

VICTORIA

Auditor-General
of Victoria

SPECIAL REPORT No. 38

PRIVATISATION
An audit framework for the future

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The President
The Speaker

Parliament House
Melbourne Vic. 3002

Sir

Under the provisions of section 16 of the *Audit Act 1994*, I transmit the Auditor-General's Special Report No. 38, "*Privatisation: An audit framework for the future*".

Yours faithfully

C.A. BARAGWANATH
Auditor-General

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Foreword

The success of privatisation will be influenced by the soundness of the management practices implemented by the Government and the quality of regulatory regimes applied to the operation of privatised industries in the future.

As a precursor for an ongoing program of detailed privatisation audits, I have determined that the Parliament and the Executive Government should initially be provided with independent comment as to the broad high level procedures that, in my opinion, the public would expect to be applied in managing the privatisation of Government Business Enterprises. It is also my view that disclosure by the Government of the practices employed to address key issues associated with major initiatives that involve immense change, such as privatisation, is an important feature of responsible economic management of the State.

In terms of promoting sound management practices in relation to privatisation, enhancing public accountability and clarifying the scope of my responsibilities as they relate to the impact of government policy, I believe that this preliminary review will be useful in stimulating debate and providing additional information in relation to the Government's privatisation program.

C.A. BARAGWANATH
Auditor-General

Part 1

Executive Summary

Executive summary

1.1 The overall program of privatisation is extremely complex and involves a number of processes in terms of preparing businesses for sale, establishing the appropriate economic and technical regulatory regime and in managing the sale transactions. The most common sale processes involve trade sales, public floats or a combination of these approaches. Recent privatisations in Victoria have included a public float of the former Totalisator Agency Board, and the trade sale of the Grain Elevators Board and 3 of the distribution businesses in the electricity supply industry through a competitive tender. The privatisation program for Victoria's electricity industry is by far the largest privatisation earmarked for completion in the ensuing years.

1.2 Where reform of the State's Government Business Enterprises involves privatisation, many complex and sensitive issues are being addressed by the Government, sometimes within a demanding timetable. As such, auditing privatisation poses a number of challenges to my Office, especially as the expectations of some members of Parliament and the public may intrude into areas of government policy, such as whether particular organisations should be privatised and issues associated with foreign ownership. These issues are clearly outside the boundaries of my legislative audit mandate which precludes me from questioning the merits of policy objectives of the Government.

What approach is to be adopted for the audit of the Government's privatisation program?

1.3 I have decided that it would not be in the public interest for my Office to undertake performance audits of any privatisation program while sale negotiations and associated processes are in progress.

1.4 In reaching this decision I have relied heavily on the following views expressed to me by the Chairman of the former Economic and Budget Review Committee, the predecessor body to the Public Accounts and Estimates Committee, in a letter of 26 May 1992: *"... that the Committee is concerned about [the Auditor-General] detailing current commercial negotiations in his report. The Committee believes the Auditor-General has the option of reporting to Parliament on negotiations once they have been completed and these aspects could be the subject of a subsequent report."*

1.5 I have, however, reached agreement with the Secretary of the Department of Treasury and Finance on a series of broad high level performance criteria that may be used on future audits of privatisation projects, where applicable, as a means of assessing the Department's management of a range of key issues. Depending on the size and complexity of the particular privatisation, I believe the public would expect some or all of these issues to be addressed by the Government. Due to the magnitude and advanced stage of the reforms occurring in the electricity supply industry at present, certain criteria have also been developed specifically for that particular industry. Agreement with client agencies on performance criteria has been a long-standing, but rarely achieved, objective of my Office and is in-line with the approach advocated by Mr Alan Talbot of Price Waterhouse in his report on the performance audit of my Office tabled in the Parliament in October 1995.

1.6 In terms of enhancing public accountability, the measures implemented by the Government to address these criteria have also been disclosed in this Report. In this regard, the Department has responded to audit's lines of enquiry in an extremely positive manner.

