Attachment C

AUSTRALIA'S PUBLIC INFRASTRUCTURE

Update Paper
Balance Sheet Impacts of Sell To Build

INFRASTRUCTURE AUSTRALIA
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Australian Government
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UPDATE PAPER – BALANCE SHEET IMPACTS OF SELL TO BUILD

BACKGROUND

Australia has a growing infrastructure deficit. Much of the deficit is the responsibility of State Governments, who have only limited capacity to fund new infrastructure, given existing and likely future budgetary constraints.

Infrastructure Australia prepared a paper in October 2012 "Australia's Public Infrastructure – Part of the Answer to Removing the Infrastructure Deficit". The paper advocated that Australian Governments should look to transfer publicly owned infrastructure to the private sector and use the net proceeds to build the new infrastructure. Infrastructure Australia's analysis conservatively estimated that the equity value of commercial infrastructure assets held by Australian governments is over $100 billion, and many of these assets could be transferred to the private sector relatively quickly.

As outlined in the previous paper, transferring existing infrastructure to the private sector would also likely achieve significant broader economic productivity benefits from introducing private sector discipline, improving the ability to finance the expansion of infrastructure as required, improved governance - where the government is no longer both the regulator and the owner, and greater transparency in the costs of community service obligations.

There are a number of successful case studies of state Government's transferring assets to the private sector and utilising the proceeds to invest in new infrastructure. For example the Tasmanian Government's sale of Hobart Airport allowed new investments in hospitals, transport hubs and agriculture water storage and irrigation. The recent lease of Port Botany and Port Kembla contributed significantly to the funding of infrastructure in New South Wales with $4.3 billion net proceeds from the lease transferred to Restart NSW.

Balance Sheet Impacts

The main benefits to the Government balance sheet from asset transfers includes:

- the financial gain to government where the proceeds from asset transfers exceeds the net present value of future dividends that the assets would have otherwise produced; and
- removing government financial obligations and risks associated with the future capital expenditure requirements which in many cases, given the nature of the assets, can be quite significant. For example, at the time of the sale of Queensland Rail's freight operations, the Queensland Government stated that the transfer would free the government from having to contribute an estimated $7 billion in future capital expenditure on QR National infrastructure.

Some opponents of the transfer of infrastructure assets to the private sector argue that in cases where the dividends are significant, a transfer of infrastructure to the private sector may not result in any substantial improvement in the Government's capacity to invest in new infrastructure assets.

Infrastructure Australia's paper noted this issue, observing that the benefits of sale to build accrued where the transfer to the private sector is above the retention value. The retention value should represent the net present value of dividend income to the public sector. However the paper did not investigate how much the impact of ongoing public sector dividends reduces the benefits to public sector balance sheets from the transfer of assets to the private sector. This paper investigates this issue in further detail.[1]

Further Balance Sheet Analysis

To consider this issue further, Infrastructure Australia has examined 30 publicly owned infrastructure assets in Australia. All 30 were included in the list compiled in Infrastructure Australia's original October 2012 report as suitable for transfer to the private sector. The assets were chosen to represent a cross section of commercial infrastructure assets in different asset classes and states and are listed in table 1.

[1] While this paper focusses on proceeds from asset transfers, it is important to be cognisant of the need to maximise the broader national economic benefits of any asset transfer process. Governments should continue to ensure that these broader economic benefits are not compromised during the asset transfer process by trading off the correct competition and regulatory settings against increased asset transfer proceeds.

Table 1: Publicly Owned Infrastructure Assets, Separated by Sector

Sector	Assets
Ports	Five port assets in three states: Port of Melbourne in Victoria Ports of Fremantle and Port Hedland in Western Australia Ports of Townsville and Gladstone in Queensland
Electricity Generators	Five electricity generation assets in four states: Snowy Hydro, a hydro asset owned by NSW, Vic and Federal Governments CS Energy and Stanwell Energy in Queensland Verve Energy in Western Australia Hydro Tasmania in Tasmania
Electricity Transmission and Distribution	Eight electricity transmission and distribution assets in four states: Energex and Ergon in Queensland Transgrid, Ausgrid, Endeavour and Essential in NSW Western Power in WA Transend in Tasmania
Water	Ten water assets in five states: Sydney Water in NSW Melbourne, South East, City West and Yarra Valley Water in Victoria Ben Lomond, Cradle Mountain and Southern Water in Tasmania WA Water in Western Australia SA Water in South Australia
Other	Two other assets: Forestry Corporation in NSW Australian Rail Track Corporation owned by the Federal Government

