AUDITOR-GENERAL'S REPORT

The Legislative Assembly
Parliament House
Sydney NSW 2000

The Legislative Council
Parliament House
Sydney NSW 2000

Pursuant to section 63G of the *Public Finance and Audit Act 1983,* I present a report titled **Oversight of Electricity Industry Restructuring.**

Peter Achterstraat
Auditor-General

August 2008

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Oversight of
Electricity Industry Restructuring

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Oversight of Electricity Industry Restructuring

I have prepared this Report to Parliament as required by section 63G and Schedule 1A of the *Public Finance and Audit Act 1983,* on certain matters relating to the Government's overall program for the authorised electricity industry restructuring.

1. CONCLUSIONS

- Based on my review, which is not an audit, apart from the key matters for consideration below, nothing has come to my attention that causes me to believe that the Government's strategy for the transfer of assets to the private sector as set out in the Strategy Document supplied by the Treasurer is not appropriate for maximising financial value for taxpayers.
- Based on information provided by Treasury, the planned measures for the proposed employee protections are generally consistent with other privatisations and Government restructures, except for the employment guarantees. A five year employment guarantee for certain Generator employees exceeds such guarantees in previous privatisations and restructures, which were for three years or less.
- Based on the information provided for my review, the nature of the protections proposed for customers in New South Wales appear broadly consistent with those in other jurisdictions.

2. KEY OBSERVATION

In the electricity sector, there are often a number of ways of executing a restructuring that are equally valid that set out to achieve the same objectives. However, there is often the potential for conflicts to emerge in fully achieving these objectives. For example, the New South Wales Government's strategy is designed to maximise employment opportunities and offer employee/consumer protection packages while achieving a reasonable financial return to the Government.

3. KEY MATTERS FOR CONSIDERATION

I suggest that after the passing of enabling legislation and Treasury and its advisers conducting a marketing effort further consideration be given to the following, which in my view could enhance the strategy:

- encouraging new entrants and new investment to promote competition in electricity generation and retail markets by:
    - using simultaneous rather than sequential Generator/Retailer transactions
    - holding separate tender(s) for a generation development site(s)
- calculating a Retention Value for each Generator and Retailer using consistent assumptions prior to commencing each transaction
- documenting contingency plans prior to commencing the first transaction which *inter alia* include the setting of a reserve price for each transaction and considerations if the reserve price is not achieved.
- Treasury continuously evaluating:
    - the restructuring process after the marketing effort and before the first transaction, and
    - the likelihood of the success of subsequent transactions and whether contingency plans require executing.

Details on the above are in sections 5 and 6 of this Report.

Implementation of the key matters for consideration, if adopted, need not delay the timing of the planned restructure. Indeed, it is in the interests of investor confidence and bearing in mind the long lead times for developers to physically obtain generation equipment, that any uncertainty relating to the proposed restructure should be removed as soon as possible.

4. BACKGROUND TO REPORT

This Report stems from the amendment to the *Public Finance and Audit Act 1983* passed in June 2008 inserting section 63G and Schedule 1A regarding oversight of the electricity industry restructuring, requiring the Auditor-General to report to Parliament on certain matters relating to the Government's overall program for the authorised restructuring.

Schedule 1A reads:

Oversight of electricity restructuring

1 Review of Government's overall program for restructuring

(1) The Auditor-General is to review and report to Parliament on the Government's overall program for the authorised restructuring.

(2) The review is to be a review of the following:

- *(a) the appropriateness of the Government's strategy for the transfer of assets to the private sector for maximising financial value for taxpayers, taking into account the following:*
    - *(i) the proposed method of effecting transactions,*
    - *(ii) the proposed timing of transactions, including the impact of external factors,*
    - *(iii) any contingent liabilities that will accrue to the State,*
    - *(iv) the impact of the proposed national emissions trading scheme (including current hedging and coal contracts of State electricity corporations),*
    - *(v) the sale price of the assets that is reasonably expected having regard to professional advice and the Government's preliminary estimates,*
    - *(vi) the impact of increased debt over the past 5 years in relation to the assets,*
    - *(vii) any relevant Commonwealth legislation regarding competition or foreign ownership,*
    - *(viii) any other factors that may impact on the potential sale price of the assets,*
- *(b) the financial impact of the proposed community safety net proposed for the authorised restructuring, in particular the protections for workers, pensioners and low-income earners, including an assessment of the consistency of those benefits with previous transactions involving the transfer of assets to the private sector.*

(3) The review of the appropriateness of the Government's strategy for the transfer of assets to the private sector is to be conducted on the basis of a statement of that strategy as provided to the Auditor-General by the Treasurer for the purposes of the review.

2 Report to Parliament

(1) The Auditor-General is to report to each House of Parliament on the results of the review conducted by the Auditor-General under this Schedule as soon as practicable after the review is completed.

(2) If a House of Parliament is not sitting when the Auditor-General seeks to present the report, the Auditor-General is to present the report to the Clerk of the House concerned.

3 Supplementary powers

(1) The Treasurer is to ensure that the Auditor-General has access to such information and resources as may be necessary to enable the Auditor-General to exercise the functions conferred by this Schedule.

(2) For the purposes of this Schedule, the Auditor-General may:

(a) exercise investigatory powers conferred on the Auditor-General under this Act, and

(b) engage any person or body with financial expertise to examine arrangements made or proposed for the purposes of the authorised restructuring and to advise the Auditor-General on those arrangements.

(3) The functions conferred by this Schedule are in addition to, and do not derogate from, any other function of the Auditor-General.

Selection of Advisers

Because of the nature and timing of the review, it could only be undertaken with the assistance of advisers. I appointed a team from Lexicon Partners to advise me.

The advisers were appointed through a selection process from a number of advisory firms and financial advisers invited to propose. The process revealed that some of these firms were unable to propose due to conflicts or potential conflicts of interest.

Lexicon Partners were selected, principally because of their experience with the international electricity industry, especially in Asia and Europe, and with the restructuring of the British, Polish, Portuguese and Hungarian electricity sectors.

The appointment of these advisers allowed this review confidently to test the assumptions and attestations of the Government and its advisers.

Exclusion of Confidential Material

My Report, based on Lexicon Partners' report to me and my Office's work, excludes certain information I consider commercially sensitive. Excluding this information was made only after careful thought, and to preserve the competitive tension in the market and to avoid reducing the value the Government is seeking to obtain from the restructure.

