Western Power Privatisation
Budget Impact Analysis

March 2017

ORION Consulting Network

Western Power Privatisation
Budget Impact Analysis

March 2017

ORION Consulting Network

COPYRIGHT: The concepts, methodologies and information contained in this document are the property of ORION Consulting Network. Use or copying of this document in whole or in part for commercial purposes without the written permission of ORION Consulting Network constitutes an infringement of copyright. The client has permission to use, copy or disclose any part of that report to other parties, for any purpose. This is subject to Orion being identified as creators of the report; the report or excerpts are reproduced or quoted in an appropriate context; and material alterations are not made to our report or excerpts.

LIMITATION: This report has been prepared on behalf of and for the exclusive use of ORION Consulting Network's Client, and is subject to and issued in connection with the provisions of the agreement between ORION Consulting Network and its Client. Forecasts and calculations in relation to past, current and future events are based on best estimates, information provided by the Client and published information, however these estimates are subject to unforeseen variables and unpublished information. ORION Consulting Network accepts no liability or responsibility whatsoever for or in respect of any use, by any party, at any time.

ORION Consulting Network

Table of Contents

List of Acronyms

($'000)	Thousands
ABS	Australian Bureau of Statistics
ASUWA	Australian Services Union Western Australia
ASX	Australian Stock Exchange
ATO	Australian Taxation Office
bn	Billions
CNP	Competitive Neutrality Payment
CSO	Community Service Obligation
ETUWA	Electrical Trades Union Western Australia
FY	Financial Year
GOC	Government Owned Corporations
HP	Horizon Power
IPO	Initial Public Offering
m	Millions
NCP	National Competition Policy
RAB	Regulated Asset Base
TEF	Tariff Equalisation Fund
TEP	Tax Equivalent Payment
WA	Western Australia
WATC	Western Australian Treasury Corporation
WP	Western Power

1 Executive Summary

1. The 2017 Regulated Asset Base (RAB) for Western Power is estimated at $10.5 billion.
2. Western Power had borrowings of $7.4bn and $617m owed in tax equivalents at the end of the 2015/16 financial year.
3. The Western Australia State Government announced the intention to sell 51% of Western Power to investors, with about 30% to Australian superannuation funds and 20% to "mum and dad retail investors". The largest shareholder will be the Government which retains 49%.
4. The Government claimed the partial privatisation would achieve proceeds of around $11billion, with $8bn to be used to reduce state debt, and $3bn to set up a Next Generation Account.
5. The $11bn proceeds quoted by the Government consists of $8bn worth of debt refinancing and only $3bn of actual proceeds from sale of equity in Western Power. $8bn of debt would remain in WP but refinanced so it can be treated as private debt, not government debt.
6. This expected proceeds implies a Government estimated enterprise value of around $14bn for Western Power, and a RAB multiplier of 1.33. This is based on outcomes achieved by other recent electricity privatisation experiences in Australia.
7. The proposed approach to privatising Western Power differs from other electricity privatisations because retail investors are involved and controlling power is retained by the Government.
8. Selling to retail investors requires the privatisation to be an Initial Public Offering (IPO) on the stock exchange. Generally unlisted infrastructure investments have relatively higher enterprise values than listed infrastructure investments.
9. Privatisation which includes the sale of the controlling power often achieve control premiums. Median control premiums of 29% (average 35.5%) applies to the Australian share market a 2013 study has found.
10. Due to majority control remaining with the State Government, it is unlikely the superannuation sector would be prepared to pay a control premium.
11. The Government has implied that the issue price to superannuation funds and retail investors would be the same. However, all sharemarket floats of government businesses to date have given a discount to retail investors. Discounts to retail investors of around 7% was provided in the Medibank Private float.
12. The proposed structure of the privatisation means that it is more likely the sale will be at a RAB multiplier of around 1.0 due to no control premium and retail investor discounts.
13. Our RAB and book/price valuation methodologies both indicate expected net proceeds of around $1bn to the Government from selling 51% of Western Power, assuming a book/price value of 1.1 and a RAB multiplier of 1.0.
14. The government remaining the largest shareholder of Western Power, could in our opinion result in the state's Auditor-General requiring the finances of WP to be consolidated into the state accounts as a controlled entity under the Australian accounting standards.
15. The government's proposed partial privatisation attempts to achieve two conflicting goals – maximise the sale proceeds and offload $8bn debt, while at the same time retaining a degree of control to ensure pricing, employment and Australian ownership are protected. But there is an inherent trade-off between these two objectives.

16. Partial sale may only yield net proceeds just under $1bn, while the government's portion of the $8bn debt may remain consolidated on the Government's books if Western Power is deemed to be a controlled entity.
17. The State Government could be in breach of State and Commonwealth legislation if Tax Equivalent Payment have not been made on a regular basis by Western Power.
18. Privatisation of Western Power would see State Government lose cash flow and indirect benefits from the full ownership.
19. Loan guarantee fee, income tax equivalent payments and dividends received by the State Government would all be either lost or dramatically reduced if Western Power is privatised.
20. Tariff Equalisation Funding to Horizon Power is around $3,000 per customer. If Tariff Equalisation Payments from Western Power was to discontinue, it would result in increased revenue requirement of Horizon Power of around 25.6% to 40.4%.
21. The State Government received $494m in net benefits from its ownership of Western Power during 2015/16. If privatised, the net benefits are forecast to decrease to $217m per annum.
22. In total the State Government will be $276.5m per annum worse off under the proposed privatisation compared to 2015/16 financial figures.
23. It will take less than 4 years before the budgetary costs from the partial privatisation exceeds the estimated privatisation proceeds of $1bn.
24. The annual loss from privatisation of Western Power will negatively impact the public sector operating balance, increasing the deficit which is a larger concern to the rating agencies than the gross debt.

2 Introduction

2.1 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 considered future full or partial privatisation of the electricity assets, similar to the strategies recently proposed by Queensland and New South Wales Governments. In the lead up to the 2017 State election, the State Government announced the intention to sell or lease 51% of Western Power to investors[1], and has announced it expects to receive proceeds of around $11billion.

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 and partial sale of Western Power will impact 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.

ETUWA and ASUWA are therefore seeking economic modelling in form of a valuation estimate 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.

2.2 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

[1] http://www.afr.com/news/policy/colin-barnett-to-sell-western-power-to-raise-12b-20161130-gt0kb6

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.

3 Privatisation proceeds

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

The WA government has announced their intention to sell or lease 51% of Western Power to investors, with indicative targets of 30% to Australian superannuation funds and 20% to "mum and dad retail investors"[2]. The government has also announced that it expects to retire approximately $8bn of debt with the proceeds from the WP sale.

The Government has announced their interest in taking a similar approach to selling Western Power as that taken in the sale of Ausgrid in New South Wales. In this deal, the borrowings held by Ausgrid were refinanced on privatisation, removing the debt from government books. The mechanics of repaying GOC debt once the business is privatised has complications which can result in large losses. During the sale of Ausgrid by the New South Wales Government, the Treasurer directed Ausgrid to refinance a large share of the long-term debt to short-term debt prior to the privatisation. The refinancing decisions made by the Government resulted in a market-to-market loss of $407.7m to Ausgrid, and resulted in Ausgrid posting a loss of $251m[34]. The loss meant that no dividend was paid in relation to the operation of Ausgrid in 2015/16.