As a comparator, Infrastructure Australia also examined seven privately owned infrastructure companies listed on the Australian stock exchange in Australia.[2] These companies covered a range of infrastructure assets including airports, ports, electricity and gas utilities and tollroad operators.

[2] Financial information is not as readily available for privately held infrastructure assets.

Table 2 shows the assets selected:

Table 2: Private Sector Comparators

APA Group	A gas transmission company with a market capitalisation of approximately A$5 billion.
Spark Infrastructure	Owner of regulated energy assets with a market capitalisation of approximately A$2.2 billion.
DUET Group	Owner of regulated energy assets with a market capitalisation of approximately A$2.6 billion.
SP Ausnet	Owner of regulated energy assets with a market capitalisation of approximately A$4 billion.
Envestra	Transmits and distributes gas with a market capitalisation of approximately A$2 billion. Envestra has recently rejected a takeover offer from APA Group.
Sydney Airport	Owner and operator of Sydney Airport with a market capitalisation of approximately A$8.8 billion.
Transurban	Owner of a portfolio of tollroad assets in Australia and North America with a market capitalisation of over A$10 billion.

The aim was to identify whether a number of the most commercial, publicly owned infrastructure assets generate dividends of a similar scale to infrastructure assets in the private sector. Where dividends of public sector assets are lower, there is likely to be a benefit to public sector balance sheets by transferring assets to the private sector, even after the consideration of public sector dividends.

Private Sector Comparators

Infrastructure assets usually require high levels of capital expenditure to construct, but once built usually generate strong returns. Prices are often regulated and revenues relatively certain, with the high capital expenditure often creating barriers to new entrants. Operating expenses are relatively low and margins can be significant. This means privately owned infrastructure assets usually generate high dividend yields once constructed.

Infrastructure companies, once construction has completed, often also have only limited growth prospects. This is another reason why such stocks need to be priced to generate healthy dividend yields to attract investors.

Dividends for infrastructure companies are also often relatively stable. Revenues are relatively certain, operating risks are low and markets are relatively stable. Such companies can usually manage any demands for capital expenditure over the medium term through their capital structure to ensure a stable dividend stream.

Given these high and stable returns, infrastructure assets can usually be structured with significant levels of debt relative to equity. This can lower the overall cost of capital of the asset and substantially increase its enterprise value.

The high proceeds received by the public sector for infrastructure assets are a direct function of the ability to generate such high and stable levels of dividends which support high levels of gearing and a low overall cost of capital.

It should be noted that in this paper we are using listed infrastructure companies as our private sector comparators, given there is more publicly available information for such companies. However, the levels of gearing for unlisted infrastructure assets are likely to be even higher than listed companies, given the backing of their owners will generally provide more flexibility and easier access in raising additional capital if required than in the listed market. This is one reason why most mature infrastructure assets are transferred to the private sector through trade sales to superannuation and other institutional funds rather than listed on the stock market.

The tables below summarises the key results. The dividend yield is the dividend as a percentage of the market value of shares and shows the dividend return to investors. The interest cover ratio is the earnings before interest, tax, depreciation and amortisation divided by interest expense and a higher number shows core earnings well cover interest payments. Capex % OCF is the proportion of operating cashflow that is reinvested in capital expenditure and a high number shows significant capital expenditure.

