Strong Choices or Weak Evasions?: How the effective sale of public assets will weaken Queensland's fiscal position

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Strong Choices or Weak Arguments?: Summary

The ‘Strong Choices Final Plan’ has been presented as a solution to Queensland’s fiscal problems that does not involve asset sales. In reality

*As Treasurer Nicholls has previously observed, the distinction between a 99-year lease and an outright sale is meaningless

* The Plan document concedes that the program will have an adverse fiscal impact

* After repaying GOC debt, the projected net proceeds from privatization are around $19 billion

* The majority of the net proceeds are allocated to non-commercial infrastructure investments and subsidies for electricity consumption. Only around $7 billion will be available to repay general government debt

* As a result, the interest savings from privatization fall far short of the foregone dividends and tax equivalent payments

* The loss will grow over time

* Based on the government’s own projections of GOC earnings, the adverse impact will be around $2 billion a year by the end of the forward estimates period

* The cumulative loss will be around $9 billion by 2020

* The Plan will reduce the government’s net worth by $8 billion to $10 billion over the same period

* The claimed job creation benefits are temporary and far outweighed by previous cuts

* Public expenditure, including the provision of non-commercial public infrastructure, must be financed primarily through taxation. Governments that evade this reality are exhibiting weakness not strength.

Strong Choices or Weak Arguments?: How the proposed asset divestment program will weaken Queensland's fiscal position

The central issue in the Queensland state election, due to be held by March 2015, will be the LNP government proposal for the transfer to the private sector of major government assets. After lengthy public discussion, which provided evidence that the Queensland public is strongly opposed to privatisation in any form, the government has produced a proposal to divest publicly owned assets through long term leases. This proposal has been presented in the Strong Choices Final Plan, released in October 2014.

The Strong Choices Final Plan is unsatisfactory in a number of respects. Although it is presented as a proposal for 'secure public finance' it contains no analysis of the fiscal impact of the proposed problem. The reason is clear, although the Plan document does its best to obscure the facts. On the government's own analysis, the fiscal benefits of reducing public debt will be more than offset by the loss of dividends and tax equivalent payments, a loss that will grow over time.

The report is organised as follows.

Section 1 deals with the claim, made prominently on the cover of the Strong Choices Final Plan, that the proposal does not involve asset sales. The primary conclusion is that there is no practical difference between the proposed leases and an outright sale.

Section 2 is a critical analysis of the Strong Choices Fiscal Plan, with a focus on the discussion of fiscal impacts. The key observation is that the Plan implicitly concedes that the fiscal impact will be negative rather than positive.

Section 3 presents the analysis of fiscal impacts that should have been provided in the Plan. The analysis, based on official projections of dividends and tax equivalent payments from Government Owned Corporations shows that the plan will produce a cumulative net loss of $5 billion by 2019-20.

Section 4 is a response to claims made by the Commission of Audit, and restated in the Plan, that the failure to privatise state assets as proposed in 1996 led to a loss of $7.2 billion. These claims fail to take account of the appreciation in the value of public assets. A correct analysis suggests that the rejection of privatisation has substantially increased the net worth of the Queensland public sector.

1. Lease or sale?

Before considering the economics of the issue, it is necessary to discuss the way the proposed transaction is being described. Until September 2014, the proposal was to sell most of the assets, with the exception of the most valuable, the electricity networks of Ergon and Energex. The preferred option for these assets was described as a 'non-share equity interest', a concept which apparently mystified the intended purchasers as much as did the economists who tried to understand how it would work.

The new proposal, for a 50 year lease with an option of a 49 year renewal, took us back to more familiar ground. It is common for governments undertaking politically sensitive privatisations to dress them up as leases.

However, the Strong Choices Final Plan stands out as 'protesting too much' on this score. The most prominent design element on the cover of the plan is the phrase "No asset sales" highlighted in a gold disk. By contrast, there is no mention of privatisation or leasing. The plan is described in glowing, but non-specific terms as 'the smartest and strongest choice' for 'secure finances and a strong economy'.