Acknowledgements

The preparation of this Report critically depended on the co-operation of my advisers (Lexicon Partners) and the Government's advisers (Treasury, Credit Suisse and Lazard Carnegie Wylie). Their willingness to help was greatly appreciated.

Reliance on this Report

Finally, this Report has been prepared for the benefit of Parliament and my views and findings have been formed in this light. While the New South Wales Parliament can rely on the findings and conclusions in this Report, they are not intended to provide any comfort to other parties. Parties in the private sector, including those ultimately associated with the restructure process are expected to undertake their own examinations, and in any event, should not place any reliance that this Report addresses their interests or concerns.

5. DETAILED FINDINGS

Strategy Document

The Strategy Document supplied by the Treasurer of New South Wales for my review sets out a recommended transaction strategy for leasing the State-owned Generators and transferring the retail functions of the electricity distributors to the private sector to secure New South Wales' energy supply.

The Strategy Document states that the Government's objectives for the Project, approved by Cabinet in December 2007, are to:

- optimise the conditions to ensure private sector investment in generation capacity in New South Wales that is adequate, economic and timely
- ensure a reliable, safe and least cost supply of power for New South Wales customers
- ensure the fair and equitable treatment of Government employees and maximise employment opportunities for employees of the State-owned electricity retail and generation businesses
- maintain and, where feasible and warranted, promote competition in the electricity generation and retail markets
- minimise ongoing financial risks and liabilities for the State
- achieve a reasonable financial return for the State from the State-owned electricity retailing activities and generation businesses, and
- complete the Project efficiently and in accordance with appropriate probity and accountability standards.

Table 1 - State-Owned Businesses

Retailers	Generators
EnergyAustralia	Macquarie Generation
Integral Energy	Delta Electricity
Country Energy	Eraring Energy

The strategy is planned to be implemented through sequential trade sale/lease transactions of Retailers and Generators followed by a public share offering of a combined Retailer/Generator. The Strategy Document provides for flexibility to refine the strategy after the first two transactions occur. However, the Treasury has since advised that following the passing of enabling legislation, a marketing effort to interact with local and international potential investors will be undertaken, and the additional insights obtained through this process will be used to inform and refine the strategy prior to the first transaction. The Treasurer in his media release of 25 June 2008 advised that the final timing and sequence of these transactions would be decided on the recommendation of the State's expert financial advisers and on prevailing market conditions.

Appropriateness of the Government's Strategy

Clause 1(2)(a) of Schedule 1A of the *Public Finance and Audit Act 1983* requires me to review the appropriateness of the Government's strategy for the transfer of assets to the private sector for maximising financial value for taxpayers. I am not commenting on the merits of transferring electricity assets to the private sector. My role is to review the Strategy Document that has been developed to give effect to any such transfer.

I have interpreted *maximising financial value for taxpayers* to include:

- optimising proceeds
- encouraging new investment in the New South Wales electricity sector by the private sector
- producing an industry structure that will promote competition in the New South Wales electricity sector encouraging least cost supply of power to consumers, and
- minimising the ongoing financial risks and liabilities for the State.

These components need to be considered in total as it is possible to optimise proceeds but not achieve some or all of the other components.

Based on this definition and taking into account the matters listed in (i) to (viii) of clause 1(2)(a), I report as follows:

> Based on my review, which is not an audit, apart from the key matters for consideration below, nothing has come to my attention that causes me to believe that the Government's strategy for the transfer of assets to the private sector as set out in the Strategy Document supplied by the Treasurer is not appropriate for maximising financial value for taxpayers.

The strategy outlined is based on a number of assumptions and opinions of the Government's advisers, information provided to them by the management of the New South Wales State-owned electricity generation and retail businesses, as well as dialogue with a significant number of local and international potential investors.

In the electricity sector, there are often a number of ways of executing a restructuring that are equally valid that set out to achieve the same objectives.

Key Matters for Consideration

I suggest that after the passing of enabling legislation and after Treasury and its advisers have conducted a marketing effort further consideration be given to the following, which in my view could enhance the strategy:

- encouraging new entrants and new investment to promote competition in electricity generation and retail markets by:
  - using simultaneous rather than sequential Generator/Retailer transactions
  - holding separate tender(s) for a generation development site(s)
- calculating a Retention Value for each Generator and Retailer using consistent assumptions prior to commencing each transaction
- documenting contingency plans prior to commencing the first transaction which *inter alia* include the setting of a reserve price for each transaction and considerations if the reserve price is not achieved
- Treasury continuously evaluating:
  - the restructuring process after the marketing effort and before the first transaction, and
  - the likelihood of the success of subsequent transactions and whether contingency plans require executing.

Details on the above are in section 6, Analysis and Review.

Implementation of the key matters for consideration, if adopted, need not delay the timing of the planned restructure. Indeed, it is in the interests of investor confidence and bearing in mind the long lead times for developers to physically obtain generation equipment, that any uncertainty relating to the proposed restructure should be removed as soon as possible.

Section 6 also discusses other proposals that may enhance the strategy and areas where further analysis may be necessary at the appropriate time. In my adviser's view they need not delay the start of the strategy. A summary of these proposals follows:

- further analysis could be undertaken on whether a two Retailer/Generator option could better meet the Government's objectives
- any proposals developed to facilitate the lease of Generators where there are delays in receiving clarity on ETS, should be subjected to detailed analysis and review to ensure the likelihood of the State retaining material unquantifiable risk is minimised
- close monitoring of plans for addressing coal security to ensure they are aligned with the timing of the Generator lease process.

Financial Impact of the proposed Community Safety Net

Clause 1 (2)(b) of Schedule 1A of the *Public Finance and Audit Act 1983* requires me to review the financial impact of the proposed community safety net proposed for the authorised restructuring, in particular the protections for workers, pensioners and low-income earners, including an assessment of the consistency of those benefits with previous transactions involving the transfer of assets to the private sector.

Protections for Workers

The Government has proposed a series of measures to protect the rights of employees of the Generators and Retailers. These include:

- five year employment guarantees for Award and Agreement staff at Generators
- implementation of Transition Services Arrangements of up to three years for employees of Retailers and a choice to accept an offer from a new employer or remain with the network business
- transfer payments of up to 30 weeks pay
- existing superannuation entitlements maintained, and
- statutory leave and sick leave entitlements maintained.