Table 3: Australian Comparators Key Results

	Dividend Yield	**Interest Cover Ratio**	**Capex % OCF**
APA Group	4.2%	2.2x	74%
Spark Infrastructure	6.5%	2.8x	108%
DUET Group	7.1%	1.5x	50%
SP Ausnet	5.6%	2.7x	148%
Envestra	4.3%	1.9x	103%
Sydney Airport	5.8%	1.9x	24%
Transurban	3.5%	2.2x	81%
AVERAGE	5.3%	2.2x	84%
MEDIAN	5.6%	2.2x	82%

The key conclusions from the analysis are shown in table 4 below:

Table 4: Key Conclusions for Comparators

Conclusion	Commentary
Dividend Yields are High	The dividend yield, which measures the ratio of annual dividend returns to the market value of equity invested in the company, is relatively high for the Australian listed infrastructure. The average for the Australian infrastructure companies is 5.3%, compared with an average of 4.5% for the largest 200 Australian listed stocks and 4.4% for the All Ordinaries index which comprises the largest 500 stocks.[3] This is in line with the view that once constructed, infrastructure assets have relatively low operating costs and strong margins. They often have limited growth prospects and therefore need to offer a healthy dividend return.
Dividends are Stable	The dividend yields for the seven Australian infrastructure companies show relatively low variation across asset classes and over time. Dividend yields for these companies over the five years of data show a standard deviation of only 1.3%.[4] Listed infrastructure companies have as a primary objective generating stable dividend streams which grow over time.
Gearing is relatively High	Gearing of Australian listed infrastructure companies is relatively high – earnings before interest tax and depreciation and amortisation is on average 2.2 times higher than net interest costs (this is known as the "interest cover ratio" and suggests earnings on average cover just over twice the net interest payments). In comparison, Telstra in 2012 had an interest cover ratio of over 7 times, Wesfarmers over 9 times and BHP was over 30 times.[5] The stable and healthy cashflows allow companies to gear the assets to this level, and this assists in maximising dividend returns to shareholders and share prices.
Capex is High	Capital expenditure remains substantial for these infrastructure assets, many of which are managing significant expansion programs. It accounts for on average around 84% of operating cashflows from the seven Australian listed infrastructure assets.

In conclusion, Australian listed infrastructure stocks demonstrate high dividend yields averaging over 5%, which are very stable over time. This supports high levels of gearing, despite relatively significant ongoing capital expenditure programs.

[3] Source: Bloomberg 30 September 2013

[4] Source: Bloomberg, 30 September 2013

[5] Source: Comsec 30 September 2013

Publicly Owned Infrastructure Dividends

As detailed earlier, Infrastructure Australia has also examined 30 publicly owned infrastructure assets.

The assets were chosen across a range of different asset classes and states. They include assets such as electricity generators which operate in relatively competitive markets and which have higher operating risks and others such as regulated, electricity distribution assets with relatively stable operating environments and which should generate strong and stable dividend returns. The assets were valued at approximately $92 billion if transferred to the private sector based on the approach used in Infrastructure Australia's October 2012 paper. This involved a multiple of regulated asset bases for regulated assets and a multiple of earnings for non-regulated assets. These equity values, updated for 2012 results where appropriate, have been utilised in the table below for the calculation of dividend yields. Recent sales have shown these valuations to be relatively conservative – higher asset values would produce lower dividend yields in the table below.

As for the listed comparators, we have examined five years of dividend payments to ensure our data is not biased by any one year result. We have shown the results by sector rather than by asset given the significant volatility in dividends across assets and years in the public sector.

Table 5: Public Sector Infrastructure Key Results – Average for Assets in the Sector

	Dividend Yield	Interest Cover	Capex % OCF
Ports	2.8%	4.4x[1]	82%
Electricity Generation	2.5%	6.7x	213%
Electricity Transmission and Dist	5.3%	3.2x	155%
Water	4.0%	3.8x	174%
Forestry	2.7%	N/A[2]	22%
Rail	0%	15.5x	380%
AVERAGE for all 30 assets	3.7%	4.7x	162%
MEDIAN for all 30 assets	3.4%	3.3x	139%