In practical terms, a 99-year lease is no different from a sale. Queensland's Treasurer, Tim Nicholls knows this perfectly well. Commenting on similar proposals from the Labor Party in 2010, he observed

> As anyone would know if they had observed the privatisation of assets, a 99-year lease is as good as giving away the farm

There is one arguable counterexample, that of the British lease of Hong Kong from China,which expired in 1997. However, there is a crucial difference in terms. Under the Hong Kong lease, Britain received no compensation for the transformation of Hong Kong from an obscure trading post to one of the world's great cities. By contrast, under the terms of the leases being proposed here, resumption of control will require that the lessees be fully compensated for their investments over the term of the lease, which far exceeds the life of most of the assets concerned.

The same point may be made with respect to the option of renewal after 49 years. The terms are such that, if the assets are still profitable, the state will have to pay their full value to regain control. The only real effect of the renewal option is to give the lessees the chance to walk away.

In practical terms, the proposal is for a sale. The only result of the packaging as a lease will be to deter some potential buyers who prefer the security of outright ownership, and therefore to reduce the price received by the people of Queensland.

The real issue, then, is whether the sale of the assets makes sense as a way of addressing Queensland's (real but exaggerated) fiscal problems, and as a way of managing public infrastructure. I will focus on the first of these issues.

2. Fiscal impact: Misleading description in Strong Choices Final Plan

The asset sales program has been presented as a necessary response to an alleged fiscal crisis. Yet, on the government's own account (Strong Choices Final Plan, p36, highlighted box)

> Across the forward estimates, the lease of Government businesses is not expected to have a major impact on the State's fiscal balance, noting that the impact will be ultimately determined by the actual values realised for the asset transactions.

This statement is misleading in a number of respects

*It is not stated that the likely impact is negative rather than positive. That is, the Strong Choices plan will worsen the state's fiscal balance

* The government's calculations of interest savings are overstated

* The government's own projections of future GOC earnings, which increase substantially over the period of the forward estimates, are not reported

* The loss to the public will continue to grow beyond the forward estimates period.

Negative impact

Immediately after the highlighted statement quoted above, the Strong Choices plan (p36) states

> In the longer term, the Government considers that reducing the State's debt, freeing up funds to invest in new infrastructure, and transferring business risks to the private sector outweigh the potential impacts on the fiscal balance from the loss of dividends and taxes, noting again the uncertainty of returns of these businesses to the State.

This is an implicit admission that the long-term impacts on the fiscal balance are expected to be significantly negative.

It is true that the returns from the earnings of GOCs are uncertain. However, as the government notes, 'the impact will be ultimately determined by the actual values realised for the asset transactions' that is, this uncertainty is equally relevant in estimating the return from asset sales.

Interest savings

The Newman government estimates that the sale will raise $37 billion. Of this total amount $3.4 billion will go to a 'cost of living fund', while $8.6 billion will be allocated to new infrastructure investment. That implies that $25 billion will remain to be paid off state debt, and therefore reduce the interest payments made by the state.

This government projects an interest rate saving of $1.3 billion, with an implied interest rate of 5.2 per cent. The government's calculation assumes that a reduction in gross debt from $80 billion to $55 billion will result in a pro rata reduction in interest payments, from $4 billion to $2.7 billion. In reality, however, interest rates have fallen over time, with the result that debt issued in the past carries higher interest rates than new debt. In calculating the interest saving, the most appropriate interest rate to use is the current 10-year bond rate, which has varied between 3.4 per cent and 4.3 per cent over the last couple of years.

More significantly, following past practice, it seems certain most of the sale proceeds will be used to repay debt borrowed on behalf of GOCs through the Queensland Treasury Corporation. The outstanding GOC debt to the QTC is currently around $18 billion.

The interest payments on this debt are serviced out of the the gross profits (earnings before interest and tax) of the GOCs themselves. The repayment of this debt will not yield any interest saving to the general government sector (that is, to the sector covered by the state budget), since the interest was already covered by GOC earnings. Hence, the relevant figure is the reduction in general government debt is around $7 billion.

The interest saving to the general government sector may therefore be estimated in a range from $200 million to $300 million, far below the current flow of dividends and tax equivalent payments, which is over $1 billion per year.

The loss to the budget sector largely reflects the government's decision to allocate most of the sale proceeds (after the repayment of GOC debt) to cash handouts (the Cost of Living Fund) and non-commercial investments. If all the net proceeds were used to repay general government debt, the savings would, at least initially, be comparable to the dividends and tax equivalent payments foregone. However, as discussed below, this loss will grow over time.