Government policy, process and risk management audits

1.7 Stated simply, my role in auditing privatisation will cover processes and not policy. Careful attention has to be given to avoid second-guessing the merits of the policy objectives of the Government. What constitutes government policy compared to instruments of policy or, in layman's terms, the processes to implement policy continues to be a contentious issue.

1.8 The current Audit Act specifically precludes an Auditor-General from questioning the merits of policy objectives of the Government. Policy objectives are **broadly** defined in the Act as including:

- a Government policy direction of a Minister;
- a policy statement in any Budget Paper;
- a statement of objectives in a corporate plan of an authority approved by a Minister; or
- any other document evidencing a policy decision of the Government or a Minister.

1.9 In a letter to the then Premier, the Honourable J. Cain on 14 November 1989, I foreshadowed that the proposed legislative definition of government policy had the potential to create disputation rather than providing clarification of the audit mandate. In that letter I expressed the following views:

- *"the ... legislation does not distinguish between policy and instruments of policy";*
- *"whether or not a specific issue is policy is determined by its nature and characteristics, rather than (its) source";*
- *"references ... to budget papers and other documents are by themselves inconclusive in terms of providing guidance on what constitutes government policy"; and*
- *"the reference to direction of a Minister provides an opportunity for management to avoid Parliamentary scrutiny by the simple device of channelling all administrative decisions by the agency through its Minister".*

1.10 The identification of potential risks flowing from government policy and an evaluation of the way in which the risks have been managed at a Central Agency level was recommended by Fergus Ryan in the first performance audit of my Office undertaken in 1992, following extensive changes to audit legislation in 1990. The recommendations were strongly supported by the Public Accounts and Estimates Committee in its November 1993 Report as a role that I should be pursuing. The Committee also held the view that the role of the Department of Treasury and Finance, in coordinating and overseeing the implementation of policies relating to the reform of Government Business Enterprises under the State Owned Enterprises legislation, was an area where an assessment of Central Agency risk management was appropriate.

1.11 In examining ways in which an assessment could be made by my Office of the risk management processes involved in implementing the Government's privatisation program, I have found the boundaries of government policy are unclear and that many of the risks associated with the Government's privatisation policy, by implication, could be regarded as venturing into the political arena, further complicating the fine line between policy and the processes established for implementing such policies. In addition, it is accepted that neither the Central Agency nor audit could ever identify all the potential risks relating to a particular policy.

1.12 In targeting performance audits in relation to privatisation in future years, it will be necessary for a clear distinction to be drawn between policy decisions of the Government or a Minister and processes established by agencies to implement government policy. Although there are various examples that could be used to illustrate different ways of defining these concepts, I have listed 2 scenarios in Chart 1A in relation to disposal processes involving public assets.

**CHART 1A
GOVERNMENT POLICY COMPARED WITH IMPLEMENTATION PROCESSES
DISPOSAL OF GOVERNMENT BUSINESS ENTERPRISES**

	Example 1	Example 2
Government policy	To facilitate the privatisation of Government Business Enterprises	To facilitate the privatisation of Government Business Enterprises Disposal decisions <ul style="list-style-type: none"> ▪ Method <ul style="list-style-type: none"> - float - trade sale - disaggregation ▪ Timing ▪ Determination of actual sale value (reserve price)
Instruments of policy i.e. processes to implement government policy	Disposal decisions <ul style="list-style-type: none"> ▪ Method <ul style="list-style-type: none"> - float - trade sale - disaggregation ▪ Timing ▪ Determination of actual sale value (reserve price) Businesses to be prepared for disposal Valuation process Tender process Financial control and project management	Businesses to be prepared for disposal Valuation process Tender process Financial control and project management



Audit Approach

High level performance criteria and lower level specific criteria will be applied by audit to evaluate the **processes** used by the Government to implement government policy and address the associated risks. Processes involve business decisions and procedures covering a range of issues including disposal of public assets (refer above), pricing and quality of service delivery.

As such, a clear distinction has to be made as to what constitutes government policy, which cannot be questioned by audit, compared to process.

The Chart defines this distinction by illustrating various business decisions and procedures connected to the disposal issue in the context of process, as compared to the impact on the scope of the audit if they were regarded as policy.