The decision to allocate an "indicative" 20 per cent of shares to retail investors requires the privatisation to be an Initial Public Offering (IPO) on the stock exchange This is different to previous electricity privatisations including Ausgrid, which were by a direct trade sale process. Public floats were used for the privatisation QR National (now Aurizon), Medibank Private and Telstra.

3.1 Proceeds estimation

3.1.1 Regulated Asset Base Multiplier

The New South Wales Government recently sold a long-term lease of Transgrid for around 1.55 times the RAB while Ausgrid sold for around 1.4 times RAB. The multiplier of 1.55 is regarded by most financial commentators as being an unusually high premium on the value of a regulated business[5]. However, as the multiplier paid for a business depends on the market's risk profile and the perceived opportunity to improve financial performance, 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[6], indicates that the forecast closing RAB for Western Power in 2016 (real 2012 $) is $8.4 billion (bn). Considering 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. A 2017 RAB figure of $10.5bn was recently published in an article quoting UBS as the source, which is in line with our estimate.

---

[2] https://www.mediastatements.wa.gov.au/Pages/Barnett/2016/11/Jobs-boost-from-part-sale-of-Western-Power.aspx

[3] http://www.afr.com/markets/debt-markets/gladys-berejiklian-made-a-strange-call-on-ausgrid-4b-debt-20170124-gtxmj3?btis

[4] Ausgrid Annual Report 2015/16, P34, note 3(b)

[5] 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

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

The following table indicates the estimated enterprise value of WP under differing RAB multiplier scenarios.

FY2016					
RAB ($m, 2017)[7]	$10,500				
RAB Multiplier	**1.55**	**1.4**	**1.3**	**1.1**	**1.0**
Indicative company value ($m)	$16,275	$14,700	$13,650	$11,550	$10,500
- Liabilities ($m)	$8,446	$8,446	$8,446	$8,446	$8,446
Net equity ($m)	$7,829	$6,254	$5,204	$3,104	$2,054
51% proceeds ($m)	**$3,993**	**$3,190**	**$2,654**	**$1,583**	**$1,048**

Table 1 – RAB multiplier and related proceeds

Using the highest multiplier, the potential maximum value of Western Power is estimated at around $16.3bn. This estimate range outlined in the table is in line with the PriceWaterhouseCooper's reference to a valuation of between $12 and $16bn in their report on privatisation of the Western Australia electricity networks[8].

This however is a gross value and does not take into consideration liabilities held by Western Power, which as at 30 June 2016 amounted to $8.4bn, including $7.4bn in borrowings and an additional $617m owed in Tax equivalents (this is further discussed in 3.2 below) to the State Government.

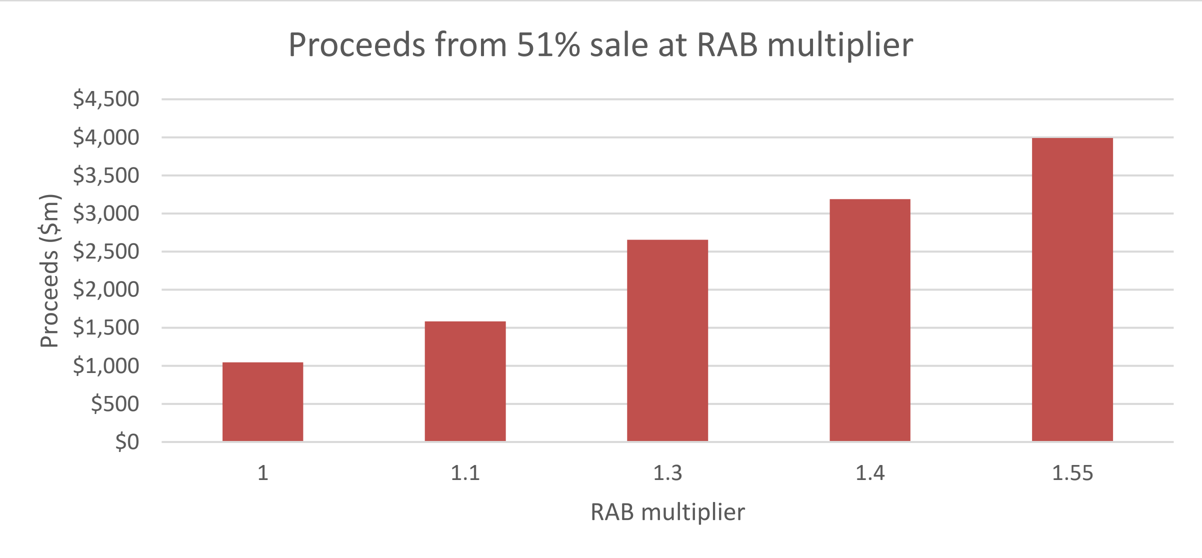

Figure 1 – Proceeds from 51% sale at RAB multiplier

Assuming no further increase in borrowings by WP during 2016-2017 financial year we estimate that the gross sale proceeds to the government would be between $1.0bn and $4.0bn depending on the RAB multiplier achieved in the float.

The government media statement does not identify an expected enterprise value from the sale, but states that of the sale of 51 per cent of its interest in WP, $8bn would be used to reduce state debt (presumably the debt in WP), and $3bn to set up a Next Generation Account. These figures imply an enterprise value of around $14bn. This implies a RAB multiplier of 1.33.

---

[7] http://www.afr.com/street-talk/lights-out-for-western-power-deal-20170213-gubom3?btis

[8] "The Case for Change – Privatisation of Western Australia's Electricity Networks", PWC, October 2016

3.1.2 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 the company's assets. However, listed utility companies are generally highly 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). At the time of preparing this report (early February 2017) the ASX is trading at a price/book value ratio of 1.50, while the utility sector a whole is trading at 1.28. The closest comparable public listed utility, AusNet Services, traded at 1.22[9] at the time of this report.

The following table indicates the estimated enterprise value of WP under differing Price/Book multiplier scenarios.

FY2016[10]			
Assets ($m)	$10,270		
Borrowings ($m)	$7,992		
Net Assets (Assets-Liabilities, $m)	$1,823		
Assets net of debt ($m)	$2,278		
Price/book ratio	1.5	1.3	1.1
Net Value at book ratio ($m)	**$2,735**	**$2,370**	**$2,005**
- 51% proceeds ($m)	$1,395	$1,209	$1,023

Table 2 –Proceeds at book ratio

The price/book methodology suggests that the potential net value of a 51% sale of WP is in the range of $1.0bn to $1.4bn as at 30 June 2016 financial year. This would equate to a RAB multiplier somewhere between 1.0 and 1.1 times the RAB, implying an estimated $11bn as indicative company value for 100% of WP.

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).

