenditure is efficient and prudent expenditure. (AER 2009c, p. 648)

In contrast, other SOCs had levels of sponsorship more commensurate with private network businesses (though still on average higher), recognising that it can be in the interests of a business to build its community standing. For example, sponsorship amounts for the various businesses in 2010—11 were around $300 000 (Transgrid — SOC); $600 000 (Endeavour Energy — SOC); $1 100 000 (Ergon Energy – SOC); $500 000 (Aurora Energy — SOC); $170 000 (SP AusNet — private); $200 000 (Jemena — private); and $125 000 (CitiPower and Powercor, including employee donations — private). These sponsorships are not included in allowable revenues.[[11]](#footnote-11)

### Political intervention

The concept of independent shareholders is that the running of the business should be left in the hands of the board and the management team. However, SOCs are routinely subject to directions — implicit or tacit — by governments. As the Energy Reform Implementation Group (ERIG 2007, p. 8) — appointed by the Council of Australian Governments to provide advice on energy sector reform — commented, ‘political factors’ appear to play a prominent role for government shareholders. In commenting on the apparently greater environmental performance of SOCs, the ASU cited the importance of political influence:

But the state government ones do do more I think because they’re required to, both in a sort of political sense, there’s pressure on the local backbenchers. (trans. p. 326)

Some recent examples of more explicit government directions include:

* a directive by the Queensland shareholding ministers that Energex not recover the 2011‑12 increases in revenue arising from the Australian Competition Tribunal’s determination on 19 May 2011, or of the costs of the 2010‑11 floods
* as noted above, directions by the New South Wales Government in relation to its procurement plan
* in 2009, the Tasmanian Government requested that Aurora Energy provide tariff relief for some customers (as discussed earlier).

These directives reduced the income flows of the businesses to their shareholders. No private shareholder would contemplate this unless there were compelling, well-articulated reasons why it would raise long‑term shareholder value.

Moreover, as noted earlier, governments can affect the capital spending of the businesses by changing reliability standards, or (as has happened in the past) by constraining expenditure through a government austerity or debt reduction program. Recently, these businesses have spent more than their forecast expenditure, while in the more distant past, some state-owned network companies appear to have spent less than is desirable. Cycles of underspending followed by reliability problems and then periods of overspending are not consistent with efficiently providing network services in the long‑term interests of consumers, and appear to reflect political, rather than economic considerations.

### Governance structures

Quite aside from the various constraints posed by regulations and ministerial directions, the governance arrangements of state-owned network businesses are sometimes flawed. In particular, not all state-owned network businesses are subject to the Corporations Act or merit-based board appointments.

The *Corporations Act 2001* (Cwlth) sets out the laws dealing with commercial business entities in Australia. It regulates such matters as the formation and operation of companies and appointment of company directors. However, not all state-owned businesses are subject to the Act (for example, Ausgrid).

Moreover, in New South Wales, the *Energy Services Corporations Act 1995* (NSW) provides that an ‘energy services corporation’ (which includes network businesses) is to have a board of directors that includes a Unions NSW nominee.[[12]](#footnote-12) The voting shareholders appoint the Unions NSW nominee on the recommendation of a selection committee comprising representatives of the portfolio minister and Unions NSW. Regardless of whether, in fact, the person selected is of high calibre, this process conflicts with open merit-based appointments, which are central aspect of the good governance of commercial enterprises (an observation also made by IPART 2010, p. 79).

Furthermore, industrial relations matters, such as outsourcing policy, are a central concern for management and the presence of a compulsorily appointed union-based director creates a perceived, if not actual conflict of interest. (The Commission understands that the New South Wales Government intends to remove the union appointment provisions from the Energy Services Corporations Act.)

## 7.4 The productivity and performance of state-owned network businesses

While analysis of relative efficiency is difficult, the empirical evidence suggests that as a group, the aggregate productivity outcomes of the state-owned network businesses are poorer that their private peers. While the main evidence is reported in chapter 6, it is useful to consider some more qualitative indicators.

### New South Wales

On the positive side, poor overall outcomes does not mean poor performance on all counts or for all businesses. For example, IPART (2010, p. 48) noted that TransGrid, the New South Wales state-owned transmission business, was in the ‘leader’ quadrant in the International Transmission Operations and Maintenance Study (ITOMS), with low cost and high service performance. IPART was more cautious in its judgments on the performance of the distribution businesses in New South Wales, reaching the conclusion that on some limited benchmarks, the operating costs of the New South Wales distribution businesses appear ‘comparable’ with their peers.