The Treasury has estimated the cost to the Government of the above measures at $111 million. My Office reviewed the methodology and sources of data used in the calculation of this cost and noted this data is now approximately twelve months old. The estimate does not take into account the impact (either positive or negative) the protection measures may have on the bids that may be offered by potential bidders for the Retailers or Generators.

Based on information provided by Treasury, Table 5 in section 6 of my Report compares the employee protections proposed with those given in previous privatisations and Government restructures. The proposals are generally consistent except for the employment guarantees. The proposed five year guarantee for certain Generator employees exceeds similar guarantees in previous privatisations and restructures which were for three years or less.

Protections for Pensioners and Low-income Earners

The Government announced a series of protections for electricity customers to be delivered once the Government's energy plans are substantially in place:

- extending of retail price regulation until at least June 2013
- increasing pensioner energy rebates from $112 to $130 per annum, indexed to the movement in CPI
- extending energy rebates to include recipients of Sickness Allowance, Carer Allowance (child under 16) and those receiving the Special Benefits payment
- introducing a new 'no disconnections' policy for small domestic customers
- increasing the level of funding under the current Energy Accounts Payments Assistance Scheme
- strengthening the rules, codes and regulation relating to marketing, and
- retailer of last resort arrangements.

As outlined in Table 6 in section 6 of my report, the financial impact of the Government's measures is estimated by the Treasury at $272 million over five years (real 2008/09 excluding the CPI component on the pensioner rebate).

Individual State and Territory Governments currently have jurisdiction over consumer protection in the energy market resulting in a number of differences between their respective consumer protection frameworks. Treasury compared the consistency of the protections proposed with those currently offered in other Australian jurisdictions. Based on the information provided for my review, the protections proposed for customers in New South Wales appear broadly consistent with the other jurisdictions.

6. ANALYSIS AND REVIEW

The strategy detailed in the Strategy Document has been designed to achieve the Government's objectives.

Overall Conclusion

Based on my review, which is not an audit, apart from the key matters for consideration, nothing has come to my attention that causes me to believe that the Government's strategy for the transfer of assets to the private sector as set out in the Strategy Document supplied by the Treasurer is not appropriate for maximising financial value for taxpayers.

The strategy would benefit from an intensive marketing campaign targeted at local and international potential investors after the passing of any necessary enabling legislation.

My advisers, Lexicon Partners, concluded the strategy detailed in the Strategy Document was proposed after careful and comprehensive consideration by the Treasury and its advisers.

The Strategy Document has flexibility to allow for the strategy to be changed as necessary according to prevailing market conditions after the first two transactions. For example, a basic proposition of the Strategy Document that the public share offering will increase competitive tension appears to be sound. However, the Strategy Document has the flexibility to enable this proposition to be re-evaluated. The Treasury has since advised that following the passing of enabling legislation, a marketing effort to interact with local and international potential investors will be undertaken and the additional insights obtained through this process will be used to inform and refine the strategy prior to the first transaction.

Clause 1(2)(a) of Schedule 1A of the *Public Finance and Audit Act 1983* lists items (i) to (viii) that I was to take into account in my review. I have included observations and suggested considerations for each of the items within this section. Implementation of the key matters for consideration, if adopted, need not delay the timing of the planned restructure.

In considering the detailed analysis and review, readers will need to bear in mind the following comments from my advisers, Lexicon Partners:

- *The valuations indicated by the Treasury Advisers at this stage are likely to be preliminary in nature. There are a number of areas where we would expect that additional work would be undertaken through the process where these valuations will develop (that could lead to either an increase or decrease in valuation). This would not be unusual to expect at this stage of the Project;*
- *In our experience, public sector restructurings in the electricity sector usually involve satisfying a series of different inter-related objectives. However, there is often the potential for conflicts to emerge in fully achieving these objectives (e.g. encouraging new investment while seeking least cost supply of power; maximising employment opportunities and offering employee/consumer protection packages while achieving reasonable proceeds; minimising financial risks and contingent liabilities to the State while disposing of ageing assets which have had and will have an impact on the environment). It is important to recognise that public sector restructurings will often require compromise between objectives to achieve an overall outcome that benefits the State;*
- *Whilst we appreciate the general political reality of any public sector restructuring and the specific heightened political nature of the electricity sector given its fundamental contribution and impact on society, it is important for all parties to recognise that in our experience of similar situations:*
  - *In the electricity sector, there are often a number of ways of executing a restructuring that are equally valid that set out to achieve the same objectives; and*
  - *A restructuring of this nature is not legally binding until all conditions precedent to legally binding documentation are satisfied with counterparties and therefore all processes are subject to possible change and will have a degree of flexibility to be amended or altered in response to changing circumstances, often with minimal overall cost or impact on timetable.*

(i) Proposed Method of Effecting Transactions

Proposed Approach

The businesses being sold/leased are valuable assets and have never before been offered. As shown in Table 2, they provide an opportunity for a new entrant to acquire a significant presence in the New South Wales and Australian markets.

Table 2 - New South Wales Electricity Businesses Share of the National Electricity Market (NEM)

Business	Share of NEM Capacity %	Retail Market Share in NEM %
Macquarie Generation	13	n/a
Delta Electricity	11	n/a
Eraring Energy	6	n/a
EnergyAustralia	n/a	15
Integral Energy	n/a	9
Country Energy	n/a	9
	30	**33**

Source: Strategy Document – Frontier Economics.
n/a: not applicable

The Strategy Document's approach is for the businesses to be sold/leased sequentially commencing with a Retailer and finishing with a public share offering of a combined Retailer and Generator. The approach adopted followed an assessment of a number of considerations, including potential bidder interest. The Treasury has since advised that following the passing of enabling legislation, the Treasury and its advisers will conduct a marketing effort to interact with local and international potential investors. The Treasury also advised that the additional insights obtained through this process will be used to inform and refine the strategy.

Under the planned sequential approach EnergyAustralia will be offered first as a standalone retailer followed later by a Generator or Retailer.

In Lexicon Partners' opinion the approach for EnergyAustralia, a trade sale of a standalone Retailer, is unlikely to attract material new entrant interest to retail because new entrants interested in retail may prefer an integrated retail/generation opportunity. Generators with an interest in entering retail are more likely to bid for a Retailer where they have either won a Generator or have a chance to win a Generator and a Retailer simultaneously.