3.1.3 Other Sale Price Considerations

The government's expectations of around $14bn in the enterprise value of WP appear to be in line with the recent electricity privatisation experience in Australia, but higher than the current price/book ratios of the listed energy companies. The Australian Financial Review recently noted that *"the multiples of 1.4 times and 1.6 times for Ausgrid and Transgrid respectively resulted from trade sale processes which typically achieve a premium price compared to an IPO."*[11]. The AFR also noted recently that unlisted infrastructure investments have relatively higher values than listed infrastructure investments.[12]

---

9 AusNet Services Ltd ratio as of 7/02/2017.

10 Western Power Annual Report 2016, page 30

11 Thompson, Macdonald and Moullakis "Unpicking Colin Barnett's potential pay day for Western Power" Australian Financial Review 1/12/2016

12 Vesna Poljak "No respite for listed infrastructure valuations, which lag behind unlisted" Australian Financial Review 6/12/2016

One potential reason given for the lower valuations for listed infrastructure is the lack of a management control premium.

A 2013 study by RSM Bird Cameron on the Australian share market showed an average control premium of 35.5 per cent and a median of 29 percent from 2006 to 2012. It noted that sectors such as energy have higher premiums than other sectors.[13]

The recent Ausgrid partial privatisation to a consortium of Superannuation funds gave effective control of the (unlisted) company to the superannuation funds. Four of the seven company directors represent the superannuation funds, and the others are independent directors with electricity industry experience and not government representatives.

However, the proposed structure of the sale process greatly limits the potential for any private investor/s to have control of the listed entity. The proposed structure is to sell around 30 per cent of the company to Australian Superannuation Funds, and around 20 per cent to individual retail investors. The WA Government will be the largest shareholder with 49 per cent of the company. This makes it unlikely that the superannuation sector would pay a control premium.

Moreover, unlike the electricity companies in Victoria and New South Wales which are regulated by the national regulator, in WA the regulation is still conducted by the Economic Regulation Authority (ERA) which is appointed by the government. The government has planned to shift the regulation of the WA electricity sector to the national regulator, but it has not been able to get this legislation passed. Although the regulator's primary role is in setting the electricity prices that the regulated entities can charge, it also considers the appropriate cost benchmarks and capital investment which impacts working conditions for the employees. Despite the proposed change in regulator, the government's media release announcing the sale stated that *"It will be business as usual for workers at Western Power as strict employee protections will be outlined as part of the float process"*[14]*.*

Therefore, we consider that the likelihood of the sale proceeds to the state being $3bn seems optimistic. If the median control premium of 30 per cent identified by RSM Cameron Bird is discounted, the price achieved is more likely to be a RAB multiplier of 1.0, rather than the 1.33 assumed by the government. This would provide the government with gross proceeds of approximately $1bn rather than the announced $3bn. Section 4 below shows that the annual loss to the state from the planned privatisation is estimated at $276m per year. This means that the gross sale proceeds may only be equivalent to four to five years of budget cash flows.

A missing element from the announcement of the proposed sale is the transaction costs associated with the proposed float. The recent float of Medibank Private by the commonwealth government paid fees to financial and legal advisers of 0.6 percent of the float value. The Queensland government float of QR National cost 1.5 percent of the float value. In addition, broker fees of 1 per cent were paid for the retail investor sales under the Medibank Private float. Therefore, the net proceeds are likely to be reduced by $30 to 60 million (assuming there are no costs associated with allocating the government's 49 per cent shareholding).

[13] RSM Bird Cameron "Control Premium Study shows clear correlation between offer price in M&A transactions and 52 week share price high of a target company" 7 June 2013

[14] https://news.wa.gov.au/jobs-boost-from-part-sale-of-western-power/

	Government estimate	Conservative estimate
RAB multiplier	1.33	1.00
Float value	$6,000,000,000	$2,054,000,000
Sale proceeds (Investor share 51%)	**$3,060,000,000**	**$1,047,540,000**
Retail investors (20%)	$1,200,000,000	$410,800,000
Adviser fees (1.5% of investor share)	$45,900,000	$15,713,100
Brokerage (1.0% of retail investor)	$12,000,000	$4,108,000
Retail discount (7% on retail investors)	$84,000,000	$28,756,000
Total fees	**$141,900,000**	**$48,577,100**
Expected proceeds (net of fees)	**$2,918,100,000**	**$998,962,900**

Table 3 – Expected proceeds at RAB multipliers

The government's announcement also implies that the issue price to the superannuation funds and retail investors would be the same. However, all sharemarket floats of government businesses to date have given a discount to retail investors. The usual discount is in the range of 5 to 10 percent. The price for retail investors in the recent Medibank Private float was $2,00 compared with $2.15 for institutional investors, which is a discount of 7 per cent. This would further reduce the proceeds by $88m if the float was valued at the government's implied equity value of $6bn, or $29m if our estimate of around $2bn is achieved. The combined impact of the fees and retail discount would reduce the most optimistic estimate of net proceeds to under $3.0bn. On our estimates using a RAB multiplier of 1.0, and the fees charged for the float of QR National, the net proceeds to the government would only be just under $1bn.

The issue of effective control also raises complications for the state's consolidated financial statements. The Australian Accounting Standards require the consolidation of "controlled Entities" into their financial statements. The test for control is not based on the percentage ownership but on *the capacity of an entity to dominate decision- making, directly or indirectly, in relation to the financial and operating policies of another entity so as to enable that other entity to operate with it in achieving the objectives of the controlling entity.*

The Accounting standard AASB10 makes it clear that the test of being a controlled entity is not the ownership percentage, but the power of the investor (shareholder) to impact on the returns to the investor. As the government will be the largest voting shareholder and there will be "strict employee protections outlined in the sale process", there is a high likelihood that the government could be regarded to have power over the business and come within the provisions of AASB10. The media release does not specify what type of 'strict protections' will be in place. Up front, static protections such as guaranteeing current employee job security would be less problematic than an ongoing process where the government has a say in ongoing staffing levels. Therefore, the more employee protections the greater the likelihood that this will be a controlled entity.

With the government remaining as the largest shareholder and 20 percent of the shares dispersed though a large number of retail investors, coupled with the government appointed regulatory regime, it is possible that the state's Auditor-General could require the finances of WP to be consolidated into the state accounts.

Therefore, although the government has assumed that the proposed sale will take $8bn of debt off its books while providing $3bn of funds for a Next Generation Account, a much worse situation could emerge. The above analysis shows that the partial sale may only yield net proceeds of just under $1bn, while the $8bn debt may remain consolidated on the government's books if WP is deemed to be a controlled entity.

The government's proposed partial privatisation attempts to achieve two conflicting goals – maximise the sale proceeds and offload $8bn debt, while at the same time retaining a degree of control to ensure pricing, employment and Australian ownership are protected. But there is an inherent trade-off between these two objectives.

Recent discussions in South Australia around potential re-nationalising part of the electricity network[15] highlights the fact that privatisation isn't always in the long-term interest of the government. Section 606 of the *Corporations Act 2001,* puts some restrictions on the ability of the WA Government to gradually buy back shares of Western Power if required in the future. For the Government to regain 100% ownership of Western Power, a takeover bid would instead have to be offered to the existing shareholders. Takeover bids of profitable businesses generally attract a premium above the share price to provide an incentive to the shareholders from who the shares will be purchased. Therefore, if the Government at some point decides to bring Western Power back as a Government Owned Corporation, it would most likely have to pay a well above the net proceeds estimated to be received from the proposed privatisation.