1.13 If my Office is to examine issues surrounding the risks involved in implementing government policy, it is my view that privatisation audits should be structured along the lines outlined in Example 1 where the Government policy is elevated to the highest possible platform. Example 2 would, in my opinion, be restrictive in scope and result in a narrower focus for audit enquiry.

□ **RESPONSE** provided by Acting Secretary, Department of Treasury and Finance

Decisions taken with respect to privatisation of GBEs such as those that materially affect value, which involve choices that entail policy trade-offs or affect the underlying institutional arrangements in which services are provided, are properly policy decisions for Government. The Department of Treasury and Finance do not believe it is appropriate that the Audit Office or any other external review mechanism should second guess these policy decisions. That said, the Department of Treasury and Finance believe it is appropriate that the Audit Office raise questions regarding the basis upon which such decisions were made. For example, identifying the factors that were taken into account and the process involved in the decision to sell the distribution business by way of trade sale rather than by public float.

*Although the boundaries of what constitutes government policy may in more general terms be unclear, it is the view of the Department of Treasury and Finance that in the area of microeconomic reform, the boundaries are relatively clear. Moreover there is a substantial body of knowledge, as evidenced by studies undertaken by policy review agencies such as the Industry Commission which assist in identifying the scope of policy in relation to industry reform. Other sources of reference include the National Competition policy reforms, which include, *inter alia* pricing by GBEs and structural reform of public monopolies as core policy issues.*

*The Department of Treasury and Finance would therefore strongly dispute the view put by the Auditor-General, (see Chart 1A), that issues in relation to disaggregation of GBEs could be construed as a process issue (more detailed comments on Chart 1A are made below). As the Hilmer report (1992) notes “The structure of a market is one of the key determinants of competitiveness and hence efficiency” “while questions of the most appropriate structure for public enterprises may be of interest from a public management perspective generally, **competition policy** concerns come to the fore when **government decisions** are being taken that may affect the competitive conditions, and hence efficiency, of markets”.*

It is the strong view of the Department of Treasury and Finance that issues regarding the timing of sale and the method of disposal are also properly policy decisions for Government. The decision of whether to sell by way of trade sale or float has important implications for other policy variables including the likely sale value of the businesses, the mix and structure of ownership and the competitive outcome. The choice among possible options depends upon the perceived consequences for the reform objectives held by the Government. As the Department of Treasury and Finance has previously indicated, such decisions, which must reflect a balance in the inevitable trade offs and policy risks are considered to be policy decisions for Government.

Moreover, the decisions that must be taken in regard to implementing reform, for example in relation to the method and timing of sale, have important consequences that extend beyond the immediate business undergoing privatisation, and consequently require a whole of Government perspective.

The role of the Department of Treasury and Finance is to support the Government’s policy decision making in these matters through well considered analysis and advice.

As the Auditor-General’s Report has indicated elsewhere, the Government’s reform and privatisation program involves arguably the most significant structural and resource management changes within the public sector. In this context, and in view of the magnitude of reforms, it should therefore not be surprising that there will be few material decisions that can be considered as “pure process or implementation issues” that can be taken without reference to Government.

*There is however, a stage in the privatisation process when the policy issues are resolved and the privatisation enters the **transaction phase**. It is at this stage in the process that the issues are dealt with as an implementation process involving transaction advisers and the relevant reform unit, at arms length from the Government. For the larger privatisations, the Department of Treasury and Finance has also appointed a "process auditor" to ensure the sales process is well managed and that potential bidders are treated evenly and fairly.*

Where to from here?