The competitive neutrality payment and double counting

By borrowing through the QTC, GOCs can secure debt finance at a lower rate of interest than would apply if they were stand-alone enterprises. Under competition policy principles, this lower cost of capital is not passed on to consumers or retained as GOC profit. Rather, it is returned to the state government in the form of a competitive neutrality fee.

The value of the associated payments is shown in Table 1

Table 1: Projected competitive neutrality fee payments

Competitive Neutrality Fee					
	2013-14 Estimate $ million	2014-15 Forecast $ million	2015-16 Forecast $ million	2016-17 Forecast $ million	2017-18 Forecast $ million
Ergon	54.9	56.4	48.2	52.8	57.6
Energex	51.4	57.9	60.5	62.5	63.5
Powerlink	36.8	38.6	39.1	37.8	37.4

(Source: Hansard, 2014-15 Estimates hearing, 16 July 2014)

The estimates of foregone income presented in the Strong Choices Final Plan take no account of this payment. It might be argued that the payment represents compensation to the government for taking on the additional risk associated with financing GOC debt. However, the Final Plan claims, as a benefit of the privatization proposal 'Lower State risk exposure of continuing to run these assets, which have variable returns.' At least as regards debt exposure, this benefit is captured in the competitive neutrality fee, so that the Final Plan analysis involves double counting.

Failure to report projected earnings

Against the savings in interest, the government loses the flow of dividends and tax equivalent payments from the assets, as well as the value of earnings that are retained and reinvested. The Strong Choices summary gives a figure of $1.083 billion for 2012-13.

This statement is highly misleading.

More importantly, the analysis fails to take account of the fact that not all of the earnings of the enterprise return to government. At least 20 per cent of earnings are retained to finance further capital investment. In addition, the accounting allowance for depreciation and amortisation is usually sufficient to finance some upgrades of existing capital. Finally, accounting profits do not take account of the fact that the value of assets increases over time, with inflation.

All of these factors mean that, unlike interest savings, the value of the flow of income from the assets can be expected to rise over time, as they have done in the past. So, the use of data from 2012-13, as is done in the government's final plan, is misleading.

3. Fiscal impact: Analysis based on official projections

The government's own estimates of future income flows, read into Hansard on17 July 2014 provide a basis for estimating the fiscal loss from the asset sales program over the forward estimates period. Table 1 shows projected dividends, rising from from $1.1 billion in 2013-14 to nearly $1.4 billion in 2017-18. Table 2 shows projected tax equivalent payments, rising from $315 million in 2013-14 to nearly $800 million in 2017-18. Table 3 shows the total flow of income foregone, rising from $1.4 billion in 2013-14 to nearly $2.1 billion in 2017-18.

Table 1: **Projected GOCs Dividends ($M):**

GOC/Year	2013-14	2014-15	2015-16	2016-17	2017-18	Total:
CS Energy	0	0	0	49.1	48	97.1
Energex	370.2	370.8	203.3	187.1	318	1449.4
Ergon Energy	393.2	461.7	378	362	395.7	1990.6
Powerlink Queensland	165.4	174.9	179.9	218	164.3	902.5
Stanwell	69.8	98.2	194.5	217.9	236.7	817.1
Gladstone Ports Corporation	47.5	49.1	64.1	81.4	84.1	326.2
North Queensland Bulk Ports	20.9	15.4	19.9	22.4	24	102.6
Port of Townsville	12.9	14.8	19.3	23.8	27.1	97.9
SunWater	33	41	63	49	60	246
Total:	1112.9	1225.9	1122	1210.7	1357.9	6029.4

Table 2: **Projected GOCs Tax Equivalent Payments ($M):**

GOC/Year	2013-14	2014-15	2015-16	2016-17	2017-18	Total:
CS Energy	0	0	0	23.8	20.2	44
Energex Limited	109.6	53.4	194.2	195	212.3	764.5
Ergon Energy Corporation Limited	0	247.4	202.5	193.9	212	855.8
Powerlink Queensland	87.4	88.5	90.2	111.9	82.8	460.8
Stanwell Corporation	84.7	56.2	112.3	126.5	145.1	524.8
Gladstone Ports Corporation Limited	26.3	26.3	34.3	43.6	45.1	175.6
Port of Townsville Limited	7.1	8.1	10.2	13.4	15.4	54.2
SunWater Limited	0	0	0	0	44.4	44.4
Total:	315.1	479.9	643.7	708.1	777.3	2924.1