An alternative to the sequential approach would be to sell/lease the businesses simultaneously by offering a Retailer and a Generator separately but at the same time. Under this process a bidder could:

- bid for a Retailer only
- bid for a Generator only
- bid for a Retailer and bid for a Generator
- bid for the combined Retailer and Generator.

In Lexicon Partners' opinion, a simultaneous sale of a Generator and Retailer may increase the prospects of an integrated new entrant emerging or bids from parties primarily focused on generation but with an interest in retail who are prepared to bid for a Retailer, and compete with incumbent retailers, using synergies between generation and retail. Offering the first Retailer transaction with the start of the first Generator transaction so that they may be transacted simultaneously may maximise the potential for new entrant interest from integrated generator/retailers or generators interested in establishing an integrated generation and retail platform.

The Strategy Document does consider adopting a simultaneous approach, but based on a number of considerations, the approach was rejected for the first two sale/lease transactions. The Strategy Document provides for reconsidering a simultaneous approach for subsequent transactions depending on the result of the first two transactions.

A simultaneous approach would appear to give greater weight to the project's objective of maintaining and, where feasible and warranted, promoting competition in the electricity generation and retail markets. Further consideration should be given to using simultaneous rather than sequential Generator/Retailer transactions following the marketing effort.

To undertake simultaneous transactions the Government would have to decide which Generator and Retailer would be transacted simultaneously.

Contingency Plans

In Lexicon Partners' opinion, existing contingency plans could be further developed, documented and additional plans prepared to enable a timely response if major issues arise as the strategy is implemented. The Strategy Document has built in some flexibility to enable review and change as transaction processes occur. To be able to execute on this flexibility requires contingency planning in advance to enable timely actions to be taken. Consideration should be given to further developing and preparing contingency plans should it be necessary to change strategy. Most of these could be completed while the first transaction is proceeding.

Prior to commencing the first transaction, consideration should also be given to documenting contingency plans which *inter alia* include the setting of a reserve price for each transaction and actions to be taken if the reserve price is not achieved.

Development Sites

A key objective of the project is to optimise the conditions necessary to ensure investment in new generation that is adequate, economic and timely.

<u>Lexicon Partners' findings:</u>

Some of the existing businesses have generation development sites and the key objective may be better met by selling a site or sites separately rather than with the businesses. This would result in spreading the risk that the sites will not be developed in a timely manner. It may also protect against reduced competition concerns. However, this should only be done where it does not have a material adverse impact on the process or on the risk profile of the business from which the site is transferred. The Strategy Document reflected that some work had been done in considering this issue and it was unclear whether the benefits of disaggregation would outweigh the costs.

We believe further consideration could be given to a separate tender for a Project development site. This need not delay the timing of the business transfer transactions.

Initial Public Offering (IPO) of Retailer and Generator

The planned IPO offering is to be a combined Retailer and Generator.

<u>Lexicon Partners' findings:</u>

There seems to be no quantitative analysis within the Strategy Document as to the value of either:

- *synergies from combining of Retailer and Generator businesses, or*
- *the combined Retailer and Generator business on a trade sale basis relative to an IPO basis.*

While the Strategy Document considers a number of combinations of the Retailers and Generators, there is no analysis as to whether combining two Retailers with a Generator for a trade sale or IPO would better meet the State's financial value objectives. It is noted that a combination of two Retailers with a Generator:

- *may provide more critical mass to it and improve its potential cost to serve relative to incumbent retailers*
- *would likely make it comparable in business structure to the two largest retail businesses in the market i.e. structurally short generation.*

We believe further analysis could be undertaken on whether a combination of two Retailers with a Generator could better meet the Government's objectives. This need not delay the commencement of the first transaction.

(ii) Proposed Timing of Transactions, including the Impact of External Factors

The Treasury advisers recommended the transactions commence with a trade sale of the retail operations of EnergyAustralia in late 2008 and conclude with a public share offering of an integrated electricity business comprising Integral Energy's retail activities and Eraring Energy in the second half of 2009. The remaining transactions involving the sale of the retail arm of Country Energy and the long-term leases of Macquarie Generation and Delta Electricity generation assets would occur through 2009 and prior to the share offering. This timing was confirmed by the Treasurer in his media release on 25 June 2008.

<u>*Lexicon Partners' findings:*</u>

Financial Market Conditions

We note the current difficulties facing financial market conditions (debt and equity) and the impact that this may have on financing and on appetite for the Generators and Retailers. There is no guarantee that the climate will improve in the short to medium term. Further, there is no guarantee that the current economic and financial climate will not deteriorate further and over what period of time.

A relevant data point is the current privatisation of the Singapore generation and retail assets. In this case, three integrated generation and retail companies (Tuas, Senoko and Seraya) are being sold sequentially by the Singapore Government's investment vehicle Temasek. By way of background, in June 2007, Temasek announced that it would be proceeding to divest Tuas, Senoko and Seraya over a period of 12 to 18 months. The process started in the second half of 2007 with the launch of the sale process for Tuas.

In March 2008, Temasek announced that Tuas had been successfully sold to Huaneng Group for S$4.2 billion (A$3.2 billion). Market commentary consistently states that Temasek received an attractive price for Tuas. Huaneng Group paid for over 50 per cent of the purchase price with debt raised as part of this acquisition.

In July 2008, having assessed all aspects of the Tuas transaction and notwithstanding the current economic and financial climate, Temasek continued its plan to divest the generation and retail assets and announced that it would launch the sale process for Senoko. This sales process is currently underway.

The Audit Office understands that a wide range of bidders have expressed an interest in this sale.

It should be noted that there is currently strong demand globally for generation equipment from the leading equipment manufacturers and suppliers (including from Alstom, GE and Siemens) creating longer lead times for developers before they can physically obtain equipment. The timing for launching the Project should be balanced against these lead times and the need for new investment.

Assessment of 'Infrastructure Capital' Demand

Infrastructure investors, such as pension funds and listed and unlisted infrastructure funds, generally focus on investments in assets that can deliver long term predictable cash flows and have material debt capacity. A standalone Retailer is unlikely to be attractive to such investors due to its asset light nature, lack of long term predictable cash flow and limited debt capacity. To the extent that they have any interest, infrastructure investors are more likely to be interested in a combined Generator and Retailer or a standalone Generator (if this is substantially hedged or low cost baseload generation).