3.2 Tax equivalent payment

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 shown in the audited financial statements of WP, the deferred income tax equivalent liabilities for Western Power were $763m as of 30 June 2016.

The Minister for Energy, Dr Mike Nahan has publicly stated *"Western Power has been and continues to be a cash flow negative drain on the state. It does not pay any tax equivalent payments to us, it never has in the 10 years it's existed"*[16].

If this statement is correct, it is a breach of section 5 of the *Western Australia State Enterprises (Commonwealth Tax Equivalents) Act 1996*, which states:

> ***5. Payment of amount in lieu of Commonwealth tax***
>
> > *(1) A State enterprise to which this section applies is to pay to the Treasurer a tax equivalent sum in respect of each financial year.*
> >
> > *(2) The tax equivalent sum is to equal the amount of any income tax or sales tax for which the enterprise would have been liable in respect of the financial year if the enterprise were not exempt from that tax under the relevant Commonwealth Act.*

The Australian Taxation Office's (ATO) "Manual for the National Tax Equivalent Regime" facilitated the establishment of the National Tax Equivalent Regime (NTER) and is to be applied to all State and Territory government-owned enterprises. The manual describes the requirements for late payment penalties and balancing payments on income tax equivalent liabilities, identical to those applied to other businesses subject to the Commonwealth tax regime. If no tax equivalents have been received for 10 years, substantial financial penalties should apply according to the manual.

The ATO manual was a direct result of the Competition Principles Agreement (11 April 1995), which was agreed on by the Australian Government and all state and territory governments to ensure that their publicly owned businesses did not enjoy any net competitive advantage simply because they are publicly owned. As per the agreement, the Western Australian Government released "Policy Statement On Competitive Neutrality" (June 1996) confirming its commitment to

[15] http://www.abc.net.au/news/2017-02-10/dramatic-intervention-needed-to-secure-sa-power/8257308
[16] https://www.businessnews.com.au/article/Network-sale-analysis-rubbish-Nahan

a tax equivalent scheme of all state-owned businesses. Tax equivalents should therefore in accordance with both the states own legislation as well as Commonwealth legislation be paid on a regular basis from Western Power to the State Government.

Essentially the State Government has four options in relation to the Tax Equivalent Payment it is owed by Western Power:

1) **Pay the debt from proceeds**

   The State Government has announced that sales proceeds from Western Power will be used to pay down debts of about $8bn[17], which is the approximate amount of borrowings and tax equivalents owed by WP. Therefore, this option is the most likely choice for if the current government remains after the state election.

2) **Instruct WP to pay the debt prior to sale**

   Instructing WP to pay the debt prior to sale would most likely require WP to take out another loan to pay for the tax equivalent liability. This option would therefore not achieve anything but shifting the debt from a tax liability to a borrowings liability, both of which lowers the net value of WP.

3) **Structure the sale to include the debt**

   The State Government could potentially also investigate an option to negotiate a transaction where the new entity keeps the debt and service it as required. This would require some extensive legal work to ensure the Competitive Neutrality Principles are not breached in the process as these require tax equivalent payments to be made from the government owned business rather than a private company.

4) **Waive the debt**

   The State Government could choose to waive the tax equivalent debt, as it essentially is a debt it owes to itself. However, by doing this the Competitive Neutrality Principles the Government committed to would be breached, as would the *Western Australia State Enterprises (Commonwealth Tax Equivalents) Act*. Furthermore, as electricity pricing includes the tax equivalent payments as a part of the calculation, waiving the payment would mean that consumers have paid a higher price than required in previous years.

The tax equivalents payable by Western Power to the State Government are listed as liabilities in the company's audited financial statements and is in accounting terms therefore regarded as a debt that is to be paid. The tax equivalents can therefore not be disregarded, but is a debt that needs to be repaid.

With borrowings worth $7,375m and tax equivalent liabilities of $763m the total outstanding liabilities to State Government controlled entities are around $8,138m. This is very close to what has been announced as being the amount of debt to be repaid from proceeds of the 51% sale. Therefore, it would appear the tax equivalent liability is intended to be repaid with sales proceeds.

3.3 Asset Recycling Initiative

The Federal Government created an Asset Recycling Fund on 1 July 2014 as a part of the Asset Recycling Initiative. The Asset Recycling Initiative provided an incentive of 15 per cent of the assessed sale value of the asset used to fund infrastructure to States and Territories when privatising assets and using the proceeds to fund infrastructure.

The development of the Asset Recycling incentive of 15 per cent was in response to calls from states for them to be able to retain the income tax equivalent payments of privatised assets,

[17] http://www.theaustralian.com.au/national-affairs/state-politics/wa-election/wa-election-colin-barnett-launches-his-electricity-privatisation-sales-pitch/news-story/b5e97876757560190ae2b410c4ffe84f

otherwise this would be a disincentive against privatisation and using the proceeds for building new assets (asset recycling). We understand that the Commonwealth Treasury found that it would be unmanageable to retain tax equivalent payments to the states after privatisation since the businesses are often combined with other tax paying businesses. Therefore, a one off 15% subsidy was proposed.

States and Territories had until 30 June 2016 to agree a payment schedule, after this data no further funding is offered by the federal government. It is also difficult to see how the WA government could argue that it should retain the recycling incentive when it was in lieu of tax equivalent payments which have never been made.

The Western Australian government is no longer eligible for the 15 percent incentive payment if Western Power is privatised. The incentive payment was most likely a part of the government's initial proceeds estimate, however as the funding is no longer available, this should not be considered in the proceeds calculations.

In the sale of Port of Melbourne, the Victorian State Government was expecting to collect the 15 percent incentive payment, but only received 9% due to failure of finalising the deal before 30 June 2016[18].

Under the asset recycling initiative, the proposed 51% sale of Western Power would at our highest valuation have generated an additional $1.2bn for the State Government to spend on infrastructure. As this scheme is no longer available, these additional proceeds can no longer be included in the estimate of the total value of a sale to the State Government.

3.4 Summary

There is a possibility the valuation of Western Power could be as high as $16bn, however it is important to stress that this is the gross value and does not take into consideration the $8bn 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 valuation of the entire business when comparing with the current market conditions for other similar utilities.

The unusual nature of the sale transaction makes it less likely for the sale proceeds to be at the maximum. Share market history shows that greater premiums are paid when there is effective control over the acquired business. However, the sale is being structured so that the maximum ownership by any shareholder initially would be around 30 per cent. This means that a premium for control is unlikely to be received.

The Western Australia government has estimated that the sale of 51% of WP would bring in $11bn in proceeds. The term proceeds can be misleading as large part of it includes the new entity refinancing the current $8bn, thereby reducing the State debt by $8bn. The actual proceeds from selling the net equity held in Western Power is according to our analysis more likely to be around $1.0bn according to both the RAB and the Price/Book valuation methodologies.

Although the government has assumed that the proposed sale will take $8bn of debt off its books while providing $3bn of funds for a Next Generation Account, a much worse outcome could emerge. The above analysis shows that the partial sale may only yield net proceeds of $999m, while the $8bn debt may remain consolidated on the government's books if WP is deemed to be a controlled entity.