1. Excludes Port of Townville which is in a net cash position.
2. Forestry Corporation has negative EBITDA

Table 6: Key Conclusions for Publicly Owned Infrastructure Companies

Conclusion	Commentary
Dividend Yields are lower	Dividend yields are on average less than half the level for the Australian private sector comparators, averaging only 2.3% of the equity values, which have been conservatively estimated. Higher asset values would lower these dividend yield estimates further. Dividend yields were highest for regulated electricity transmission and distribution and lowest for port assets and for freight rail sector. Five assets which were valued on transfer to the private sector at over $5 billion were found to have produced no material dividends over the five years analysed. This suggests returns to the public sector from ownership of infrastructure assets are on average significantly lower than those in the private sector
Dividends are more volatile	Dividend payments are also significantly more volatile in the public sector than the private sector. Whereas dividends for listed infrastructure companies rarely change significantly, many of the publicly owned companies have quite an erratic dividend history. Nine of the publicly owned companies, or almost a third of the total, recorded years of no dividend return over the five year sample. [6] The regulated assets and the larger diversified companies on average provided more stable dividend payments than assets in more volatile industries and with smaller operations. Despite the average yield being only half the size of private sector comparators, the standard deviation at 1.8% is significantly higher than the Australian listed comparators.
Gearing is relatively low	The gearing of public sector assets is substantially lower than the Australian private sector comparators.[7] Interest cover for public sector assets average 4.7 times net interest. This is substantially higher than the Australian private sector benchmark assets who have average earnings cover of just over twice net interest costs. While the gearing is higher for the regulated transmission and distribution assets, all of the Australian private sector assets have more geared interest cover ratios than the average for this sector. Some of the public sector assets analysed have very modest gearing. The lower gearing may be due in part to public sector conservatism, a lack of any ability to raise additional capital from their shareholder when required and the lower and more erratic earnings profile.

[6] Port of Townsville, Port Hedland Port Authority, Western Power, Hydro Tasmania, CS Energy, Snowy Hydro, Verve Energy
Cradle Mountain Water, ARTC

[7] A recent newspaper report referred to a private sector study argued that gearing is higher for public sector infrastructure than private sector infrastructure. The study compared gearing measures of a listed company (DUET) and a similar publicly owned business (Ausgrid). It measured debt compared to the balance sheet measure of equity for the public sector entity, and market capitalisation of the private sector entity. However book value of equity can vary due to a range of reasons and we prefer cashflow measures. DUET's interest cover ratio is currently 1.5x and Ausgrid's is 2.4x which supports our view that private sector entities are more geared on average.

Conclusion	Commentary
Capex is High	The analysis shows public sector companies in our sample on average spend approximately 160% of their operating cashflow on capital expenditure. This is double the average for the Australian private sector comparators. This could be due to these companies generating lower operating cashflows and/or spending more on average on capital expenditure. The capex spend was lowest in port and some energy generation assets, and highest in the energy and water distribution businesses. However it should be noted that many of the private sector comparators are also energy distribution businesses.

In conclusion, while Government's do receive dividends from some, but not all, of their infrastructure assets, these returns are on average less than half those in the private sector. The dividends are also more erratic and less reliable. And a number of the assets provide no dividends. Gearing – a key driver of value in the private sector – is also substantially lower for public sector assets. Finally, substantially more of the cashflow generated is reinvested in capital expenditure rather than returned to shareholders in public sector assets.

This suggests that dividend returns from publicly owned infrastructure are unlikely to generate sufficient value to public sector balance sheets to compensate for likely proceeds from a transfer to the private sector. Governments are likely to have more capacity to on their balance sheets to fund new infrastructure if such transfers occur, even after accounting for public sector dividends. The next section investigates this in more detail.

Publicly Owned Infrastructure Retention Values

Infrastructure Australia has also assessed the value to the public sector balance sheet for each of the 30 public sector assets, based on the current level of dividends being received. We can then compare this to likely proceeds on transfer to the private sector to observe whether there could be a net benefit to the public sector balance sheet by retaining these assets.

The value to the public sector balance sheet has been assessed by projecting future dividends based on the historic dividends from the last five years. These projected dividends have then been discounted back to their present value in line with equity returns required by private sector equity investors in infrastructure to appropriately reflect the risk to government of holding these assets. This should produce a net present value which should represent the equity value in retention of the asset to the public sector.