On the other hand, IPART saw considerable room for the improvement of all state-owned corporations in New South Wales, including the network businesses. The main focus for policy reform was the removal of some of the constraints on their performance resulting from their ownership, and in particular a need for more effective shareholder monitoring (IPART 2010, p. 13). IPART sought feedback from the businesses themselves, and while it is not clear to what extent these concerns applied to electricity network businesses, some pointed out that:

* some inefficient work practices were deeply entrenched (IPART 2010, p. 67)
* there were government constraints and interventions on hiring and firing (including a ‘no forced redundancies’ policy), and on out-sourcing and in-sourcing, and the conditions and types of employment offered. (The apparent processes for outsourcing for Ausgrid appear to be laborious — box 7.2).

When combined with the evidence in chapter 6, it seems likely that significant changes to governance or privatisation would lift the performance of the New South Wales businesses. However, to achieve this, it is important not to enshrine the current arrangements through long‑term commitments that constrain the ability of new owners to operate the businesses efficiently.

### Tasmania

In Tasmania, the most recent review considered that the state-owned businesses had underperformed, citing consistent overspending (Electricity Supply Industry Expert Panel 2012, p. 203):

The apparent willingness of the regulated businesses to regularly overspend regulatory allowances and the preparedness by Boards and the Shareholder Ministers to accept the financial consequences of this through poor financial performance and lower returns to the Budget has created an environment where there is an inconsistent and at times relatively weak focus on driving business performance.

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| Box 7.2 The Ausgrid Agreement: Outsourcing |
| 7.1 In circumstances where Ausgrid is examining outsourcing or contracting out of work activities:  7.1.1 It will advise the employees and their union(s) and provide them with at least 28 days’ notice to respond with suitable proposals about possible alternative arrangements to outsourcing or contracting out;  7.1.2 Prior to expressions of interest or tenders being called, where employee generated alternatives are received, such alternatives will be considered;  7.1.3 If it is subsequently determined that expressions of interest or tenders are to be invited, Ausgrid will provide the union(s) with a copy of the document which has been prepared.  7.1.4 Expressions of interest or tenders when advertised shall be timed so as to provide the employees with an opportunity to submit a conforming expression of interest or tender to do the work to an equivalent standard, timetable and price.  7.1.5 If an employee generated conforming expression of interest or tender is submitted, it shall be evaluated together with external submissions received.  7.2 Work will only be outsourced or contracted out when it can be demonstrated that either;  7.2.1 insufficient overall resources are available to meet the current Ausgrid overall work commitment and work timetable, or  7.2.2 the failure to complete the work in a reasonable time would jeopardise the safety of the public or impact adversely upon system performance, or  7.2.3 the use of outsourcing or contracting out the work is commercially the most advantageous option taking into account quality, safety, performance, cost and the overall strategic direction of Ausgrid.  7.3 When a decision is made by Ausgrid to outsource/contract out work not already outsourced or contracted out, or in a review of existing contracts, Ausgrid will only award a contract to a contractor that demonstrates it has established appropriate industrial relations policies and practices and that it complies with industry safety standards, environmental standards and quality standards.  7.4 In evaluation of conforming expressions of interest or tenders, any comparisons will be made on a basis discounting any overheads that would continue even if the work was outsourced or contracted out. Such overheads would typically include tendering costs, contact administration, contract supervision and the cost of any redundancies which may arise as a result of the decision to outsource or contract out.  7.5 In the event that it is determined to outsource or contract out work, affected employees will have access to the full range of options available under the Ausgrid policies which apply at the time, including training and/or retraining. |
| *Source*: Ausgrid (2010a). |
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### Queensland

In the case of Queensland, the Independent Review Panel on Network Costs (IRPNC 2012) used several benchmarking and other qualitative indicators of the efficiency of that state’s state-owned network businesses. It found evidence that:

* there was seemingly poor management of overhead costs
* capital expenditure (capex) per customer was higher for the two Queensland distribution businesses — Ergon Energy and Energex — than would be expected given customer density (p. 9). The best performers on this measure in Australia were the privately owned businesses
* operating expenditure (opex) per customer was higher than efficient levels for Ergon Energy (though not Energex), with private operators being again the best NEM-wide performers (p. 9). The panel also concluded that the corporate overhead and support costs suggested Queensland’s distribution businesses were ‘amongst the least efficient’ in comparison with their interstate peers (p. 10)
* Powerlink — the Queensland transmission network business — performed relatively well using the ITOMS database (described above) and had relatively low corporate costs compared with their Australian peers (p. 10‑11). On the other hand, the panel drew attention to information from the AER that showed that capex per line length was higher for Powerlink than most other transmission businesses and had trended up over time.

The Panel concluded that ‘ ... there is a compelling case for privatisation of DNSPs in Queensland that can unlock further cost savings to ultimately benefit consumers’ (p. 39).

### Victoria as a comparator

As noted in chapter 6 and apparent from some of the results above, Victorian network providers appear to have performed relatively well. Fearon and Moran (1999) noted that by any standards, privatisation in that state was an ‘immense success’ (p. 10).

* In terms of standards of service, regular reports by the Office of the Regulator-General have demonstrated that private entities have improved performance in terms of reliability of supply and meeting customer demands for connections and response to problems.
* All the distributors had considerably pruned and rationalised their workforce since privatisation. Numbers have been reduced from 6000 at the time of the creation of the five corporatized distributors to less than half of this. One central business district distributor now employed 40 per cent of the staff it employed at the time of its sale, prior to which numbers had already been reduced.[[13]](#footnote-13) Its rule of thumb had been that the employment saving yielded a 30 per cent cost saving with about 70 per cent of the jobs being essentially outsourced. Another Victorian business had outsourced much of its maintenance to an electrical contractor and made comparable savings.
* With regard to the sale process itself, investors paid $8.3 billion for the five distribution businesses with initial valuations of $3.8 billion.
* The Victorian Auditor General estimated the outcome in terms of savings to the State revenue at a net gain of $317 million for 1997‑98 after taking into consideration revenue foregone and debt savings. In addition, the reduction of State debt further enhanced State finances by contributing to an improved credit rating.

Though incomplete, the empirical evidence strongly suggests that SOCs have lower levels of efficiency than their privately-owned peers. In the Commission’s discussions with participants, several highlighted that the state-owned businesses tended to be more risk averse and had an historical engineering focus on building things — ‘if in doubt make it stout’, or as EnerNOC (sub. 7, p. 3) characterised it: ‘capex good, opex bad’. Some claimed that this attitude had persisted to a greater degree in the corporatised state-owned enterprises.

### What does the international literature suggest?

Only a few studies have examined the privatisation of network businesses alone — and these have consistently shown improvements in performance.[[14]](#footnote-14)

However, our preliminary reading of the remaining literature on privatisation is that it mostly does not control for other coincident events, which confuse estimates of the impacts of privatisation of network businesses with other changes. In many instances, privatisation was associated with broader liberalisation of the electricity sector, particularly changes in regulatory arrangements and vertical separation of generation and retailing from network provision (Pollitt 2012, in a wide-ranging meta study).

As an example, in the United Kingdom, Crouch (2006) concluded:

This system has worked well since privatisation. Costs have fallen signiﬁcantly, distribution charges to domestic customers have reduced by 50% in real terms and companies have broadly delivered the requirements that have been placed on them to the beneﬁt of consumers, including improvements in the quality and security of supply.

However, much of this gain would have reflected the joint implementation of CPI-x regulation and privatisation. Jamasb and Pollitt echo this conclusion, arguing that ‘when accompanied by effective regulation, privatisation has achieved efﬁciency improvements’ (2007a, p. 6164). This is certainly consistent with the empirical evidence for Australia.

## 7.5 The perceived risks of privatisation

#### Are network prices higher?

Some have claimed that privatisation may increase electricity prices. For example, the ETU (2012) noted that South Australia (which had privatised network businesses many years ago) had the highest prices for electricity. However, the relevant issue for privatisation of network businesses is not electricity prices — which are strongly influenced by generation and other non-network costs — but the network contribution to those costs. In 2010‑11, New South Wales and Queensland had significantly higher network costs than other states (chapter 2), which are likely to reflect genuine differences in the nature of their networks, but also lower levels of efficiency (chapter 6).