[18] http://www.theage.com.au/victoria/port-of-melbourne-sale-hands-labor-a-97-billion-windfall-20160919-grjbfr.html

4 Budget Impacts

The Western Australian Government has stated that if re-elected they will proceed with the sale of 51% of WP to investors. While privatisation of the electricity assets will provide a short-term cash injection and reduction in State held borrowings, the flow-on long term impact on revenue streams received by the Government from the Government Owned Corporation (GOC) has not been outlined by the government and is not included in the Forward Estimates. This sections examines the estimated cost to the budget and whether this outweighs the one-off monetary benefits.

4.1 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 be able to receive tax equivalent payments, dividends or any other such payments from WP. A partial sale would still entitle the government to a 49% share of dividends, but it would lose the entitlement to tax equivalent payments as income tax would be payable to the Commonwealth rather than the State since WP would no longer considered a GOC. Similarly, the government would lose the loan guarantee fees.

After the release of our previous report, the Treasurer claimed that WP had never paid any TEP's to the government, and therefore these should not be included in the budgetary analysis. As noted in the previous section, this would breach of the competition policy agreements and WA legislation. The unpaid TEP obligations have accumulated in the WP Balance Sheet as liabilities.

These obligations should have been accrued as revenue in the government's accruals budget. The "Readers Guide" to the WA Budget, states that "*Revenues are recorded at the time they are earned, rather than the time at which payment is received, so revenue amounts in the Income Statement may differ from receipts from operating activities in the Statement of Cashflows.*"

After the partial privatisation WP will no longer have the luxury of not paying its tax liabilities to the Australian Taxation Office (ATO), therefore the following analysis and tables include the government's current annual entitlements to TEP's.

The following table shows the budgetary impact on the general government sector using an accrual budget approach, over the last 3 financial years.

Western Power to State Government ($'000)			
	2015/16	**2014/15**	**2013/14**
Loan guarantee fee[19]	$47,200	$40,800	$51,600
Tax equivalent[20]	$149,886	$147,406	$87,841
Dividend payments[21]	$400,988	$131,915	$124,395
Tariff equalisation fund[22]*	*$141,000*	*$136,000*	*$209,000*
Total Budget Impact	**$739,074**	**$456,121**	**$472,836**
***For benefit of Regional Power Corporation**			

Table 4 – Budget Impact from Western Power to State Government

As the sole owner of Western Power, the WA State Government currently is entitled to choose the level of dividends collected from profits made by WP. Dividends paid by WP amounted to

[19] Hansard Tuesday 14 June 2016, p3478b-3479a
[20] Western Power Annual Report 2016, page 40, note 6(b)
[21] Western Power Annual Report 2016, page 67, note 22(b)
[22] Western Power Annual Report 2016, page 37, note 5(c)(ii)

$226.6m for 2015/16, plus another $174.3m in special and interim dividends, taking the total dividend to $401m. This apparent large increase in dividends is mainly due to the introduction of an interim dividend and the timing of the payment of these. Following the end of the 2016 reporting period, the dividends paid by WP in relation to the 2016 financial year were proposed to increase from $226.6m to $270.5m, subject to the Minister's approval[23].

Western Power reported borrowing costs of $324m during the 2016 financial year. While it is not specifically identified that the payment is made to Western Australia Treasury Corporations (WATC), we have assumed that WATC is the primary lender and the receiver of the payments.

($'000)	2015/16	2014/15	2013/14
Loan guarantee fee	$47,200	$40,800	$51,600
Loan repayment	$276,804	$274,724	$270,992
Borrowing costs[24]	**$324,004**	**$315,524**	**$322,592**

Table 5 – Western Power itemised borrowing costs

Under the National Competition Policy (NCP) State owned corporations are required to pay the equivalent of commercial rates of interest on borrowings. To reflect the difference in borrowing costs under the State's credit rating versus the business's credit rating, a loan guarantee fee is paid from the business to the State guaranteed lender (WATC). This is often referred to as a Competitive Neutrality Payment (CNP) and is applicable in WA. Because WATC is not a part of the general government sector, the loan guarantee fee does not appear in budget papers and is therefore difficult to identify, but forms part of the total borrowing costs paid to WATC. Hansard documents identifies that the loan guarantee fee for 2015/16 was $47.2m, and that this is forecast to increase to $52.6m for 2016/17. Privatising WP would see the loss of the loan guarantee fee to WATC, as the loans would be shifted to a commercial lender.

The payments made to the Tariff Equalisation Fund (TEF) do not go directly to the State Government but are used to ensure equal charge between urban and rural areas. The TEF is currently funded by the consumers through the electricity prices, and in turn passed on from WP to the State Government. If WP did not make this payment, the State Government would make the payment as a Community Service Obligation from general revenue. The decision to have levy a charge on consumers to fund the TEF is therefore benefiting the State Government as they do not have to use moneys from general revenue to fund the payment.

The Productivity Commission (PC) is currently reviewing the Telecommunications Universal Service Obligation[25] which is similar to the WA Tariff Equalisation Payments in that it is a levy created to benefit a group of consumers that would otherwise not be able to afford the services. The PC identified two funding approaches for review; an industry levy and funding through general government revenue. The PC's draft findings are in favour of funding from general government revenue over an industry levy. WA is currently applying the industry levy approach, by having WP consumers cross-subsidising the Horizon Power consumers through higher charges. Choosing not to fund from general government revenue is therefore a benefit to the State Government and improves its budget position.

In total, the Western Power 2015/16 financial statements indicates that just around $740m in payments were transferred either directly to the State Government or state controlled entities from WP, as illustrated in Table 4 above.

---

[23] Western Power Annual Report 2016, page 67, Note 22

[24] Western Power Annual Report 2016, page 39, Note 5 (d)(ii)

[25] http://www.pc.gov.au/inquiries/current/telecommunications#report

4.2 State Government Contributions to WP

The State Government also has outgoing payments in relation to the operation of Western Power. The outgoing payments identified are borrowing costs and equity contribution.

State Government payments ($'000)			
	2015/16	**2014/15**	**2013/14**
Equity contribution[26]	$201,701	$92,936	$74,862
Total payments from Govt	**$201,701**	**$408,460**	**$397,454**

Table 6 – State Government payments to Western Power

In the 2016 financial year, the State Government had outwards payments relating to the operation of Western Power totalling $201.7m. 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[27].

While this is a payment from the State Government to WP, the equity contribution is treated as increased equity in business which adds to the value of Western Power. This payment to Western Power is therefore not actually an expense to the Government.

4.3 Budget Impact Summary

Total dividends received during the 2015/16 financial year amounted to $401.0m, however $174.3m of the dividends received by the State Government were in addition to the annual dividends and were excluded for the purpose of this exercise. An increase to the final dividend of $43.9m was also proposed, taking the final dividend paid to the State Government to around $270.5m. A $86.9m adjustment to the contributed equity was also made as this related to the newly introduced interim dividend and should not be considered when estimating annual benefits received in subsequent years.