We are aware that many State Governments use an alternative method of calculating the equity retention value. They calculate free cashflows from an asset, discount these at a WACC representing debt and equity return requirements to calculate the enterprise value. Then they subtract the net debt of the entity to determine the equity retention value.

For example, the Special Commission of Inquiry into the Electricity Transactions in NSW detailed that this method was used by the Retention Value Working Group on the NSW electricity sales.[8]

This approach has the same theoretical groundings as our method. However, Infrastructure Australia has adopted the dividend discount model because while publicly owned assets may generate profits and cashflows, a number may never return dividends to their shareholders to support public sector balance sheets. Infrastructure Australia has identified assets that have generated significant cashflows across our sample period but have not returned any dividends. This may be due to non-commercial investment incentives for any residual free cashflow. Therefore we have utilised a measure of retention value to the public sector that focuses on measuring actual dividends returned to public sector budgets.

Infrastructure Australia has used the most recent dividend for the project where it is in line with recent trends, or taken an average of recent dividends where they have moved erratically. We have grown this dividend at 2.5% per year in most cases (6% for the first three years for faster growing port assets) and discounted it back at the cost of equity to obtain the equity retention value.

The dividends have been discounted at an assumed required return on equity of 12%. There are a range of views on the appropriate required return on equity. Some CAPM based calculations generate a required rate of return on equity below 10%, however our understanding of recent bid processes is that bidders are likely only to bid at this level where they identify significant upside or synergies and our analysis does not assume significant upside or aggressive prices for transfer to the private sector. The retention value approach used in this paper is on a business as usual approach reflecting the current financial value to government. A recent analysis of independent experts reports, used to assess transactions for listed Australian companies, found that in the period 2008-2013 the average cost of equity used was 14.4%.[9] While there is unlikely to be a definitive required return on equity estimate, and returns are likely to vary across assets and investors, we believe 12% reflects a conservative hurdle rate for an equity investor in the Australian market.

[8] Final Report, October 31 2011, Appendix 11, pp 297-300.
[9] Evidence on the required return on equity from independent experts reports, SFG Consulting, 24 June 2013, p18

Some may argue a risk free rate or bond rate might be a more appropriate discount rate. However such a discount rate does not reflect the substantial additional risk these government infrastructure businesses bring to public balance sheets. The discount rate needs to reflect such risks.[10]

The table below shows the equity proceeds estimated using the method in our October 2012 report for transfer to the private sector against the present value of dividends estimate of retention value.

Table 7: Difference between Proceeds on Transfer and Retention Value

A$m	Transfer Proceeds (Equity Value)	Dividend Retention Equity Valuation	Difference	Difference as % of Transfer
Ports	**6,704**	**1,015**	**5,689**	**85%**
Electricity Generation	**13,426**	**5,064**	**8,362**	**62%**
Electricity Transmission and Distribution	**31,880**	**10,015**	**21,865**	**69%**
Water	**37,544**	**12,082**	**25,462**	**68%**
Other (Forestry and Freight Rail)	**2,403**	**155**	**2,248**	**94%**
Total	**92bn**	**28bn**	**64bn**	**69%**

Our conclusion from this analysis is the total net present value calculated from the dividend stream for these 30 public sector assets is $28 billion. This is under a third of the value of the conservative estimation of the likely proceeds these assets would generate on transfer to the private sector, which totals $92 billion. The transfer of assets would therefore result in a significant improvement to government balance sheet which would enable them to fund new economic infrastructure.

It is important to reiterate that the valuations on transfer are conservative and recent sale processes have generated significantly higher transaction multiples. The multiples have been applied to current "business as usual" earnings results, and make no adjustment for any upside as the business is prepared for sale or achieved post sale. Therefore it is possible the retention value gap identified here is significantly underestimated.