The story might be different were private networks to be unregulated (a point made in section 7.1). However, regardless of ownership, all network businesses in Australia are subject to the National Electricity Rules, which constrain the exercise of market power. Consequently, assertions that market power justifies government ownership (as argued by Toner in an accompanying paper to the submission made by the ASU to the Commission — appendix A, sub. DR57) are not compelling, and the evidence on prices substantiates this.

#### Do private networks have lower reliability?

The evidence suggests that privatisation does not adversely affect reliability (chapter 2). Measures of reliability (such as the system average interruption duration or SAIDI and the system average interruption frequency index or SAIFI) are not worse in Victoria or South Australia. Indeed, over the 10 year period from 2000‑01 to 2009‑10, Victoria and South Australia had the lowest SAIDI among the NEM regions, while South Australia had the lowest SAIFI (and Victoria the third lowest).

Moreover, the Commission has proposed a new framework for reliability that should ensure that all network businesses know the reliability standards they must meet and are incentivised to do no more or less than valued by the community (chapters 14 to 16). Currently, the mostly costly reliability standards apply in those states with SOCs.

#### Bushfire Risk

The Electrical Trade Union (2012) expressed concern about infrastructure neglect and fire risk, arguing that the Productivity Commission had overlooked this issue in its draft report:

“Saving a bit of money from neglecting maintenance starts to look like a pretty false economy when you actually weigh up the real risks,” Mr Hicks said. “Of course it’s not just major disasters like Black Saturday that you risk when you neglect power assets, any number of minor fires and shocks are also likely to occur. The key point is that the terrible cost of those bushfires is not being borne by the private operator, but by the Victorian taxpayer. Recent Australian history shows privatisation of electricity assets is far more of a win for private operators than for the public.

The ASU (sub. DR57, Attachment, p. 7) also claimed that there were large reductions in maintenance expenditures following privatisation, and said that the Victorian Bushfires Royal Commission (VBRC) found inadequate maintenance to be an important factor in the 2009 Victorian bushfires. SP AusNet strongly contested these claims (sub. DR 102, p. 2).

The Productivity Commission was unable to identify any specific finding by the Royal Commission that *neglect* of maintenance had caused the fires, though the Royal Commission did partly attribute the fires to failed electricity assets, and recommended improved inspection processes (VBRC 2010b, p. 148‑185).[[15]](#footnote-15) However, the relevant issue for this chapter is not any judgment about the alleged negligence of SP AusNet or any other electricity network business — the subject of a class action that commenced in March 2013 — but whether privatisation itself was a risk factor. On this score, a relevant indicator would be whether the incidence of fires increased after privatisation. The Royal Commission provided evidence that the incidence of network-related fires did not appear to have risen over time from periods when the network was state-owned (VBRC 2010b, p. 150). Moreover, state-owned businesses in other jurisdictions report numbers of fire ignitions by network assets of a similar magnitude. In 2010‑11, there were around 130 fire ignitions by network assets for the four New South Wales networks (which sometimes excluded fires that caused no public damage).[[16]](#footnote-16) In comparison, there were 119 fire ignitions by network assets in the five private Victorian networks, of which half appear to have only affected network assets (Energy Safe Victoria 2012, p. 27). Consideration by an expert group on bushfires concluded:

Based on the data gathered in the survey, Victoria’s rate of fire starts from rural electricity networks appears to be not unusual when compared with other jurisdictions. However, this measure (fire starts from electricity assets as a proportion of total fire starts) is not tracked in a nationally consistent way and not tracked at all in some jurisdictions. Victoria’s methods of measurement could be expected to result in higher figures than some other jurisdictions, e.g. where distributors count only those fires actually attended by fire services. (Nous Group 2010, p. 40)

Furthermore, non-Victorian networks have responded to the Victorian Bushfire Royal Commission by reforming their fire safety arrangements — suggestive that, regardless of ownership, all networks have perceived a heightened risk in this area (for example, Essential Energy 2011a, p. 59).