Net Dividends ($'000)	**2015/16**	**49% ownership**
Dividend payments	$400,988	
- One off dividends (special and Interim)	*-174,349*	
+ Final dividend increase[28]	43,867	
- Equity contributions	-$201,701	
+ interim dividend equity contribution	$86,900	
Net dividends	**$155,705**	**$76,295**

Table 7 – Net Dividends

As this analysis is concentrating on transactions between WP and the State Government, the equity contributions made to WP have been subtracted when estimating the net benefits. These contributions are in relation to developer and customer contributions to the network and in reality, these contributions increase the value of WP by an equal amount, benefitting the State Government by increasing the value of WP. The calculated estimate of net benefit therefore is likely to understate the actual 2015/16 benefit to State Government of owning WP.

Under the current pricing arrangements, the State Government makes equity contributions to WP equal to the dividend payment attributable to capital contributions. If WP is privatised, equity contributions would no longer be required from the State Government, instead the allowable

[26] Western Power Annual Report 2016, page 66, note 20
[27] Western Power Annual Report 2016, page 66, Note 20
[28] Western Power Annual Report 2016, page 67, Note 22

return on assets would consider capital contributions, thereby lowering the dividends received by the owners by an equal amount to the current equity contributions. The 2015/16 net dividends can therefore be used as a proxy for the dividends to be distributed under the privatisation option.

One of the unknowns of the privatisation is the dividend policy to be adopted by the owners. The current dividend payable by WP is calculated at 65% of net profits after tax, but this could change under new ownership. Our estimates are based on the current 65% dividend payout.

($'000)	2015/16	49% ownership	Difference
Loan guarantee fee	$47,200	$0	-$47,200
Income Tax equivalent	$149,886	$0	-$149,886
Net dividends	**$155,705**	**$76,295**	**-$79,410**
Tariff equalisation fund	*$141,000*	*$141,000*	$0
Net Budget Impact	**$493,791**	**$217,295**	**-$276,496**

Table 8 – Net budget impact, current and 51% sale outcomes

The net benefit to the State Government from the ownership of Western Power for the 2016 financial year was $493.8m. It is estimated that the net annual benefit realised by the Government post privatisation would be around $217m. However, if a loan conversion loss is realised (as occurred during the privatisation of Ausgrid, which is the model for the treatment of debt in the proposed partial privatisation), no dividends may be payable in the first year of privatisation.

After the proposed floatation and partial sale of Western Power, the State Government will no longer be entitled to tax equivalents. All taxes will need to be paid to the Commonwealth through corporate taxes. Similarly, the loan guarantee fee paid will no longer be payable to the State Government, but will be collected by commercial banking sector through higher interest rates.

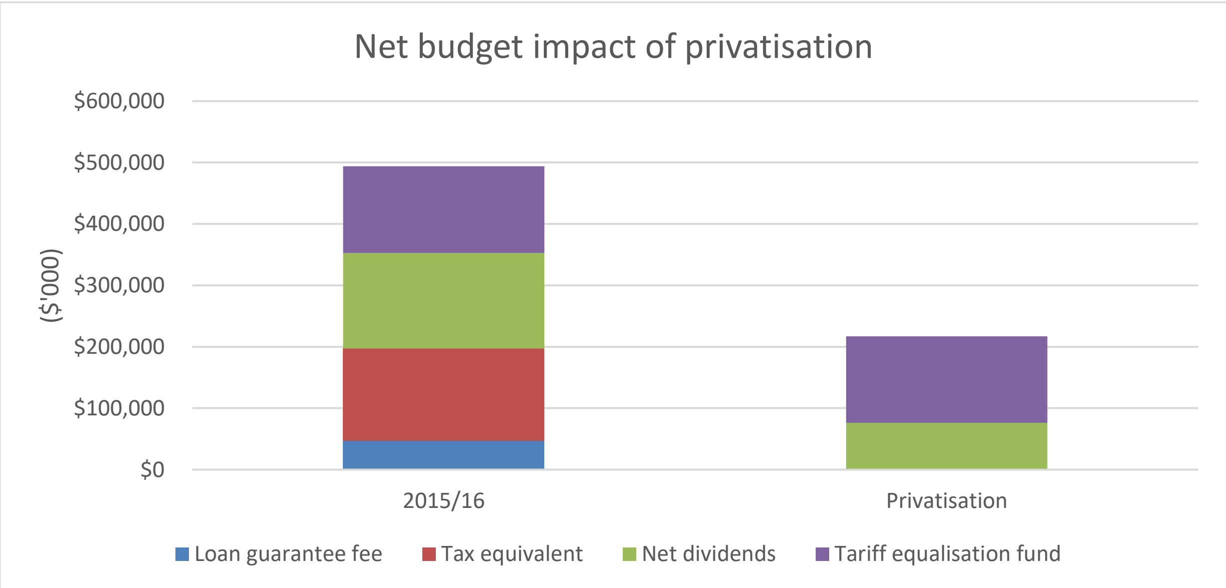

Figure 2 – Net budget impact of privatisation

The annual budget benefit to the State Government from retaining 49% ownership in Western Power, is estimated to reduce to $217.3m, including $141.0m in tariff equalisation funding. **In**

total the State Government will be $276.5m per annum worse off under the proposed privatisation. The above figures are based on 2015/16 actual figures, and does not take into consideration future revenue increases which would increase the negative budget impact under the partial privatisation scenario.

4.3.1 Government budget impact

The WA Department of Treasury have released their "Pre-election Financial Project Statement" which projects governments financials to 2019-20[29]. According their data, the total public sector deficit was $2,559m in 2015-16, and is predicted to increase to $3,462 in 2016-17.

($m)	2015-16	2016-17	2017-18	2018-19	2019-20
Total public sector net operating balance	-$2,559	-$3,462	-$1,824	-$1,146	-$746
Loss from privatisation of WP	-$276	-$290	-$298	-$305	-$313
Net operating balance	**-$2,835**	**-$3,752**	**-$2,122**	**-$1,451**	**-$1,059**
Increase in total public sector deficit	10.8%	8.4%	16.3%	26.6%	41.9%

Table 9 – Public Sector operating balance impact

The loss from privatisation of WP in the above table is using a simple assumption of 2.5% annual increase (long term CPI) in revenue loss from the privatisation of WP. Based on historical data, the growth rate is could be larger as tax equivalent obligations have increased 71% ($87.8m to $149.9m) over the past three years while dividends have increased 117% ($124.4m to 270.5m). However, to maintain our conservative approach, an increase of only 2.5% has been assumed for future years.