[10] The following quote from a Standard and Poor's submission to the Senate Standing Committee on Finance and Public Administration reflects the level of additional risk being undertaken by a state government by retaining infrastructure companies: "From a credit perspective, there is always a trade-off between the diversity of revenue and business risk associated with ownership of government businesses, such as electricity businesses. This is because although investment in trading enterprises increases revenue flow for governments, this revenue is subject to more risk than taxes, fees and charges – particularly when the revenue is generated by businesses operating in competitive markets such as electricity generation... trading enterprise ownership does require offsetting strengths to achieve the 'AAA' rating. Just as South Australia's weaker economy relative to peers requires a stronger balance sheet relative to peers to achieve an 'AAA' rating, those states with large ownership of higher risk trading enterprises require a stronger balance sheet than peers to mitigate the extra risk. The flip side of the same coin is that states without ownership of higher risk trading enterprises can hold higher levels of debt to fund other spending – such as roads and hospitals – than states that do own trading enterprises and still maintain similar credit quality" Submission March 19 2008.

The results for each asset vary and given the volatility of dividends and our high level earnings multiple valuations we believe it is better to focus at sector and overall estimates of the retention value gap. The analysis shows that the largest differences as a percentage of asset value between the potential proceeds on transfer and the value of retention is in the port sector, where dividends are relatively low. Smaller percentage differences occur in the electricity transmission and distribution and some businesses in the water sector. However, given the size of these assets the amount that can be recycled into new infrastructure from these transfers are very significant in dollar terms.

Interest Spreads and Tax Equivalent Payments

A recent newspaper report[11] argued that state governments will resist transferring infrastructure assets to the private sector because, as well as obtaining dividends; they generate interest rate margins on loans and receive tax equivalent payments from infrastructure assets. These two issues are discussed in this section.

The report argued that states are enjoying a "debt arbitrage" from borrowing money at low interest rates by value of their higher credit rating (in some cases AAA) and lending to public sector infrastructure assets at higher rates to reflect their lower credit ratings and earning a margin on the difference in interest rates.

However this argument ignores the additional risk that the state government is bearing from owning and operating such entities. The spread is not an additional dividend; it is a payment for bearing significant additional risk. The spreads are usually benchmarked to market rates these entities would face if they were borrowing in the private sector. Therefore we do not believe the spread should be included in any measure of equity returns to the state for owning an asset.

The report also comments that states are earning tax equivalent payments from their energy utilities in public ownership. Our retention values have been estimated using only dividends in the analysis and not other transfers between the infrastructure entity and the state Government including subsidies, community service obligations or tax equivalent payments.

Tax free status is given to all assets owned by the state, and is not specific to any particular asset. If a state Government transfers an infrastructure asset to the private sector and uses the proceeds to invest in a new asset generating income, this income would be tax free and the state could levy tax equivalent payments on it. Infrastructure Australia advocates sell to build for the proceeds of any transfer to the private sector, which provides a new opportunity for states to generate tax equivalent payments. We do not believe state Governments lose the right to such payments on transfer of an asset and therefore do not believe they should be included in retention values.

[11] "Kennett's power play not right this time" Sydney Morning Herald September 23 2013

There has been recent press speculation that the Federal Government may allow state governments to keep tax equivalent payments on infrastructure transferred to the private sector, if it uses these funds to invest in new infrastructure.[12] While we do not believe that the states need to be compensated for tax equivalent payments, any such incentives would provide a funding source to address the infrastructure deficit.

Infrastructure Australia is aware that state Governments do include tax equivalent payments in their calculation of retention values. Therefore we have run our estimations again, including tax equivalent payments. The net present value of the 30 public sector assets including their tax equivalent payments increases under this analysis to $54 billion. [13] This remains on our estimates approximately $38 billion lower than the likely equity value proceeds from transfer to the private sector.

However, as Professor Bob Officer argued in his CEDA paper "Privatisation: Efficiency or Fallacy? Two Perspectives"[14] in 1999 - if we are to use pre-tax cashflows in our valuation analysis, they should also be discounted at a pre-tax WACC, not a post-tax WACC. This reflects the fact that any alternative asset owned by the state will also be tax-free. The result should be the same as discounting dividends excluding tax equivalent payments at a post-tax WACC obtained from benchmarking private sector rates. This suggests the $64 billion difference between equity proceeds and retention values is the more theoretically correct estimate.