There is significant competition for investment opportunities among infrastructure investors globally. As outlined in the Strategy Document, there is currently US$200 billion of capital in this sector compared with US$50.0 billion in January 2006.

A key consideration for infrastructure investors in determining their interest in the New South Wales electricity assets is likely to be the management of wholesale commodity risk – fuel, electricity offtake and potentially carbon certificates. This is due to the volatility associated with such commodity prices. The vast majority of pure infrastructure investors do not invest in such businesses with these risks unhedged. There are exceptions to this rule.

Assessment of Demand from Other Financial Investors

As outlined in the Strategy Document, sovereign wealth funds and private equity/hedge funds may also have investment appetite for the New South Wales electricity assets. It would be unlikely for such funds to have any appetite for a standalone Retailer. Instead, we believe private equity and hedge funds would have most appetite for a combined Generator/Retailer business or a standalone Generator. It is too early to take a view on whether private equity or hedge funds would take a minority stake alongside a strategic player or seek to take a leading position in the acquisition of a standalone Generator or combined Generator/Retailer business. It is likely that such funds will require further clarity on items such as the ETS, retail pricing regulation and on the ability to contract the commodity risk (particularly clarity on volume and maturities) of the investment to maximise leverage.

We note that the Strategy Document suggests that private equity funds are most likely to participate in consortia led by experienced electricity and infrastructure operators. We agree that this is a potential strategy of such funds. However, we would also highlight a number of situations where private equity and hedge funds have led the acquisition of a combined generation and retail electricity business and standalone generation assets.

For comments on the impact of other external factors refer to the following sections:

- the Impact of the Proposed National Emissions Trading Scheme (including Current Hedging and Coal Contracts of State Electricity Corporations)
- any relevant Commonwealth Legislation regarding Competition or Foreign Ownership
- any Other Factors that may Impact on the Potential Sale Price of the Assets.

(iii) Any Contingent Liabilities that will Accrue to the State

The project has the potential to leave the State with a number of contingent liabilities and residual risks that could continue for a length of time after the completion of the transactions. One of the State's objectives for the restructure is to minimise the impact of any ongoing financial risk and liabilities for the State. The Strategy Document identifies a number of such potential contingent liabilities and residual risks and outlines that the State proposes to put in place a number of mitigating processes and strategies, including the allocation of these liabilities and risks to successful bidders where it is economic and efficient to do so.

<u>Lexicon Partners' findings:</u>

The Treasury legal advisers have undertaken work to identify potential contingent liabilities and residual risks and have proposed ways in which the State's continuing exposure is likely to be minimised. While we are not legal advisers, and have not had access to all the documents that would have been reviewed by the legal advisers, we have reviewed the commercial aspects of the proposals made in the Strategy Document.

While the proposed approaches vary in nature according to the source, type of liability or risk potentially assumed or retained by the State, there are common strategies that have been proposed to mitigate such liabilities or risks, namely:

- *ensure that the Project is structured in such a way as to maximise competitive tension and so allow appropriate drafting of transaction documentation in favour of the State; and*
- *undertake a robust assessment of the creditworthiness of the purchasers and leaseholders of the assets to be transacted to confirm they are capable of assuming such liabilities or risks (or have passed these risks to other parties e.g. through insurance).*

We have highlighted in particular areas that could require further analysis later in the Project in order to assess the potential contingent liabilities or risks to the State. These two areas are: Generator Leases – Plant Environmental Liabilities; and Power Purchase Agreements.

The success of the State in minimising these contingent liabilities and residual risks can only be assessed later in the Project. From a commercial perspective, based on the limited information reviewed and in our experience, we have seen nothing in the data to suggest that the recommended strategy is not considering reasonable measures designed to minimise the extent of contingent liabilities and residual risk retained by the State.

(iv) The Impact of the Proposed National Emissions Trading Scheme (including Current Hedging and Coal Contracts of State Electricity Corporations)

National Emissions Trading Scheme (ETS)

Lexicon Partners' findings:

The Generators are large producers of greenhouse gases and will require compensating measures to avoid the ETS having an adverse material impact on their value. The Strategy Document recommends delaying the sale of any Generator until ETS details are known. On balance, we have seen no evidence to question this approach.

The Commonwealth Government released a Green Paper outlining options for the design of a Carbon Pollution Reduction Scheme ('CPRS') on 16 July 2008. The document reaffirms the commitment to implement the CPRS in 2010 and states the intention to release a white paper and draft legislation in December 2008. Assuming the draft legislation provides the requisite clarity on ETS, this timetable is consistent with that envisaged in the Strategy Document which expects clarity on ETS to be received by the end of 2008 to allow the first Generator transaction to proceed in 2009.

Should there be delays in receiving clarity on ETS the Strategy Document considers proposals which could facilitate the lease of the Generators. In my view any such proposals should be subjected to detailed analysis and review to ensure the likelihood of the State retaining material unquantifiable risk is minimised.

Hedging Output

Lexicon Partners' findings:

The implementation of the Project proposes that medium term hedging contracts be put in place between the Retailers and the Generators. The Treasury Advisers have indicated that the terms of the hedge contracts have yet to be finally determined and are the subject of ongoing discussions.

The Australian Competition and Consumer Commission ('ACCC') would normally request the Government to seek authorisation for these hedge contracts as a result of a previous ACCC ruling prohibiting the use of vesting contracts in New South Wales beyond 2000. Therefore, the establishment of hedge contracts as part of the Project will require either a 'no action' letter from the ACCC or enabling legislation to be passed allowing the contracts between the Retailers and the Generators to be entered into.

We have seen no evidence to suggest that the proposed hedging contracts would be inconsistent with the achievement of the State's objectives if they are part of the Project. However, such contracts would need to adequately capture the additional costs of ETS and the terms and duration of the contracts should not hinder competition between retailers or act as a disincentive for future investment by generators. A review of the actual commercial terms of these contracts would be required to confirm this.

Treasury have now advised this will be addressed in developing the commercial terms of the contracts.

Coal Security

A key driver in the value of the Generators is the availability and price of coal. The Strategy Document identifies the benefits from having some certainty in these areas. The Strategy Document includes plans for addressing this issue.

Lexicon Partners' findings:

It is important that these plans are managed to align their execution with the timing of the Generator lease process to enable bidders to incorporate details into their bids.