1.14 As the success or otherwise of privatisation will not in many cases be fully known until well after the year 2000, the long-term nature of the reforms may prevent my Office from forming firm conclusions at this point of time on whether the policy objectives set by the Government for privatisation will in fact be met. In addition, as these objectives are stated in broad terms they will not, in my opinion, be easily quantifiable, particularly in the short-term. Generally speaking, what is clear is that Victorians are interested in the future impact of privatisation on prices, quality of service delivery and the environment and whether the State has achieved value for the sale of the public asset. Uncertainty as to the behaviour of the newly formed private sector enterprises in an open market with a "light handed approach" to government intervention and regulation undoubtedly also raises concerns in the minds of some segments of the community who, over time, have become accustomed to the delivery of essential services by the public sector. The Regulator-General of Victoria, in his 1994-95 *Annual Report*, stated that "As far as reasonably practicable, the regulatory framework is light handed. That is, it lets the participants in the "regulated industries" get on with their business and provides for intervention only where it is necessary to correct misuse or abuse of market power in the interests of competition or customers."

□ **RESPONSE** provided by Acting Secretary, Department of Treasury and Finance

*The Department of Treasury and Finance believes there is ample evidence available world-wide to demonstrate conclusively the benefits of reform and privatisation of GBEs. Some of the recent studies which establish the benefits of privatisation include Megginson, W.; Nash, R.; and Randenborgh, M. (1994) "The Financial and Operating Performance of Newly Privatised Firms: An International Empirical Analysis". *Journal of Finance* 49(2) 403-452 and Kikeri, S.; Nellis, J.; and Shirley, M.; (1994) "Privatisation: Lessons from Market Economies *The World Bank Research Observer* 9(2) 241-72.*

The Department of Treasury and Finance believes that it is important to acknowledge the substantial international experience in privatisation, not only from the point of view of establishing the substantial benefits arising from privatisation but to take advantage of the lessons of previous experience in developing our own reform and privatisation programs.

*The Department of Treasury and Finance believe the objectives of reform and privatisation **are quantifiable** as evidenced by overseas studies that have identified improvements in operating efficiency as a consequence of privatisation. It is true however, that the benefits from reform and privatisation are not always obvious. Discerning the impact of privatisation is made more difficult because of the lack of a 'control' against which to test the reforms and the lags in receiving the benefits of reform. Nevertheless, quantifiable benefits of privatisation can and have been measured using appropriate econometric methods. At a more prosaic level the objectives of privatisation in terms of reducing debt and providing a return on public assets are clearly measurable in terms of the sale prices received and how these receipts are allocated to debt retirement. Other objectives, of delivering choice and lowest prices may be measured against changes in the institutional and regulatory structure of the industry.*

To further emphasise that the benefits of reforms can be measured, I draw your attention to the recent report by the Bureau of Industry Economics "International Benchmarking - Overview 1995" which finds that among the States, Victoria offers the cheapest basket of infrastructure services and reports "Victoria's rapid productivity improvement in recent years shows that a serious and well targeted reform program can provide tangible benefits quickly".

*In response to the Auditor-General's statement on page 8... "What is clear ... Victorians are interested in the future impact of **privatisation** on prices ...".*

The statement tends to reinforce the view that any future change in prices and standards can be attributable to privatisation. In view of the wider reforms that precede privatisation, and the possible influence of external factors, this view is mistaken. As the Department of Treasury and Finance has previously argued, it is important to consider the consequences of privatisation against the appropriate frame of reference.

The impact of privatisation should also be considered in the context of the wider reforms (of which privatisation is a component) which will also have an impact on prices etc. For example, the question should be - does privatisation offer a greater prospect of price falls than other forms of (public) ownership? Alternatively, are environmental standards or service quality likely to be improved or diminished (or unaffected) by privatisation (as compared to the likely outcomes in public ownership)?

1.15 After sales have taken place and the boundaries of government policy have been clarified, performance audits will be targeted at selected privatisations in the electricity industry as well as other sectors and evaluative comment, where considered necessary, will be relayed to the Parliament. Broadly speaking, issues to be pursued by my Office will essentially involve assessing whether risks and disposals have been well managed and whether the taxpayer has received value for the assets sold. My Office will also need to examine whether the Government's policy objectives for the privatisation program have been achieved. The broad criteria outlined in this Report, together with the formulation of more specific desirable management procedures, are intended to be used in the conduct of these audits.