Finally, in its analysis of the causes of the 2009 Victorian bushfires, the Royal Commission concluded that inadequacies in regulation, not the ownership of the businesses, were a significant factor:

Victoria’s electricity assets are ageing, and the age of the assets contributed to three of the electricity-caused fires on 7 February 2009 — the Kilmore East, Coleraine and Horsham fires. Distribution businesses’ capacity to respond to an ageing network is, however, constrained by the electricity industry’s economic regulatory regime. (VBRC 2010a, p. 12)

To that extent, the concern is not with ownership per se, but with the design of incentive regulation and other regulations. All states and territories have safety regulations in place, regardless of the ownership of the networks, and Victoria has now (alone among jurisdictions) introduced an incentive scheme, the F‑Factor Scheme, that penalises networks for fires caused by network asset failures. The Victorian Department of Primary Industries (DPI 2013a) notes:

The f-factor (and the related reliability incentive schemes) has been introduced to balance the incentive for network monopoly businesses to reduce service levels and increase profitability, by rewarding (penalising) the electricity distribution businesses for improved (decreased) service in the area of fire mitigation … the incentive will operate by linking annual changes in an electricity distributor’s regulated revenue to the number of fires started by its electricity distribution assets each year.

Chapter 5 examines the nexus between state-based safety regulation and incentive regulations, while chapter 15 examines the F-Factor Scheme in the context of the broader reliability framework (and the extent to which it complements or complicates the NEM-wide Service Target Performance Incentive Scheme).

## 7.6 The bottom line on private ownership

The rationale for government ownership of network businesses no longer holds. State-owned status is ill-suited to the current incentive regulatory regime. State-owned network businesses appear to be less efficient than their private sector peers. This is not surprising given their multiple objectives, political intervention and the imposition of non-commercial restrictions.

Privatisation is not a radical move despite some of the political concerns (and was regarded favourably by most stakeholders — box 7.3). As it is accompanied by regulation, it does not allow the businesses to exploit their market power nor to lower reliability and safety. Indeed, notwithstanding the concerns expressed by some, most evidence points to the community being better off after privatisation — when it is properly managed.

There have been few problems in Victoria or South Australia, and indeed, on the whole they appear to give consumers better value. (Moreover, privatisation of generators and retailers also do not seem to have produced adverse outcomes.)

There are compelling grounds for privatisation of all electricity network businesses in the NEM. In saying this, the Commission is not criticising the managements of the existing state-owned network businesses. They have had to respond to the long‑running structures and incentives presented to them by their shareholders.

Recommendation 7.1

State and territory governments should privatise their government‑owned network businesses.

In the event that privatisation does not occur, jurisdictions should undertake reforms to the governance of their state-owned network businesses that create, as much as is possible, the same incentives that exist for private businesses. The degree of reform required would vary between jurisdictions, but reforms should aim to mitigate the deficiencies identified by the Commission above.

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| Box 7.3 Stakeholder views about privatisation and shareholder disciplines |
| … there is no rationale for state ownership of electricity network businesses given the sophisticated economic and technical regulatory regimes in the NEM. As noted in the draft report, state ownership also creates perverse interactions with incentive based economic regulation (EnergyAustralia, sub. DR82, p. 3).  … the national regulatory regime is moving towards greater use of incentives to drive improved performance. The Panel considers that Government owned entities are much less responsive to regulatory incentives due to less constrained access to capital and because the strict commercial charter that should apply under corporatisation is often compromised by the collateral social and economic objectives of Government. … The experience of private ownership and operation of NSPs in Victoria and South Australia is that this essential service can be safely, reliably and more cost effectively provided under the national regulatory regime that applies to all NSPs regardless of ownership (IRPNC 2012, p. 39).  If privatisation occurs, there will be a reduction in community service standards, a reduction in employment, skills and training, and a reduction in many service aspects to the community, plus there will be an added cost to the community (ASU, sub. DR57).  The Australian regulatory framework is an incentive based approach predicated on profit being a motivating factor. Whilst this is true for privately owned DNSPs, it is not solely the case for publicly owned DNSPs who face multiple competing objectives of which profit is only one. Acknowledging these conflicting objectives for publicly owned networks, the Businesses consider that the regulatory framework changes being promulgated in themselves will not deliver the efficiencies being sought. ... the Businesses consider there to be a need for a greater focus on structural reform rather than further regulatory reform. (CitiPower et al., sub. DR90, pp. 5‑6).  … we remain convinced that the commercial disciplines driven by the values of private owners ultimately result in lower costs for consumers. (GDF Suez Energy Australia, sub. DR68, p. 5).  The ENA has no comment to make on ownership of network businesses as this is a matter for the relevant shareholders (ENA, sub. DR71, p. 3 of attachment A).  I think issues of ownership is ultimately a decision for government. I think people can advise, but to the extent that government have no intention of privatising, that's their issue. I think the task is to make the best of whatever ownership arrangements the governments choose. So I think in principle, regulatory choices shouldn't be conditioned by changes in ownership. (Bruce Mountain for EUAA, trans. p. 96).  These recommendations [the PC’s draft recommendations for privatisation and better corporate governance] are strongly supported by the MEU. Governance arrangements applying to State owned businesses are particularly important, especially in the light of the AEMC’s [Australian Energy Market Commission] inadequate final position in relation to the prescribed treatment of the financing costs of the State-owned networks by the AER in pricing reviews. (Major Energy Users, sub. DR66, p. 7). |
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Other stakeholders also identified the importance of good governance arrangements for state-owned network businesses. For example, in responding to the Productivity Commission’s draft recommendation for improved governance arrangements for state-owned network businesses, the Australian Energy Market Commission considered that:

… effective corporate governance by shareholders of network service providers is a very important component of delivering good outcomes for consumers. The rules and application of the rules are only part of delivering an effective outcome for consumers. (AEMC, sub. DR89, p. 18, in response to draft recommendation 7.2).

The Queensland review panel went further. It strongly favoured consideration of privatisation, but in the event of continued government ownership, it proposed the establishment of a holding company that brought together the two Queensland distribution businesses under a single CEO, senior management group and board (IRPNC 2012, p. 26). It considered two other alternatives: reform of the businesses as separate entities and a legal merger. The first it saw as ineffective because of concerns that the ‘prevailing culture’ of the businesses would stymie the capacity to achieve the identified efficiency savings. It saw the second as involving relatively high level of implementation complexity and costs.

The Commission does not have a view about the particular solution suggested by the panel, which has had the opportunity for detailed consultation on governance with the businesses concerned. Instead, the Commission has focused on the principles for a better governance model.

Recommendation 7.2

If state and territory governments do not implement recommendation 7.1, then they should promote more efficient outcomes for their government‑owned network businesses by ensuring that:

* directors are appointed on merit, following a transparent selection process
* ministerial directions are publicly disclosed at the time they are made and are also disclosed in the annual report
* directors and officers are subject to the obligations under the Corporations Act
* governments review objectives currently given to network businesses and:

remove those that would be more appropriately allocated to other agencies

remove those that are non–commercial and make it clear that the board is expected to deliver a dividend payout and rate of return on the equity invested in the network business that would be considered acceptable by a commercial investor

where conflicting objectives remain, provide publicly transparent guidance on how to prioritise them.

## 7.7 The transition to privatisation

Privatisation involves a range of complex activities that require careful management and leadership. Indeed an essential precursor before initiating a formal privatisation process is one of governments communicating effectively with the community and with other key stakeholders about the fundamental drivers and justifications for privatisation. The privatisation process itself involves the preparation of necessary legislation, identifying policy and regulatory issues that require attention, obtaining expert advice on the sale of the businesses, further restructuring of businesses in preparation for sale, valuing the businesses, managing and selecting among bidders, negotiating contractual agreements, and continuing to effectively engage with stakeholders and the wider community.

The privatisation experiences of the Victorian and South Australian government provide some guidance about possible pathways.

In Victoria, an Electricity Supply Industry Reform Unit was established in mid-October 1993 within the Department of Treasury and Finance to advise the State Government on the reform of Victoria’s electricity industry, in particular the State Electricity Commission of Victoria. (In May 1996, responsibility for electricity industry reform, along with gas and aluminium industry reform, was moved to an integrated Energy Projects Division within the Department.) The Reform Unit engaged legal, accounting, financial and electricity industry advisers. The Reform Unit’s first tasks were to:

* undertake a rigorous analysis of the Victorian industry
* examine electricity supply industry reform worldwide
* examine national industry reform considerations
* develop appropriate recommendations.

The sale process took around two years for the state-owned distribution businesses and four years for transmission businesses — but in the context of a much broader privatisation agenda, which could have constrained the speed of achieving sales of the assets.