We believe consideration should be given to implementing close monitoring procedures to ensure plans are managed to align with the timing of the Generator lease process.

Although the Strategy Document acknowledges this observation, documented time lines and a monitoring process to ensure achievement were not included.

(v) The Sale Price of the Assets that is Reasonably Expected having regard to Professional advisers and the Government's Preliminary Estimates

The scope of my review, including the role of my advisers Lexicon Partners, specifically does not include the preparation of an independent valuation of the Generators or Retailers.

The Strategy Document sets out an estimated Enterprise Value range. The range is consistent with statements made by the Treasurer in his media release of 25 June 2008, 'Financial advisers have confirmed the Owen Inquiry estimate of expected net proceeds from the transactions at around $10.0 billion.' This comment is consistent with the estimate of Enterprise Value in the Strategy Document and is net of existing debt and transaction costs.

Lexicon Partners' findings:

In computing the preliminary estimates of the valuation of the Retailers and Generators, the Treasury Advisers have applied a number of standard valuation methods for the businesses of this nature and size, including a discounted cash flow, precedent transactions within the sector and comparisons with comparable companies. The Treasury Advisers are both institutions with considerable experience within the Australian market generally, and specifically within the electricity sector. The overall methodology is consistent with what we would expect.

As indicated above, we would expect the valuations to be preliminary in nature at this stage in the Project and we would expect the Treasury Advisers' views to develop as greater certainty is provided in areas of current uncertainty (e.g. ETS).

Achieving the valuation proposed is crucially dependent upon the process being competitive and the method of effecting the transactions being successful in creating a scarcity premium for the assets.

Retention Value

The Strategy Document outlines the intended approach to be adopted to estimate the value of the businesses under continued Government ownership. This approach values the projected future dividends from the businesses and projected corporate taxes paid by the businesses which are ultimately received by the State under the Tax Equivalent Regime. The projections should reflect the expected performance of the businesses under continued Government ownership taking into account any impact of Government ownership on the businesses' growth strategy, capital structure and performance. The projected future dividends and tax payments should be discounted at an appropriate cost of equity reflecting the risks associated with the projected cash flows.

The Retention Value could be one of the factors used to determine the reserve price for each transaction.

<u>*Lexicon Partners' findings:*</u>

Retention Value is a concept which is intended to reflect the financial value to the Government of retaining the Generators and the Retailers. The Strategy Document suggests that an appropriate calculation would be the present value of the expected future dividends paid by the Generators and Retailers which would have been received by Government plus the expected tax revenue generated by each asset. The financial and operational projections used in computing the relevant valuations for the Generators and Retailers would be based on the expected performance of the businesses under Government ownership.

The Strategy Document does not contain a calculation of Retention Values, stating that forecasts from the businesses remain subject to further review and that further information is required to assess the impact on dividends and tax received of upgrading existing plant and building new generation capacity. The Strategy Document states that a Retention Value will be calculated in due course by the Treasury Advisers and is anticipated to be lower than the transaction value. Further, the Treasury Advisers also note that it may be appropriate in certain circumstances for the Government to proceed with a transaction even when estimated proceeds are lower than the Retention Value given the broader objectives of the Project.

It is recommended that a Retention Value for each Retailer and Generator should be calculated using consistent assumptions and agreed by relevant parties prior to the launch of the sales process for the respective Generator and Retailer. Consideration could be given as to whether the Retention Value for the State should also reflect, where quantifiable and practicable, any material actual or potential liabilities or, if relevant, any opportunities foregone. If deemed appropriate, this could incorporate a valuation independent of the Treasury Advisers' work. Clearly, there should be strict confidentiality maintained over these values.

Treasury advised that the Retention Value will be determined prior to the commencement of the first transaction. I am of the view it is also essential for a confidential reserve price for each transaction to be established by the Government before each transaction proceeds.

(vi) The Impact of Increased Debt over the Past Five Years in relation to the Assets

<u>*Lexicon Partners' findings:*</u>

All Retailers have a net debt position of zero. Any debt that is within the combined retail network State Owned Corporations (SOCs) is allocated to the network businesses because it was used to fund network capital expenditure. While total gross debt within the sector has increased over the past five years, the total gross debt outstanding attributable to the Generators has fallen by $200 million over the past five years from $2,045 million in 2002/03 to $1,845 million in 2006/07. The net increase in debt in the sector has been attributed to investment in the electricity distribution and transmission (TransGrid) networks. These assets are not due for sale or lease and therefore this recent increase has no impact on the Project. Proceeds from the restructure will be used to repay all Generator debt. Electricity distribution and transmission networks' debt of $8,757 million at 30 June 2007 will remain with the Government's network businesses.

(vii) Any relevant Commonwealth Legislation regarding Competition or Foreign Ownership

<u>*Lexicon Partners' findings:*</u>

The recommended approach in the Strategy Document is for the State to not enact legislation that would impose cross-ownership restrictions on private sector purchasers and lessees. Instead, it is recommended that there should be reliance on existing regulation and legislation with any specific matters of concern (such as restrictions on the ability to resell the assets purchased or leased before completion of the Project) dealt with in transaction documentation.

The Strategy Document recommends that, given existing Commonwealth powers to block a sale or lease if it is considered not to be in the national interest, there is no need for further restrictions on foreign ownership.

We believe that a process which bidders view as being free of artificial restrictions may attract a higher level of interest.

(viii) Any Other Factors that may Impact on the Potential Sale Price of the Assets

Lexicon Partners' findings:

Based on the information and data disclosed to date, there are no other factors which have not been mentioned within our report or that have come to light that we believe would have a material impact on the potential sale/lease price of the businesses.

However, it should be noted that the utility sector is a global sector. It is the subject of constant change and development, including significant corporate activity, emerging investment opportunities and use of the equity and debt capital markets. Market conditions and market opportunities elsewhere that are not currently known could emerge prior to completion of the Project and could have a material impact (negative or positive) on the final outcome of the Project.

