Western Power Privatisation
Budget Impact Analysis

May 2016

ORION Consulting Network

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List of Acronyms

($'000)	Thousands
ABS	Australian Bureau of Statistics
ASUWA	Australian Services Union Western Australia
ASX	Australian Stock Exchange
bn	Billions
CNP	Competitive Neutrality Payment
ETUWA	Electrical Trades Union Western Australia
GOC	Government Owned Corporations
m	Millions
NCP	National Competition Policy
RAB	Regulated Asset Base
TEF	Tariff Equalisation Fund
WA	Western Australia
WATC	Western Australian Treasury Corporation
WP	Western Power

1 Introduction

1.1 Report background

There is ongoing discussion nationally and within Western Australia as to whether the State Government will or should privatise its electricity assets to pay down government debt and/or “recycle” funds into new infrastructure. This report focuses solely on potential privatisation of Western Power electricity assets. Privatisation could be in the form of asset sales or sale of long-term leases. It is assumed that only the electricity assets will be sold or long-term leased, and that the proceeds of such transactions would firstly be utilised to pay out the current debt held within the electricity business.

The Western Australian Government has launched an Electricity Market review which is being under taken in two phases, with the first phase finalised. Following the recommendations from phase 1, phase 2 was launched in April 2015, and has four work streams:

1. Network Regulation;
2. Market Competition;
3. Institutional Arrangements; and
4. Wholesale Electricity Market Improvements.

The work streams include changes to the regulatory regime, and various forms of privatisation.

As a part of the review process, the WA Government has not ruled out future full or partial privatisation of the electricity assets, similar to the strategies recently proposed by Queensland and New South Wales Governments.

The state owned electricity sector has complex financial arrangements, with Government Owned Corporations (GOC’s) paying dividends and tax equivalents to the state budget. Much of the state’s debt is within these GOC’s, and the debt is therefore currently serviced from electricity revenue. In addition, there are payments between the GOC’s for Community Service Obligations (CSO), particularly payments required to ensure price parity for the more remote Horizon Power customers.

The proposed reforms will have an impact on the employment conditions of Electrical Trades Union Western Australia (ETUWA) and Australian Services Union Western Australia members (ASUWA), and any potential privatisation will have a budgetary impact on the state finances.

The WA government recently announced to examine full or partial privatisation through lease or sale. ETUWA and ASUWA are therefore seeking economic modelling in form of a valuation of the price of the Western Power (WP) network in the current market as well as the impact on returns to government (e.g. increases/decreases to dividends, tax equivalencies etc.) of privatisation of WP.

Orion has previously undertaken similar analysis in other states.

1.2 Report Data

This report and the related analysis is based on official Western Australia Government publications, corporate financial statements and other published literature relevant to the analysis. Wherever possible, the calculations presented have been supported with source references to publicly available material or explanatory notes to provide full transparency of the analysis. Where data has not been available, we have taken a conservative approach in estimating the financial impacts to ensure that our report is as objective and accurate as possible.

2 Privatisation proceeds

The value of most businesses are determined according to their ability to generate revenue and profits. The allowable revenue for Western Power is determined and monitored by the Economic Regulation Authority and is a function of the Regulated Asset Base (RAB). For this reason, the expected proceeds from a sale or lease of the utility businesses can be estimated as a multiplier of the RAB.

2.1 Proceed estimation

2.1.1 Regulated Asset Base Multiplier

The New South Wales Government recently sold a long-term lease of Transgrid for around 1.55 times the RAB. This multiplier is regarded by most financial commentators as being a unusually high premium on the value of a regulated business[1]. However, as the multiplier paid for a business depends on the market's risk profile and the overall belief in the efficiency of the regulators such a high multiplier can be an indication of the current market appetite for similar utilities.

Appendix 1 of the current (2012-2017) Access Arrangement for Western Power Network[2], indicates that the forecast closing RAB for Western Power in 2016 (real 2012 $) is $8.4 billion (bn). Taking into account inflation as per Australian Bureau of Statistics (Cat. 6401.1) for Perth, the forecast nominal value of the 2016 RAB is estimated at around $9.7bn.

Year	**2016**				
RAB ($m, forecast)	$9,726				
RAB Multiplier	**1.55**	**1.5**	**1.3**	**1.1**	**0.9**
Proceeds ($m)	$15,075	$14,589	$12,644	$10,699	$8,754
- borrowings ($m, 2015)	$7,220	$7,220	$7,220	$7,220	$7,220
Net proceeds ($m)	**$7,855**	**$7,369**	**$5,424**	**$3,478**	**$1,533**

Table 1 – RAB multiplier and related proceeds

Using the highest multiplier, the potential maximum proceeds of Western Power is estimated at around $15.1bn. This however does not take into consideration the borrowings held within Western Power, which as at 30 June 2015 amounted to $7.2bn. Assuming no further increase in borrowings by WP during 2016 the net proceeds available to the WA government after privatisation of Western Power and repaying the borrowings is estimated to be around $7.9bn at the maximum. It should be noted that borrowings in WP increased by $387m in 2015.