The South Australian Government followed a roughly similar course. It announced its decision to privatise its electricity assets in February 1998, a process it completed in 2000‑01. To achieve this, the Government established an Electricity Reform and Sales Unit within the Department of Treasury and Finance. The Government provided very clear guidance about the timing of privatisation and the desirable process. It indicated that the reforms, to be completed over a two-year period, would consist of three stages:

* a three month preparatory period for information gathering and for a detailed study of proposed market reforms and business structures
* a period of implementation of the reforms and for restructuring ETSA Corporation and Optima Energy over three to nine months
* the sale of the businesses over approximately a one year period.

Unlike Victoria, the electricity networks were not sold in perpetuity, but rather through long‑term leases (of 200 years). Some have suggested that such long‑term leases may be more popularly acceptable, but from an economic perspective, the long length of the lease makes them effectively equivalent to the full sale of the assets.

The privatisation processes used in Australia drew on some of the experiences in the United Kingdom. In particular, the UK Government failed to anticipate the magnitude of the cost and efficiency gains, which resulted in windfall gains to the privatised businesses. Given this, the Victorian Government lifted the performance of the businesses before privatisation to maximise the public benefit from the sales.

### Some principles

Given the Australian and United Kingdom experiences, the best practice guidelines developed by the OECD (2009, 2010), and first principles, a successful pathway to privatisation should include several features.

#### Adopt a cost–benefit approach

When privatising their electricity network businesses, governments should be guided by the principle of maximizing the net benefit to the community. Within this objective, governments may have multiple goals for privatisation, such as obtaining productivity improvements for the businesses, lowering consumer prices, and increasing government revenues from the proceeds of sales that could be used to retire government debt or to spend on other activities of benefit to the community. Governments should identify and prioritise such goals, as these will further guide decisions on particular elements of the privatisation process (such as when to start the process, and the choice of sales method).

#### Clarify the regulatory environment before sale

Asset sales should take place in a regulatory environment that is well understood. Any significant regulatory uncertainty can affect a purchasers’ view of the value of the business and thus affect potential sale proceeds. Accordingly, reforms that are likely to significantly affect the value of the businesses should proceed apace. In particular, decisions about the reliability and planning framework — chapters 14 to 17 — should not be delayed or perpetuate the parochialism of the current arrangements.

#### Establish a responsible entity for managing privatisation

The Victorian and South Australian experiences indicate that creating a dedicated unit in government to oversight privatisation facilitates an orderly and coherent process. Given that, governments should establish a unit in a central agency to manage privatisation, with an appropriate governance structure, expertise, terms of reference and timetable for achieving specific milestones. Given their greater comparative advantage in this area, state treasuries are likely to be the most appropriate.

#### Consult appropriately

While privatisation is not a radical option, it nevertheless can be popularly controversial, and would typically lead to some reduction in employment in the relevant businesses. Accordingly, a best practice feature of a privatisation process is that governments consult with all affect parties to outline the rationale for privatisation and explain the consequence of privatisation for them (Auditor-General of Victoria 1995, p. 27). Consultation should include consumers — which are likely to be the main long‑run beneficiaries. A related issue is public confidence in the process. There are strong grounds for all aspects of the privatisation process to be subject to independent monitoring and review by the state auditor-general.

#### Expert advice is needed to determine the best form of sale

Based on expert advice at the time, none of the sales of network assets in Victoria or South Australia was achieved through public flotation. Trade sales and long‑term leases appear to be less costly methods of privatisation compared with initial public offerings. Trade sales are more likely to offer higher sales proceeds than long‑term leases (because the latter does not involve ownership control). Long-term leases may be more acceptable to a community that has a strong preference for ongoing public ownership of network businesses. However, in principle, there is no inherent advantage to any of these sale processes, and the form of sale should be addressed as part of any process for privatisation of the existing SOCs.

Recommendation 7.3

In giving effect to recommendation 7.1, governments should:

* be guided by the overarching objective of maximizing the net benefit to the community, with clear identification and prioritisation of any subsidiary goals
* undertake key regulatory reforms prior to sale
* avoid the transfer to the new owner of unjustified liabilities, obligations or restrictions that may inhibit the future efficiency of the business
* establish an expert unit within the relevant treasury to oversee the process, and develop clear milestones and a timetable
* undertake genuine consultation with the public and key affected groups, including likely beneficiaries, accompanied by effective communication of the benefits of privatisation
* ensure adequate accountability through independent auditing of the privatisation process.