Financial Impact of the proposed Community Safety Net

Protections for Workers

Lexicon Partners' findings:

As part of the Project, the Government has proposed a series of measures to protect the employment rights of employees of the Generators and the Retailers. They include:

Table 4 - Key Proposed Employee Protection Measures

Measure	Generator Employees	Retailer Employees
Job Security	▪ Five year employment guarantee for Award and Agreement staff ▪ Contract employees to retain protection of their contracts ▪ Company holding lease of generation asset(s) must also employ the staff – restrict scope for 'stranded' employees	▪ Transition Service Agreements (TSA) with new employer of up to three years allow staff to remain in current positions for length of agreement ▪ Retail staff can choose to either accept an offer from the new employee (if received) or remain with the State-owned network business
Voluntary Redundancy	▪ Not offered	▪ Not offered
Transfer Payment	▪ Up to 30 weeks pay depending on length of service	▪ Up to 30 weeks pay depending on length of service ▪ Applies only if employment offer from new employer accepted
Superannuation	▪ Existing arrangements maintained ▪ Superannuation reserves to be fully funded at time of employee transfer ▪ Government to provide last resort undertaking for defined benefit scheme	▪ Existing arrangements maintained ▪ Superannuation reserves to be fully funded at time of employee transfer ▪ Government to provide last resort undertaking for defined benefit schemes
Statutory Leave Entitlement (Annual and Long Service)	▪ All current entitlements maintained ▪ No change in accrual rate ▪ Could be transferred or paid out	▪ All current entitlements maintained ▪ No change in accrual rate ▪ Could be transferred or paid out
Sick Leave	▪ Transfer to new employer; no cash out	▪ Transfer to new employer; no cash out

A transfer payment is a cash payment that will be made by the Government to employees who, as part of the restructuring, will no longer be employed by State-owned companies. Instead, such employees will subsequently become employed by the new private owners or lessees of the Retailers and the Generators. Transfer payments are intended to reward and incentivise staff for their cooperation during the restructuring process and are calculated for each eligible employee with reference to length of service.

Consistency with Previous Transactions

In considering the consistency of the measures outlined above, we have reviewed the Treasury documentation regarding the employee transfer packages that were offered as part of sixteen privatisations and Government restructurings in New South Wales and Queensland. We understand that the Freight Rail Corporation ('FreightCorp') sale in 2002 has been used as the basis for a number of the proposed worker protection measures.

The worker protection measures proposed are consistent with previous privatisations and Government restructurings with the exception of the employment guarantee for generation staff which at a duration of five years is longer than that offered in any of the previous privatisations and Government restructurings reviewed. Further details on the terms of the package are outlined below.

The longest employment guarantee, and also the most common, in the precedent transfer packages reviewed was three years. The decision to provide a five year guarantee for generation employees therefore exceeds any of the precedent transfer packages reviewed.

Voluntary redundancy was offered as part of a number of the previous transfer packages but has not been considered appropriate for the Project. The advice to Government notes that suitably qualified generation employees are difficult to obtain in the current labour market and as a consequence it is expected that the lessees of the Generators would wish to retain current employees for longer than precedent.

The proposed structure for the transfer payments to be made to all generation and eligible retail employees is consistent with those implemented as part of the FreightCorp sale. The structure proposed as part of the Project allows for up to a maximum of 30 weeks pay.

The Government has approved all electricity employees retaining membership of their current superannuation schemes. Both the lease holders of the Generators and the purchasers of the Retailers will be required to become scheduled employers and make contributions to the relevant schemes. Furthermore, current employees will retain in full their current entitlements following the transactions. The approach taken in relation to superannuation benefits is consistent with that used as part of the FreightCorp sale.

It is proposed that accrued but untaken statutory leave attributable to electricity employees could be either cashed out (sick leave can only be transferred), transferred to the new employer and drawn down during their future employment or paid out upon termination of employment with the new employer. A comparison with other transfers of assets to the private sector shows that this treatment of statutory leave is a widely used approach and was, by way of example, part of the transfer package accompanying the FreightCorp sale. It is proposed that the entitlements will be secured by the General Employee Entitlement & Redundancy Scheme ('GEERS') which compensates employees for inter alia accrued leave entitlements in the event of employer insolvency and subsequent termination of employment.

Based on information provided by the Treasury, we summarise in Table 5 below a comparison of the employee protections proposed for the Project with a number of employee protections in other privatisations and Government restructurings.

Financial Impact

The financial impact on the Government of these measures to protect the employment rights of employees of the Generators and the Retailers is estimated by the Treasury to amount to $111 million.

My Office has reviewed the methodology and sources of data used in the calculation of this cost. We noted that this data is now approximately twelve months old. The estimate does not take into account the impact (either positive or negative) that the protection measures may have on the prices that may be offered by potential bidders for the Retailers or Generators.

Table 5 - Comparison of Employee Protections with other Privatisations and Government Restructurings

Item	Proposed NSW Electricity Restructuring - Generators	Purposed NSW Electricity Restructuring - Retailers	Freightcorp	Pacific Power	Harness Racing Authority	Greyhound Racing Authority	Rail Infrastructure Corporation	Powercoal Pty Limited	Rail Services Australia
Date	**2008/2009**	**2008/2009**	**2002**	**2002/2003**	**2003**	**2003**	**2004**	**2002**	
Job Security	5 years	No guarantee; TSAs of up to 3 years with choice to accept offer from new employer or remain with network SOC	3 years	Remain in Government employment if not offered position with new owner	1 year	1 year	3 years	3 years	2 years
Transfer Payment	Up to 30 weeks	Up to 30 weeks	Up to 30 weeks	Severance pay 3 weeks per year service & lump sum	Equivalent to VR	Equivalent to VR	Up to 30 weeks	1 week pay / year service	Up to 23 weeks
Annual Leave	Transfer / Paid out	Transfer / Paid out	Transfer / Paid out	Award entitlements as part of severance	Transfer / Paid out	Transfer / Paid out	Transfer / Paid out	Pay out all but 20 days (transfer)	Paid out
Long Service Leave	Transfer / Paid out	Transfer / Paid out	Cash out and/or transfer	Award entitlements as part of severance	Transfer / Paid out	Transfer / Paid out	Transfer / Paid out		Paid out
Sick Leave	Transfer	Transfer	Transfer	Min of 18 days	Transfer	Transfer	Transfer	Pay out all but 15 days (transfer)	Transfer
Superannuation	Existing arrangements maintained	Existing arrangements maintained	Existing arrangement maintained	Mirror scheme or accumulated benefits scheme	Local Government equivalent	Local Government equivalent	Existing arrangement maintained	Comparable fund	New Fund
VR Offered	No	No	Limited	Yes	Not within first 12 months	Not within first 12 months	Limited	Limited	Limited

Source: Information provided by Treasury

Protections for Pensioners and Low-income Earners

The Government announced a series of protections for electricity customers to be delivered once the Government's energy plans are substantially in place:

- extension of retail price regulation until at least June 2013;
- $65.0 million over five years to increase pensioner energy rebates from $112 to $130 per annum, indexed to the movement in CPI;
- $27.5 million over five years to extend energy rebates to include recipients of Carers Allowances (child under 16), Sickness Allowances and Special Benefits;
- $125 million over five years to support the introduction of a 'no disconnections' policy for small domestic customers in New South Wales;
- $55.0 million over five years to increase the level of funding under the current Energy Accounts Payments Assistance ('EAPA') Scheme to $100 million;
- strengthening the rules, codes and regulation relating to marketing; and
- retailer of last resort ('ROLR') arrangements.