Table 3: Total Dividends and Tax Equivalent Payments ($M)

GOC/Year	2013-14	2014-15	2015-16	2016-17	2017-18	Total:
CS Energy	0	0	0	72.9	68.2	2213.9
Energex Limited	479.8	424.2	397.5	382.1	530.3	2846.4
Ergon Energy Corporation Limited	393.2	709.1	580.5	555.9	607.7	1363.3
Powerlink Queensland	252.8	263.4	270.1	329.9	247.1	1341.9
Stanwell Corporation	154.5	154.4	306.8	344.4	381.8	1341.9
Gladstone Ports Corporation Limited	73.8	75.4	98.4	125	129.2	501.8
Port of Townsville Limited	28	23.5	30.1	35.8	39.4	156.8
SunWater Limited	12.9	14.8	19.3	23.8	71.5	142.3
Total:	1395	1664.8	1702.7	1869.8	2075.2	7694.4

If these projections are realised the Strong Choices Plan will imply a net loss of income to the public of around $1 billion a year by 2017-18, a loss that will grow over time.

Table 4 illustrates the projected cumulative loss over the period 2015-16 to 2019-20, assuming that the income foregone grows in line with nominal Gross State Product at a rate of 6 per cent per year. The cumulative loss by 2019-20 is nearly $9 billion.

Table 4: Projected fiscal impact of asset sales

	2015-16	2016-17	2017-18	2018-19	2019-20
Income Foregone ($m)	1702.7	1869.8	2075.2	2199.7	2331.7
Interest saved ($m)	300.0	300.0	300.0	300.0	300.0
Annual loss ($m)	1402.7	1611.9	1823.6	1954.4	2090.3
Cumulative loss ($m)	1402.7	3014.6	4838.1	6792.6	8882.9

4. The Commission of Audit analysis

Privatisation of the electricity industry was previously advocated by the 1996 Commission of Audit, which estimated a sale price of $12.5 billion, as opposed to an estimate of more than $30 billion today. Strong Choices refers to a claim by the 2012 Commission of Audit that the failure to adopt the 1996 recommendation cost the state $7.2 billion. The Commission's analysis, in full (pp 2-86-7 and footnote 17), is as follows:

> The desirability of divestment of government ownership interests in the energy sector was flagged by the 1996 Queensland Commission of Audit. It estimated that, in 1996 dollar terms, withdrawing the $12.5 billion in energy investments from the sector would deliver an annual benefit of $1.1 billion to the State at the prevailing cost of capital, a return $741 million higher than expected from dividends and taxes (the benefit of which the State enjoys under the taxation equivalent regime).
>
> Over the 16 years since that time, annual returns to owners from the energy GOCs (measured on the same basis, but excluding returns of capital from asset sales) have never exceeded the potential annual benefit which was identified at that time, even in nominal terms. This result is despite significant increases in gearing and total capital invested in the sector. The Commission has estimated the loss in value arising to the Government for not taking up that recommendation is in the order of $7.2 billion (in 2011-12 dollars).
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> fn 17. Loss of value assessed as the difference between the 1996 Commission estimate of the market value of energy investments and the net present value (calculated in 1996 dollars, but inflated to 2012 dollars using Brisbane all groups CPI) of dividends and current taxes paid between 1997-98 and 2011-12, flows of equity between the GOCs and the State over the same period and the total book value of energy GOC equity at 30 June 2012.

This analysis is highly unsatisfactory. The government's own estimates suggest that the electricity assets are now worth more than $30 billion, implying an annual appreciation rate of more than 5 per cent. On this basis, the combined value of capital gains, dividends and tax equivalent payments in 1996 would have been around $1 billion, almost as much as the short-term interest savings from privatisation. Moreover, while the amount foregone would have risen steadily in nominal terms, to be well over $2 billion by

2013-14, the interest saving from privatisation would have fallen as interest rates declined from the high levels of the 1990s.

5. Other aspects of the Plan

Much of the anticipated revenue from the asset sales will not be used to repay debt, but will be allocated to a 'Cost of Living' fund and to new infrastructure investment.

Cost of living plan

Around $3.4 billion will be allocated to a 'Cost of Living' fund, which will be used to finance a variety of subsidies, most notably a 'Strong Choices Electricity Price Relief plan', claimed to reduce electricity prices by about 2.5 cents per kilowatt-hour.