1. Some may propose broader arguments for government ownership — such as social norms about what the community should own collectively and what should be held in private hands. However, beyond assertion, it would be difficult to verify when those circumstances arise. Regardless, for the present purposes, it would be hard to argue that government ownership of wires and poles meets an Australian social norm. [↑](#footnote-ref-1)
2. While in some instances, government ownership has served as an alternative to a regulated private monopoly, in many others, entry by state-owned businesses was apparently intended to ensure adequate investment and to intensify competition in what remained largely private markets. This was an important driver of government ownership in the first half of the 20th century (Goot 2010). [↑](#footnote-ref-2)
3. These include Sims (2012b); Biggar (2011b, pp. 14ff); the Energy Users Association of Australia (EUAA 2009, p. 1); Mountain and Littlechild (2010), Mountain (2011); the NSW Commission of Audit (2012, p. 204); and an IPART paper by Cox and Seery (2010, p. 22), Energy Australia (sub. DR82, p. 3) and the independent review panel examining the source of network cost pressures in Queensland (IRPNC 2012, p. 39) [↑](#footnote-ref-3)
4. In Australia, the tensions are even more complex. The AER acts as the regulator of network prices, while state-based regulators still regulate retail prices (though this is hopefully due to change). State-based regulators may bring (government-mandated) non-commercial considerations to their determinations of retail prices (for example, QCA 2012), while the AER is purely an economic regulator. [↑](#footnote-ref-4)
5. These multiple objectives are repeated in the *Energy Services Corporation Act 1995* (NSW). [↑](#footnote-ref-5)
6. S. 7 of the *Territory-owned Corporations Act 1990* (ACT). [↑](#footnote-ref-6)
7. S. 16 (a) Principle 1 of the *Government Owned Corporations Act 1993* (Qld). [↑](#footnote-ref-7)
8. s. 7(1)(i) of the *Government Businesses Enterprises Act 1995* (Tas). [↑](#footnote-ref-8)
9. These data relate to electricity, gas and water utilities as a whole, but it would be surprising if it did not hold at the disaggregated level. Other evidence also suggests that overall labour returns are higher (such as the significant overtime levels apparent in the state-owned enterprises, as discussed later) and the higher apparent opex for given customer density for SOCs (chapter 6). The New South Wales economic development agency, Industry and Investment (2010, p. 29) noted that New South Wales network businesses’ wages increased faster than the New South Wales average from 2004–05 to 2009–10. On the other hand, the Electrical Trade Union (ETU 2012) contested claims of differences between wages, saying that that wages and conditions were much the same between the states (despite the private ownership of networks in Victoria and South Australia). However, they did not provide evidence on this matter. [↑](#footnote-ref-9)
10. Of the stock of people in this category, the majority were apprentices and trainees — some 112 in July 2011 (SP Ausnet 2011b). [↑](#footnote-ref-10)
11. Based on various annual reports and plans issued by the businesses (SP AusNet 2011a; CitiPower and Powercor 2011; Ausgrid 2011a; Jemena 2011; Endeavour Energy 2011a). [↑](#footnote-ref-11)
12. New South Wales is an exception, with Queensland and Tasmania requiring merit-based appointments. [↑](#footnote-ref-12)
13. Accordingly, privatisation has been a continuation of the process of shedding labour and increasing efficiency that commenced with corporatisation (a point also made by Marsden 1998). [↑](#footnote-ref-13)
14. Anaya (2010); Bradbury and Hooks (2008); Söderberg (2011); and as summarised by Pollitt (2012) — Domah and Pollitt (2001); Galal et al. (1994); Mota (2003); and Toba (2002). [↑](#footnote-ref-14)
15. SP AusNet has separately contested the Royal Commission’s conclusion about the role of inspections as a factor in the fires (2013a, pp. 2‑3) [↑](#footnote-ref-15)
16. Based on data from Transgrid (2011, p. 17), Endeavour Energy (2011a, p. 44), Essential Energy (2011b, p. 42) and Ausgrid (2011d, p. 38). [↑](#footnote-ref-16)