Each of these items is considered below.

<u>*Lexicon Partners' findings:*</u>

Consistency with Previous Transactions

The Treasury has advised that a review of publicly available information on community safety net arrangements arising from previous electricity privatisations has not been able to identify the required level of information on comparable arrangements. In addition, the measures that were provided at the time of other Australian electricity privatisations and restructurings have since been subject to a number of revisions which would limit the relevance of any comparison of the measures as they applied at the time of privatisation/restructuring to the Project's current proposed community safety net.

Therefore, the approach taken in assessing consistency with the consumer protection measures to previous transactions is to undertake a comparison of the Project's proposed protections with the current community safety net arrangements in other states where privatisation/restructuring of the electricity industry has already been undertaken. We set out below a review of the consistency of the protections proposed by the New South Wales Government with those already implemented in other states (specifically South Australia, Queensland and Victoria).

Retail Price Regulation

The New South Wales Government is proposing that retail price regulation be extended until at least June 2013. The Strategy Document recommends that, to provide greater certainty, the enabling legislation should also ensure that the Terms of Reference cannot be altered once issued without agreement from the affected Retailers.

The current method of retail price regulation in New South Wales which is proposed to continue post privatisation is consistent with South Australia where an independent regulator is responsible for issuing a price determination which is able to be accessed by households and small businesses using less than 160MWh per annum. In Queensland, there is no longer a five year regulatory review, instead there is a benchmark retail cost index which is prescribed in legislation and the Queensland Competition Authority ('QCA') applies to decide on any allowable price increases. The QCA then makes a recommendation to the Government which then makes the final decision on pricing. In Victoria, regulated prices are determined through a process of direct negotiation between the Victorian Government and retailers. Furthermore, the Australian Energy Market Commission has recommended the removal of price regulation for small customers in Victoria; regulation of small business customers was removed from 1 January 2008 but timing has yet been announced in relation to household customers.

Pensioner Energy Rebates

The New South Wales Government is proposing to increase the pensioner energy rebate from \$112 per annum to \$130 per annum. The policy of offering pensioner energy rebates is consistent with both South Australia and Queensland. Victoria does not offer pensioner energy rebates, offering instead a number of targeted concession and financial assistance programs.

Extension of Energy Rebates

The New South Wales Government is proposing to extend energy rebates to include recipients of Sickness Allowance, Carer Allowances (child under 16) and those receiving the Special Benefit payment. No information was provided specifically on extension of rebates to particular groups but it was noted that Victoria in particular offers a variety of targeted assistance via a range of concessions and financial assistance to eligible parties.

No Disconnections Policy

The New South Wales Government is proposing there be an obligation to supply a customer experiencing financial hardship who would otherwise be disconnected on a regulated tariff. The relevant customer's accounts would be managed by appropriate agencies and the customer would be provided with financial counselling, access to a strengthened EAPA Scheme, energy audits and financial assistance to increase their property's energy efficiency. The precise details of the package are still being developed by the Department for Water and Energy.

Other States appear not to have an explicit 'no disconnections' policy but rather have limitations on the ability of a retailer to disconnect a customer for non-payment and requirements to offer assistance to customers to pay their electricity. In particular, Victoria prohibits disconnection if a customer has agreed a first instalment plan but fails to make payments under the plan. This is strengthened by further prohibiting disconnection should the amount outstanding be less than an amount stipulated by the independent regulator.

Increase Level of EAPA funding

The New South Wales Government is proposing to increase the level of EAPA funding from the current level of \$9.2 million per annum to \$20.0 million per annum. The EAPA Scheme is designed to offer financial assistance to customers (in the form of \$30 vouchers) with paying electricity and/or gas bills due to a crisis or emergency situation.

The New South Wales Government policy of supporting EAPA funding is consistent with the policies of all States reviewed.

Retailer of Last Resort (ROLR)

The New South Wales Government will implement an overall ROLR policy to include price regulation for ROLR customers who are transferred due to the inability of their current retailer to continue to supply electricity. ROLR arrangements are moving to a national framework expected to be in place in 2009 which, subject to full participation of all States, should ensure regional consistency of arrangements. The current ROLR arrangements for New South Wales only apply to failure of a second tier retailer and no arrangements are in place in the event of the failure of a Retailer. The Unsworth Committee recommended that the charge to transfer a customer to the ROLR be removed; at present retailers in New South Wales charge a fee of \$35 to cover administration costs.

In contrast, South Australia, Queensland and Victoria have ROLR arrangements that cover all customers and either the legacy retailers act as ROLRs to each other or the electricity distributor acts as the ROLR. The fee charged by retailers in New South Wales is below that of both South Australia (\$85 or 130 per cent of standard contract tariff) and Victoria (\$44). The cost of transfer in Queensland is determined upon application to the Queensland Competition Authority.

On balance, based on the information provided by the Treasury, the nature of the protections proposed for customers by the strategy appears consistent with the other States.

Financial Impact

As outlined in the Table 6 below, the financial impact on the Government is estimated by the Treasury at $272 million over five years (real 2008/09 excluding the CPI component on the pensioner rebate).

Table 6 - Financial Impact of Protections for Electricity Customers

Item	Cost over 5 years $m
No disconnection policy for small domestic customers	125
Increase Funding under EAPA Scheme	55
Increase current pensioner rebate	65 (1)
Extend energy rebates	27
Total	**272**

(1) CPI component not included

The costs outlined above are for the forward estimates for the next five years.