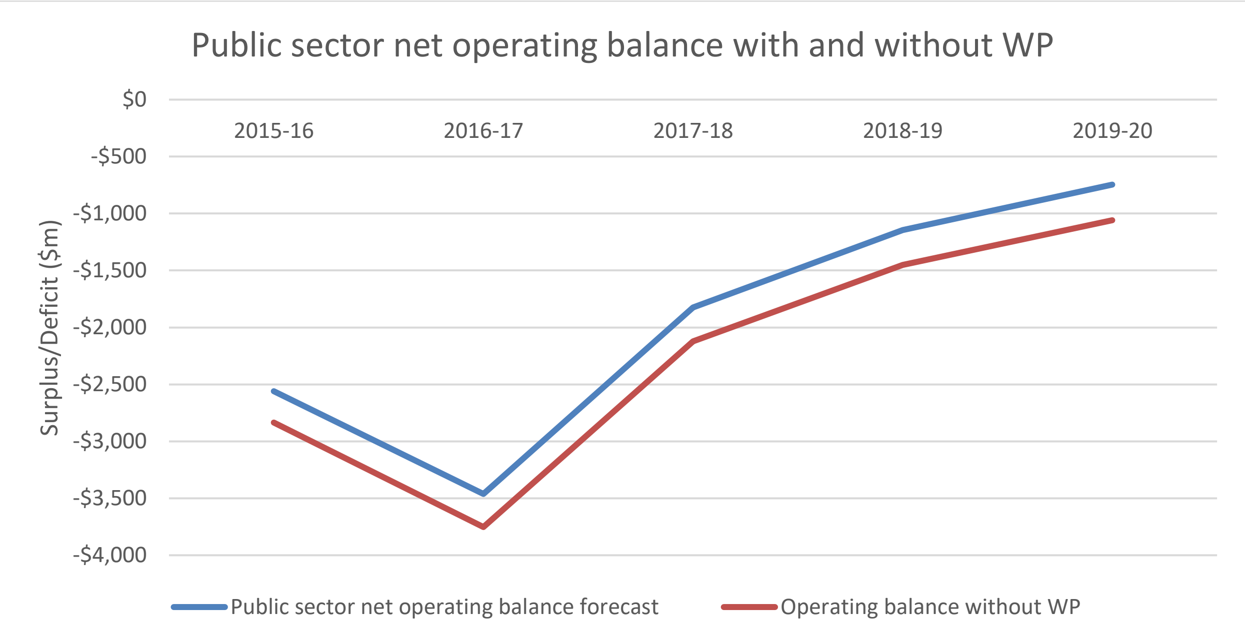

Figure 3 – Public sector net operating balance with and without Western Power

Had WP been privatised during 2015-16, the public sector deficit would have increased by 10.8%. The budget loss from the proposed partial privatisation is estimated to increase the forecast budget deficit by 16.3% in 2017-18, rising to 41.9% in 2019-20. As the operating balance is

[29] http://www.treasury.wa.gov.au/StateFinances/

projected to improve over the projection period, the percentage impact of the privatisation of WP on the public sector deficit becomes larger.

The rating agencies have raised serious concerns about the WA Government forecast deficit, and not just the gross level of debt. The increased budget deficit from the loss of net income from WP can only worsen the outlook.

In section 3 we outlined that the partial privatisation may only yield $999m to the government due to the lack of a management control premium being offered to the market, and likely transaction costs. If this estimate proves to be correct, it will take less than 4 years before the budgetary costs from the partial privatisation exceeds the privatisation proceeds

5 Tariff Equalisation Fund

The state-owned electricity sector has complex financial arrangements and are subject to the national competition policy, requiring them to pay dividends and tax equivalents to the state budget. Much of the state's debt is within these GOC's, and the debt is serviced from the GOCs revenue. Western Power is responsible for the transmission and distribution of electricity in the more urbanised areas of Perth and the south-west corner of Western Australia, while Horizon Power manages all parts of the supply chain (generation, distribution and retail) urban distributor. Both are owned by the Western Australian Government.

The vast remoteness of the Horizon Power network means that significant infrastructure is required to service customers, resulting in a higher cost per connection than the urban networks.

2015-16	Western Power[30]	Horizon Power[31]
Approximate cost per connection	$966	$9,305

Table 10 – Cost per connection

To ensure price parity for the more remote Horizon Power customers, contributions are made from Western Power to the Tariff Equalisation Fund. These funds are then released to Horizon Power (in accordance with the determination by the WA Treasurer) to reduce the required revenue raised through residential and small business tariffs, thereby ensuring that residential and small business customers of Horizon Power are charged the same tariff as they would in the Western Power network.

5.1 Horizon Power Customer Impact

5.1.1 Outline

The purpose of the Tariff Equalisation Fund (TEF) is to ensure that all residential and small business customers in Western Australia are charged the same electricity tariffs. The TEF is currently funded by the consumers through a levy on the electricity prices, which is turn passed on from WP to the State Government's Tariff Equalisation Fund and on to Horizon Power (HP). If the levy was to be abandoned to ease the cost pressure on the consumers in the Western Power area, would have to make a payment as a Community Service Obligation (CSO) 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.

A large share of Horizon Power's revenue (2015/16: 29%) originates from the Tariff Equalisation Fund, without which HP would have incurred a significant loss before income tax equivalent ($90m) for the 2016 Financial Year (FY). HP is therefore reliant on the TEF revenue stream to remain financially sustainable.

	FY2016
HP Tariff Equalisation Fund Revenue[32]	$141,000,000
HP profit before income tax equivalent	$51,485,000
Implied loss without TEF, before income tax eq.	-$89,515,000
Horizon Power Customers[33]	47,168

[30] Western Power Annual report 2015/16, p75
[31](Total Expenses/customers), Financial Report 2015/16 page 2 and Horizon Power Annual Report 2015/16, page 2
[32] Horizon Power Financial Report 2015/16, p.12
[33] Horizon Power Annual Report 2015/16, p.4

TEF subsidy per customer	$2,989

Table 11 – Tariff Equalisation Fund

Horizon Power received $141m in Tariff Equalisation Contribution from the TEF during FY2016 (FY2015: $136m) and reported having 47,168 customers at the end of FY2016. The TEF payment received therefore represents around $2,989 per customer serviced by the HP network.

	FY2016
Total power purchased/generated (kWh)[34]	1,020,161,400
'Cost to Supply Unit Cost (cents/kWh)'[35] (variable operating cost)	27.9
Total unit cost (cent/kWh)	43.0
Revenue per kWh generated/purchased (cents/kWh)	48.1

Table 12 – Cost and revenue per kWh

Total power purchased and generated by Horizon Power during FY2016 amounted to just over 1bn kWh. The cost of supplying the electricity was reported to be 27.9 cents/kWh. From our analysis, it would appear this figure on relates to variable operating costs incurred and does not include the capital related costs of depreciation or finance costs. When including depreciation and finance cost for FY2016, the total unit cost is approximately 43.0 cents/kWh. The total revenue collected by HP equates to around 48.1 cents/kWh.

5.1.2 TEF discontinuation

If Western Power is privatised and the legislation is not amended to reflect the new ownership, it could potentially result in HP having to raise additional revenue from customers equivalent to the shortfall in TEF revenue to stay solvent.

The same would be the case if the State Government decides to ease the cost pressure on the WP consumers by discontinuing the electricity levy paid by consumers and not provide a CSO to HP.

In 2016, the TEF payment of $141m equated to a subsidy of roughly 13.8 cents per kWh purchased and generated by HP.