□ **RESPONSE** provided by Acting Secretary, Department of Treasury and Finance

I agree with the Auditor General's objective to assess whether the processes are well managed. However, I am concerned the Auditor-General may be taking a narrow view of the benefits of reform. As I have previously indicated, the taxpayer receives "value" from the assets sold in a variety of forms - only one of which is measured by sale price. As you are aware the fundamental benefits of reform and privatisation arise from the more efficient use of resources, measured in terms of improvements in industry productivity, lower prices and innovation. I therefore suggest that the Auditor-General can only satisfy himself that the best price is achieved in the context of the wider reform objectives of the Government.

Part 2

Introduction

WHAT IS PRIVATISATION?

2.1 Privatisation involves the transfer of ownership and operation of a government business enterprise from the public sector to the private sector.

GOVERNMENT OBJECTIVES

2.2 According to the Department of Treasury and Finance the objectives of privatisation are to provide enduring incentives for efficiency improvements pursued under the umbrella of GBE reform and to ensure that commercial risks are borne by private sector investors, and not by taxpayers and customers. The benefits of privatisation therefore include:

- transfer of commercial risk to investors;
- promoting contestability in supply of services;
- providing a return on public assets;
- reducing public debt; and
- through competitive pressure, delivering the lowest possible prices to consumers.

VIEWS OF THE DEPARTMENT OF TREASURY AND FINANCE ON PRIVATISATION

2.3 *The reform of GBEs within the Privatisations and Industry Reform Division (PAIRD) of the Department of Treasury and Finance is progressing across a wide variety of fronts. Not all reforms lead to privatisation of business units.*

2.4 *Privatisation is not by itself a measure to achieve the Government's overall reform objectives, but is a logical consequence of reforms which allow a more commercial, market-oriented approach to the delivery of services to the community. Privatisation is a complement to, not a replacement for, the other aspects of the Government's reform program which involve corporatisation and the creation and promotion of competition through structural and economic reforms.*

2.5 *The fundamental objective of GBE reform is to promote efficiency in resource use. The introduction of competitive discipline into GBEs through the structural and regulatory reforms is the basic driver of the efficiencies sought by the Government. The reasons for privatising GBEs include:*

- *Privatisation offers a means of transferring business risk from the public sector to those best equipped to manage and be held accountable for market risk.*
- *While businesses remain in Government ownership there is a tension between commercial and parliamentary accountability which is difficult to manage in the longer term in the best interests of the State. Privatisation assists in clarifying the accountability of the businesses to the market-place for their commercial decisions. Government's role is to ensure technical, safety and environmental requirements are met and to oversee market conduct of the participants.*

- *Privatisation and the wide ownership of industry avoids the risk that businesses under government ownership will in some way be constrained from being fully efficient by the imposition of non-commercial obligations.*
- *Privatisation provides the opportunity for the Government to retire public debt associated with the public ownership of GBEs. However, the major benefits of privatisation for the Victorian budget and the wider economy flow from the stimulus provided to the economy from more cost-effective businesses. It is worth noting that the Government has not sought to maximise the sale price through the sale of a vertically integrated monopoly business. Prior to privatisation the Government has pursued a vigorous program of structural reforms in order to maximise competitive pressure where appropriate and imposed an economic regulatory regime where market forces are deemed to be absent or not fully effective. This policy of pursuing pro-competitive reforms, has been supported by policy principles contained in the National Competition Policy legislation.*
- *Although the major factor promoting efficiency is likely to be competition rather than ownership per se, the transfer of ownership locks in the benefits of reform by introducing appropriate and enduring incentives and disciplines on businesses.*
- *Privatisation, correctly conceived and implemented, fosters efficiency, encourages investment (and thus new growth and employment), and frees public resources for investment in infrastructure and social programs.*

2.6 *The elements of risk that are properly the province of PAIRD in developing options for industry reform involve the economic and business risks attached to the operation of GBEs and the likely impact the reforms will have on the quality, level and price of services available to the community. A key objective that underpins the reform program is the desire to allocate business risk to the sector that is best placed to manage risk and where the appropriate commercial incentives operate.*