If these net proceeds were to be used to retire additional State Government debt at the same implied interest rate paid by WP (4.37%[3]), it would provide an interest saving of around $343.5m.

2.1.2 Price/book valuation method

Another financial valuation method commonly used to compare a company's current market price to its book value (price/book value) can also be applied to estimate the value of the assets. This enables us to examine the ongoing market value of existing utilities, rather than the RAB method applied to occasional privatisation transactions. (The RAB is a subset of the book value of all of the company's assets. However, listed utility companies are generally highly

[1] https://theconversation.com/three-of-many-problems-for-the-evolving-electricity-industry-in-australia-51647
http://www.afr.com/street-talk/ausgrid-deal-could-get-gridlocked-by-canberra-20160428-gohfjq?btis
http://www.smh.com.au/business/energy/overpaying-fear-on-transgrid-prompts-sell-call-20151126-gl8jp3.html

[2] https://www.erawa.com.au/cproot/10992/2/WP%20FFD3%20revenue%20model%20-%20Public.PDF

[3] $315.5m interest on $7.22bn debt

geared, whereas privatisations are usually conducted on an asset-only basis.) Using the implied 'price/book value' methodology, we have calculated the net equity of WP and applied the price/book ratio to estimate a net value of the company. The ratios used are based on the current values for comparable electricity companies listed on the Australian Stock Exchange (ASX). Currently the ASX is trading at a price/book value of 1.30, while the utility sector a whole is trading at 1.27.

2015 financial year[4]			
Assets ($m)	$9,780		
Borrowings ($m)	$7,220		
Current Net Equity ($m)	$1,702		
Net equity without debt ($m)	$2,559		
Price/book ratio	1.5[5]	1.3	1.1
Net proceeds at book ratio ($m)	**$3,839**	**$3,327**	**$2,815**

Table 2 –Proceeds at book ratio

The price/book methodology suggests that the potential net proceeds of a lease or sale of WP was in the range of $2.8bn to $3.8bn at the end of the 2015 financial year. Comparing this to the RAB methodology, a net proceeds of $3.8bn would equal a RAB multiplier somewhere between 1.2 and 1.1 times the RAB, implying an estimated $11bn in gross proceeds.

Since 30 June 2008, the Western Australia Government has increased its equity in Western Power from $911m to $1.7bn, an increase of 87%. During the same period, borrowings increased from $3.1bn to $7.2bn (132% increase) while the value of assets increased from $4.5bn to $9.8bn (117% increase).

2.2 Summary

It is possible the gross proceeds of the privatisation of Western Power could be as high as $15bn, however it is important to stress that this is the gross value and does not take into consideration the $7.2bn debt currently held by Western Power.

Using the price/book valuation methodology, the net equity currently held in Western Power by the State Government suggests a valuation closer to $11bn as being a realistic gross value of the business when comparing with the current market conditions for other similar utilities.

[4] Western Power Annual Report 2015, page 29
[5] AusNet Services Ltd ratio as of 21/4/2016 was 1.53.

3 Cash flow

The Western Australian Government has not ruled out the option of entering into sale/leasing agreements of all or parts of its electricity network assets as a part of future reforms. While privatisation of the electricity assets will provide a short-term cash injection, the flow-on long term impact on revenue streams received by the Government from the Government Owned Corporation (GOC) could outweigh the short term monetary benefits.

3.1 Western Power to State Government

Privatisation of WP through the offering of long-term leases or sale of the WP assets would mean that the State Government would no longer receive tax equivalent payments, dividends or any other such payments from WP.

Western Power to State Government ($'000)		
	2014/15	**2013/14**
Borrowing Costs[6]	$315,524	$322,592
Tax equivalent[7]	$147,406	$87,841
Dividend payments[8]	$131,915	$124,395
Tariff equalisation fund[*9]	*$136,000*	*$209,000*
Total cash flow out	**$730,845**	**$743,828**
**For benefit of Regional Power Corporation*		

Table 3 – Cash flow from Western Power to State Government

The tax equivalent payment from Western Power to the State Government is a substitute for paying company tax to the Commonwealth, as WP is exempt from the Commonwealth of Australia's Income Tax Assessment Acts. If WP was to be privatised, this payment to the State Government would cease to be received by the WA government, and would instead be received by the Commonwealth.

As the sole owner of Western Power, the Western Australian State Government is entitled to dividends from profits made by WP. Dividends paid by WP amounted to $131.9m for 2014/15.

The payments made to the Tariff Equalisation Fund (TEF) do not go directly to the State Government but are used to ensure uniform charging in rural areas. If WP did not make this payment, the State Government would make the payment as a Community Service Obligation from general revenue. The payment to the TEF by WP is therefore benefiting the State Government as they do not have to use money from general revenue to fund the payment.

In total, the Western Power 2014/15 financial statements indicates that approximately $730.8m in payments were transferred either directly to the State Government or state controlled entities from WP.