In conclusion, interest rate margins and tax equivalent payments do not provide an argument for retaining control of public sector infrastructure assets. Even after accounting for both dividends and tax equivalent payments, transfer to the private sector of our sample of publicly owned infrastructure assets will release significant capacity from public sector balance sheets for investment in new infrastructure.

Previous Analysis on Public Infrastructure Efficiency

The conclusion that public sector infrastructure assets do not fully generate private sector returns and that transfer to the private sector is likely to free up significant proceeds to invest in new infrastructure is in line with recent experience.

[12] 'Hockey offers states billions to sell off assets', AFR, 28 November 2013

[13] Difference between Proceeds on Transfer and Retention Value including Tax Equivalent Payments

A$m	Transfer Proceeds (Equity Value)	Dividend & TEP Retention Equity Valuation	Difference	Difference as % of Transfer
Ports	6,704	3,281	3,423	51%
Electricity Generation	13,426	9,458	3,968	30%
Electricity Transmission and Dist	31,880	18,269	13,611	42%
Water	37,544	22,009	15,535	41%
Other (Forestry and Freight Rail)	2,403	1.094	1,309	54%
Total	92bn	54bn	38bn	41%

[14] CEDA Discussion Paper No. 61, 1999

When the NSW Government transferred its Port Botany and Port Kembla assets to the private sector through a 99 year lease for a price of $5.07 billion it was noted that those assets had not generated any dividend return for over 5 years. Consequently net proceeds of around $4.3 billion were fully invested in the NSW Government's infrastructure fund, Restart NSW. The Sydney desalination plant was leased to the private sector for a price $300m above the value in Sydney Water's accounts.

Numerous other investigations have found that Government Business Enterprise returns are not meeting their cost of capital. The NSW Treasury commissioned a Government Business Performance Assessment and Capital Management Project which found NSW Government Business Enterprises do not consistently meet their benchmark Weighted Average Cost of Capital.[15] It compared performance against private sector peers and found that using Return on Invested Capital as a benchmark the performance of businesses in the water ports and forestry sectors did not compare well to their private sector peers. In contrast it found electricity assets performed better but still not as well as the private sector. The project found that gearing of Government Business Enterprises was low and that increasing gearing could improve returns to Government.

The Productivity Commission undertook annual reviews of Government Business Enterprises in its reports "Financial Performance of Government Trading Enterprises" until 2006/07. In their final report they concluded "Despite some improvement, about half of the monitored Government Trading Enterprises did not achieve commercial rates of return in 2006-07, underscoring a long-term inability to operate these businesses on a fully commercial basis in accordance with competition policy undertakings. " The Commission observed that the efficient operation of Government Trading Enterprises was important both to the wellbeing of the community and to the competitiveness of Australian industry and that the continuing poor performance of many Government Trading Enterprises was therefore of concern.

Causes of the Lower Dividend and Retention Values

There are a number of reasons to expect that dividends from public sector infrastructure assets will likely be substantially lower than those earned from private sector operations.

1. Publicly Owned Utilities Often Do Not Operate as Efficiently as Private Sector Utilities

The original report by Infrastructure Australia discussed the rationale for why public sector entities may operate less efficiently than private sector comparators. Public sector operators do not face the rigorous disciplines of capital markets like private sector managers, are not rewarded to the same extent for taking commercial risks and driving efficiencies and are often unable to respond quickly to market changes or take advantage of broader commercial opportunities.

This can result in lower revenues, more operating costs, a more conservative capital structure and a tendency to gold plate capital expenditure. All of this reduces operating profits and the ability to distribute higher dividends.

[15] NSW Financial Audit 2011 p 9-11

For example, the Tasmanian Premier identified significant opportunities in property development for Hobart Airport when he announced its successful lease to the private sector. However he commented that it would have been difficult to progress this property development opportunity while the airport was owned by the public sector.

2. Publicly Owned Utilities Are Often Subject to a Range of Non-Commercial Objectives and Policies

Publicly owned infrastructure can also often be directed by the State Government as shareholder to comply with a range of public sector restrictions such as procurement policies which can constrain their commercial operations, and reduce profitability and dividends.