Expenditure of this kind is rarely justified in economic terms, and is frequently used as a vehicle for political pork-barrelling.

In any case, the amount allocated to the Cost of Living package is roughly equivalent to the adverse fiscal impact of the asset sales program over a four-year forward estimates period. So, by the end of that period, the fund will, in effect be exhausted. If it is to be maintained, it will be necessary to raise other charges or impose further cuts and services

Additional infrastructure

The Strong Choices plan estimates that, after debt repayments and the Cost of Living fund, around $8.6 billion will be left to finance new public investment. Australian governments have a long history of using infrastructure investments for political pork-barrelling. The problem is particularly severe when the source of finance is a pot of 'free money', such as the proceeds of asset sales, which can be allocated without going through normal budget processes.

In this case, the danger of political pork-barreling has already become apparent. The government is already in negotiations with Adani, the Indian conglomerate corporation planning a rail line and port expansion to support its proposed coal mine in the Galilee Basin. It has been suggested that proceeds from the asset sale program will be used to finance an equity investment in the rail line.

Major banks have refused financing to this project, citing both environmental concerns and the likelihood that the venture will prove uneconomic. The only other financier to show interest, the State Bank of India, has also been criticised for apparent political motivation, reflecting close links between Adani and the recently elected Modi government in India. It seems clear, therefore, that any investment by the government will be at high risk, and will reflect political rather than economic criteria.

Based on past experience of the dissipation of privatisation proceeds, as much as 25 per cent of the funds allocated to infrastructure projects, or $2 billion, could be dissipated. This would bring the loss in public sector net worth up to $10 billion.

6. Employment issues

The Strong Choices Final Plan declines to estimate the employment impacts of privatisation, instead quoting an isolated and unrepresentative example, that of the Commonwealth Serum Laboratories. In reality, privatisation has almost invariably resulted in declining employment, and in the replacement of permanent workers by insecure contract employment.

The Plan also claims

> The Strong Choices Future Investment Program is expected to directly support approximately 25,000 full time equivalent (FTE) jobs in the Queensland construction and supporting industries

It is important to observe that these jobs are not permanent, but will last only for the duration of project construction. The only specific example so far is the proposal to make a (high-risk) equity investment in the North Galilee rail project, linking Adani's proposed Carmichael coal mine to the Abbot Point coal terminal, claimed to deliver more than 10 000 jobs. This project is still on the drawing board, but Adani is promising to deliver its first coal by 2017, implying that the construction phase for the rail line will last less than three years. By contrast, the first major policy decision of the LNP government was to destroy around 15 000 permanent jobs.

The commitment to use the proceeds of asset sales to fund non-commercial infrastructure such as the North Galilee project reflects the incoherence of the LNP government's approach to infrastructure and employment policy. A rhetoric of crisis, fuelled by the spurious Commission of Audit report, has been used to justify drastic cuts in expenditure on physical and social infrastructure. At the same time, artificial financial structures have been used to fund projects that would never pass a normal benefit-cost test (the demolition and replacement of the main ministerial office building in Brisbane is another example).

7. What is the alternative

Advocates of the Strong Choices Plan have argued that none of the alternatives, such as increasing tax revenue, reducing public expenditure or tolerating higher levels of debt, is acceptable. In reality, however, asset sales and leases make little difference to the fiscal positions of governments that undertake them even when they are managed optimally. When the proceeds are dissipated on politically motivated projects, as in the present cases, privatization makes governments worse off.

In the end, public expenditure, including the provision of non-commercial public infrastructure, must be financed primarily through taxation. Governments that evade this reality are exhibiting weakness not strength.

Unfortunately, successive Queensland governments have maintained the fiction that we can be a low-tax state while still providing the same public services and high-quality infrastructure as other states. Until this delusion is abandoned, we will experience financial difficulties whenever government revenue experiences one of its regular cyclical declines, as is happening at present.

7. Concluding comments

Every aspect of the Strong Choices Final Plan is misleading, beginning with the prominent claim that the Plan does not involve asset sales. In reality, the Plan involves the effective sale of public assets, and the dissipation of much of the proceeds in vote-buying policies. The Plan will produce a substantial negative fiscal impact of up to $2 billion a year by 2020, and reduce public sector net worth by up to $10 billion.