[6] Western Power Annual Report 2015, page 38, note 5(d)(ii)
[7] Western Power Annual Report 2015, page 39, note 6(b)
[8] Western Power Annual Report 2015, page 30, note 22
[9] Western Power Annual Report 2015, page 37, note 5(c)(ii)

3.2 State Government cash flow payments

The State Government does not only receive payments from WP, but also has outgoing payments in relation to the operation of Western Power. The outgoing cash flows identified are borrowing costs and equity contribution.

State Government cash flow ($'000)		
	2014/15	**2013/14**
Borrowing Costs	$315,524	$322,592
Equity contribution[10]	$92,936	$74,862
Total payments from Govt	**$408,460**	**$397,454**

Table 4 – State Government cash flow payments

Western Power reported borrowing costs of $315.5m during the 2015 financial year. While it is not specifically identified that the interest payment is made to Western Australia Treasury Corporations (WATC), WATC is the primary lender to WP, and therefore it is reasonable to assume that most of the interest payments would be going to WATC. To eliminate the uncertainty around the end destination of the interest payments, it has also been assumed that the full interest payment is passed on by WATC to their lenders without WATC retaining any of the interest payment. Interest payments are therefore assumed to be a zero sum game between WP, the State Government and external parties. However, in Queensland the electricity businesses are required to pay a Competitive Neutrality Payment (CNP) under the National Competition Policy (NCP) to reflect the difference in borrowing costs under the the state's credit rating versus the business's credit rating. This is not shown in published WA documents, but is likely to be applicable in WA. This would be an additional revenue loss to the state if WP is privatised.

In the 2015 financial year, the State Government had outwards cash flow relating to the operation of Western Power totalling $408.5m. This included an equity contribution by WA State Government to WP to offset the portion of the dividend payments made by WP that is attributable to developer and customer contributions[11].

Following the end of the 2015 reporting period, the dividends paid by WP in relation to the 2015 financial year were proposed to increase from $131.9m to $232.4m, subject to the Minister's approval[12]. To balance out the proposed increased dividend, an additional payment of $91.4m is forecast in the mid-year budget estimates[13]. These proposed changes are not included in the above calculations.

3.3 Cash Flow Summary

The net cash flow to the State Government from the ownership of Western Power for the 2015 financial year was $322.4m. In addition to this, $192.3m in net retained earnings was added to the State Government equity holding in WP. The total 2014/15 benefit to the State Government from its ownership of WP was therefore $514.7m.

If the State Government was to use the estimated net proceeds ($3.48bn to $7.86bn) for repayment of other debt, the interest savings to the State Government would be in the range of $152.1m to $343.5m. With the total benefit to the WA State Government during the 2015 financial year from its ownership of Western Power estimated at $514.7m, the **annual Cash flow loss** to the State Government of privatising Western Power would be somewhere between $362.6m and $171.2m.

[10] Western Power Annual Report 2015, page 30, note 20
[11] Western Power Annual Report 2015, page 65, Note 20
[12] Western Power Annual Report 2015, page 66, Note 22
[13] 2015-16 Government Mid-year Financial Projections Statement, p.168 (excess of $91.4m)

4 Conclusion

It is possible that the gross proceeds of Western Power can be as high as $15bn. However, using the current book/price ratio of similar companies in the utility sector, the estimate of the potential gross proceeds from privatisation is more likely to be around $11bn. It should be noted that this is the gross proceeds and therefore does not take into consideration the $7.22bn debt currently held by Western Power.

Estimated net proceeds (after debt repayment) range from $3.48bn to $7.86bn. These proceeds will most likely be used by the State Government to retire other government debt or to fund new infrastructure projects. Considering that the total cash flow benefit to the WA State Government during the 2015 financial year from its ownership of Western Power was $514.7m, using the net proceeds to retire more State Government debt would result in an annual net cash flow loss to the State Government of somewhere between $362.6m and $171.2m, compared to retaining ownership of Western Power.

Privatisation scenarios	**Scenario 1 (High estimate)**	**Scenario 2 (Current market price)**
Gross proceeds	$15,075m	$11,020m
Net Proceeds	$7,855m	$3,839m
Loss of cash flow	($515m)	($515m)
Potential Interest saving	$344m	$152m
Annual Cash flow surplus/(loss)	**($171m)**	**($363m)**

Table 5 – Privatisation scenarios where net proceeds used for debt reduction

Another alternative is to use of the privatisation proceeds is to invest in new infrastructure. In the short term increasing the net proceeds on large infrastructure projects could create more activity, however large infrastructure is expensive to maintain and will during its life cycle cost considerably more than the initial capital expenditure. Selling or leasing revenue generating asset to invest in assets with high maintenance costs will result in an ongoing negative impact on State Government cash flow.

It is important to note, that the above estimates are based on figures from the 2015 financial year. It is likely that both the cash flow to the State Government and the net proceeds will increase over time as a result of the organic growth of Western Power.

Throughout the report a conservative approach has been taken to provide an objective view of the budget impact of privatisation of Western Power.