	FY2016
Revenue without TEF, per kWh generated/purchased (cents/kWh)	34.2
+ Implied required revenue increase per kWh purchased/generated (cents/kWh)	13.8
= Total Revenue per kWh generated/purchased (cents/kWh)	48.1
Revenue increase requirement	40.4%

Table 13 – TEF removal with current profit target

A discontinuation of the TEF would likely result in HP having to recover the lost revenue from its customers by increasing its retail prices. Our calculations show that, all else being equal, discontinuing the TEF revenue stream to HP will mean an increase in required tariff revenue of around 13.8 cents/kWh, an increase of 40.4% compared with the current revenue collected

[34] Horizon Power Annual Report 2015/16, p.18
[35] Horizon Power Annual Report 2015/16, p.14

through tariffs. Such an increase would maintain their current HP profit level. It should be noted that historically HP has retained all profits as retained earnings rather than paying dividends to the State. These retained earnings are used to fund some of the capital program and thereby reducing the amount which needs to be borrowed.

5.1.3 No Profit or TEF

Horizon Power reported a profit before income tax equivalent of $51.5m. Assuming a zero-profit target and no TEF revenue, the increase in revenue required is around $90m for 2016. This is roughly similar to the planned savings outlined by Horizon Power in their Statement of Corporate Intent 15/16, which estimates a reduction in the required subsidy by $100m per annum by 2017/18, up from current $67.8m savings[36].

	FY2016
Tariff Equalisation Fund Revenue	$141,000,000
Profit before income tax equivalent	$51,485,000
Zero profit, Implied required additional revenue	$89,515,000
Revenue without TEF (cent/kWh)	34.2
+ Additional revenue required for break-even per kWh purchased/generated (cents/kWh)	8.77
= Break-even revenue (cents/kWh)	43.0
Break-even unit cost increase	25.6%

Table 14 – TEF removal with reduced revenue requirement

To ensure a break-even situation where no TEF revenue is received by HP, an additional revenue of around $90m would be required (2016 figures). To achieve this, an increase of around 8.77 cents per kWh generated or purchased would be required. This represents an increase of 25.6% compared to the current revenue collected.

The revenue required to be raised by Horizon Power from a household with a consumption of 6,000 kWh per year would therefore increase from $2,052 to $2,580 if TEF was discontinued and a zero-profit approach was adopted. The majority of the increase in required revenue would presumably be recovered directly from the customer through increases to the consumption charge (tariffs), while a portion would be spread across a broader base through increases to access charges for all customer groups.

The annual surpluses generated by Horizon Power are largely retained within the organisation as retained earnings. If the annual profits are reduced in the future, HP will have to use borrowings as the main funding mechanism for capital expenditure, resulting in increasing interest cost and an increased incentive to reduce ongoing asset maintenance and replacements.

5.2 Conclusion

Privatisation of Western Power could have a significant impact on the financial sustainability of Horizon Power unless the Tariff Equalisation Fund contributions are legislated to also be met by the new owner of Western Power, or the State Government chooses to fund the revenue shortfall out of general revenue as a Community Service Obligation.

Based on the 2015/16 financial statements, privatisation of Western Power and the discontinuation of the TEF revenue stream would result in an increase in the revenue requirement of Horizon Power of between 25.6% and 40.4%. This increase in revenue requirement would

[36] Statement of Corporate Intent 15/16, Horizon Power, p.4

have to be funded either by significant increases in Horizon Power's tariffs, the new owners of Western Power or the State Government.

6 Summary

Privatising Government Owned Corporations is not a straight-forward process and have in some cases resulted in unexpected additional losses in regards to debt refinancing, or less than expected funding from other levels of Governments.

The Western Australian Government is expecting to receive approximately $11bn in 'proceeds' from selling 51% of Western Power to investors. The Government figure includes about $8bn worth of debt refinancing and $3.0bn of actual proceeds from sale of equity in Western Power, under the assumption of a RAB multiplier of around 1.33.

The unusual nature of the sale transaction makes it less likely for the sale proceeds to be at the maximum. Share market history shows that greater premiums are paid when there is effective control over the acquired business. However, the sale is being structured so that the maximum ownership by any shareholder initially would be around 30 per cent. This means that a premium for control is unlikely to be received.

The proposed privatisation of Western Power, will see the government remaining the largest shareholder. This coupled with a government appointed regulatory regime, could in our opinion result in the state's Auditor-General requiring the finances of WP to be consolidated into the state accounts as a controlled entity under the Australian accounting standards. In such an instance, the government's portion of the $8bn debt held by Western Power will remain on the state accounts after the privatisation.

We have used two separate valuation methodologies in our conservative assessment of the net proceeds from the partial privatisation of Western Power. Our estimates both indicate expected net proceeds of around $1bn to the Government from selling 51% of Western Power, assuming a book/price value of 1.1 and a RAB multiplier of 1.0.

The total 2015/16 net benefit to the State Government from its ownership of WP was $493.8m. This is a conservative estimate and doesn't include the increased equity share in WP due to Government equity contributions, or any future increase to revenue. If the State Government was to isolate the identified benefits, it would only take around 2 year to reach the same monetary amount as the estimated sales proceeds will bring, while still maintaining full ownership of Western Power. Excluding Tariff Equivalent Payments, it would take between around 3 years, while using the Governments proceeds estimate of $3.0bn, it would take about 6 years.

The net budgetary cost from the partial privatisation of Western Power is estimated to be around $276.5m per annum, as only half of net dividends are received and both the loan guarantee fee and tax equivalent payments are no longer payable to the State Government. In addition, privatising Western Power will also mean the State Government will lose the power to determine the level of dividends payable, with larger share of profits likely to be held as retained earnings. If this estimated budgetary costs proves to be correct, it will take less than 4 years before the budgetary costs from the partial privatisation exceeds the estimate privatisation proceeds of $1bn.

The interest in privatising Western Power seems to be driven by a desire from the State Government to reduce the amount of headline debt currently held by the Government. While the level of debt held is one issue to consider, the servicing of that debt also need to be considered. The interest on debt held in relation to Western Power is currently fully serviced by Western Power through the tariff determinations. Holding the debt therefore does not cost the Government's budget anything.

The concern of holding a high level of debt might be out of fear it will impact the State's credit ratings, this is however not the reasons the rating agencies have provided when reviewing the State finances. On 8 February 2016, the WA credit rating was downgraded by Moody's to AA2[37],

[37] http://www.abc.net.au/news/2016-02-08/moodys-downgrades-wa-credit-rating-aa1/7149196

with the main concern highlighted by Moody’s being in relation to the State Government spending rate and increasing deficits. Similar concerns were raised by Standard and Poor's in recently giving a “negative” outlook for the State credit rating. Selling a cash generating business will not improve these metrics and could result in larger deficits in future years.

Privatisation and long term lease of Government Owned Corporations has been a controversial topic the last few years as a privatisation agenda has been championed at all levels of Government. In some cases, such privatisations will benefit the community and makes economic sense. The case for Western Power however is less clear and seems to not be in the public interest.

Tax equivalents are currently not being paid from Western Power to the State Government, this is a breach of the States own policies, the Competitive Neutrality Principles and State and Commonwealth legislation. Regardless of whether the privatisation goes ahead, the missing tax equivalent payments from Western Power should be investigated further as these are meant to benefit the State Budget and therefore all Western Australia residents.