The recent Queensland Commission of Audit found that Government Owned Corporations were subject to 21 different policies from the State Government and concluded that "the nature and extent of the specific policies outlined extend beyond the specific remit of the shareholding Minister and into areas of day-to-day management. Some of these...compromise the effectiveness of the GOC model". 2-55

The report identifies a range of examples of non-commercial legacy agreements which are designed to achieve policy objectives unrelated to the Government Owned Corporations. These include peppercorn charges to the sugar industry in the Port of Townsville, non commercial rail access charges to miners and the agricultural industry and The Gladstone Interconnection and Power Pooling Agreement which obligates CS Energy to pay uncommercial fees to the owners of the Gladstone Power Station annually for generation capacity. The Government Owned Corporations are not compensated for these arrangements. 2-57

The New South Wales Financial Audit, (The Lambert Report) also found that for NSW Government Owned Corporations there had been "a relatively low level of involvement by shareholder ministers in recent years which has reduced the focus on businesses' strategic direction and allowed for greater incursion into their activities by portfolio ministers, generating costs that must be met by users or taxpayers generally" Lambert Report NSW Financial Audit 9-17

3. Publicly Owned Infrastructure Does Not Have As Strong Governance Demanding Dividends

The consequences for a CEO of a listed infrastructure company who fails to meet equity market expectations for profit and dividends can be significant in comparison with a publicly owned entity.

Publicly owned infrastructure may "hold back" paying dividends because of the difficulties in raising new capital when required compared with a privately owned company.

Fiscally constrained state governments may not have the resources to fund new expansions when such financing is required. This lack of an ability to raise new funds may also be the cause of the lower gearing in public sector entities.

The volatility of dividend flows may be because public sector Treasuries periodically need additional funding for projects and budgets and impose requirements on Government Owned Corporations to provide additional funding. Such erratic dividend processes are not optimal in managing these businesses.

4. Public Pressure Not to Remit High Dividends

There can also be adverse public reactions to significant dividend payments being made from public utilities to Governments. For example, recent electricity price increases have often led to public comment on the level of equity distributions from electricity distributions and accusations this is a factor driving price increases.

A Senate Select Committee on State Government Financial Management in 2008 concluded "It is difficult to escape the conclusion that some GBEs are being milked for short-term gain at the expense of their medium to long term health. Funds transferred to state governments for recurrent spending cannot be used by enterprises to modernise infrastructure and situate themselves positively for the future". (Final Report p67)

This concern that larger dividend payments may be politically difficult may also contribute to lower dividend payments for public sector infrastructure assets.

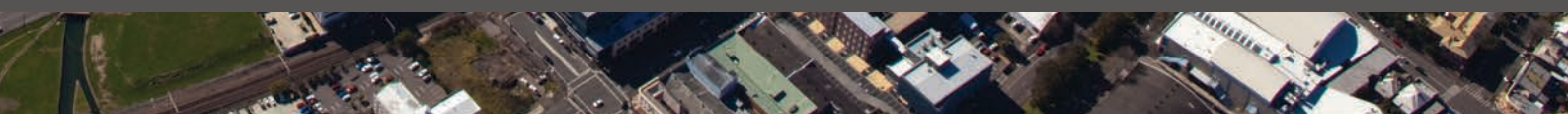
Conclusion

This paper has analysed the dividend returns generated by infrastructure assets retained on public sector balance sheets. While many public sector infrastructure companies do return dividends, and do have some retention value on public sector balance sheets, these returns are usually substantially lower than those generated in the private sector and will not fully compensate for the potential proceeds from a transfer to the private sector.

Transferring assets to the private sector is likely to generate substantially more capacity for governments to invest in new infrastructure than maintaining those assets in public ownership. For the 30 public sector assets analysed, our estimate after factoring in dividends, is that such a transfer will generate an additional $64 billion for investing in infrastructure.

Featured image: Port of Newcastle, NSW.

In November 2013 the NSW Government announced that it will proceed with the long term lease of the Port of Newcastle the world's largest coal export port. Net proceeds from the lease will be used to fund infrastructure in central Newcastle as well as road, school and hospital projects across NSW.



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