2.7 *A risk that falls outside the province of PAIRD is the political risk attached to the reform program. Judgements of political risk are for the Government of the day. PAIRD assists Ministers resolve complex policy options by illustrating, through thorough analysis, the economic and commercial consequences of alternative policy options. The analysis provided by PAIRD to assist the Government develop its preferred policy position draws on an assessment of the strengths and weaknesses of similar reforms which have been implemented elsewhere. The privatisation experience in the United Kingdom (UK) has drawn attention to the need for thorough structural reform and the establishment of a stable and predictable regulatory regime as necessary preconditions for privatisation. The lessons from the UK and from many other countries where privatisation is being pursued, are taken into account in the Victorian Government's reforms, which are aimed at ensuring maximum public benefit.*

2.8 *The Department of Treasury and Finance regard the establishment of a stable and predictable economic regulatory regime, administered at arms length from Government, as a key to the success of the GBE reform program. The merits of governments establishing expert and independent pricing bodies were also identified by the Hilmer Committee in their review of National Competition Policy.*

2.9 *The economic regulatory framework for GBEs has centred on the establishment of the Office of the Regulator General (ORG). The independence of the of the ORG is a guarantee against the use of economic regulation to achieve non-commercial political objectives at the expense of customers.*

2.10 *In performing its functions, the ORG has the following general objectives:*

- *to promote competitive market conduct;*
- *to prevent misuse of monopoly or market power;*
- *to facilitate entry into the relevant markets;*
- *to facilitate efficiency in regulated industries; and*
- *to ensure users and consumers benefit from competition and efficiency.*

PRIVATISATIONS COMPLETED OR THOSE IN PROGRESS

2.11 Developments to date in some areas of privatisation reform are set out below.

Electricity supply industry

Disaggregation of the former State Electricity Commission of Victoria

Five distribution companies established on 3 October 1994:

- United Energy (a);
- Solaris Power (b);
- Eastern Energy (c);
- Citipower; and
- PowerCor Australia.

(a) sold to the private sector - August 1995.

(b) sold to the private sector - October 1995.

(c) sold to the private sector - November 1995.

Five generation companies established on 31 January 1995:

- Hazelwood Power Corporation;
- Loy Yang Power;
- Southern Hydro;
- Yallourn Energy; and
- Ecogen Energy (operating as a separate business unit within Generation Victoria which currently remains in public ownership).

One generation company earmarked for sale.

Grain Elevators Board

The Board was sold to a consortium headed by the Victorian Farmers Federation in May 1995.

Totalizator Agency Board

A public float of TabCorp, which is now listed on the Stock Exchange as a public company, occurred in August 1994.

Ports

Key decisions include the sale of onshore assets of the ports of Geelong, Portland and Hastings with retention in public ownership of underwater assets of Geelong, Portland and Hastings.

Bass

In April 1995 the Victorian Arts Centre Trust agreed to sell 50 per cent of BASS to Ticketmaster Corporation.

Part 3

Conduct of the review

OBJECTIVES OF THE REVIEW

- 3.1** The objective of the review was to:
- identify, in the public interest, broad high level criteria (desirable management procedures) for the management of economic, social and environmental issues associated with privatisation of GBEs;
 - document the way in which the desirable management procedures have been implemented by the Government; and
 - lay the foundation for future performance audits.

SCOPE OF REVIEW

3.2 Due to the advanced stage of electricity sector reform, the scope of the review predominantly covered the privatisation reforms of the Victorian electricity supply industry.

- 3.3** The review involved:
- seeking responses from the Department of Treasury and Finance to a wide range of questions in order to publicly disclose the processes implemented by the Government to address various key issues involved in the privatisation program;
 - identifying broad high level criteria for the management of economic, social and environmental issues associated with privatisation at a macro level;
 - documenting the comments provided by the Department on the manner in which these criteria have been implemented; and
 - providing an overall commentary on the approach to be followed in undertaking performance audits of the privatisation of the State's GBEs.

3.4 In terms of value added, the review provided an opportunity for information to be presented to Parliament to enhance public accountability. The review also enabled examples, that could be regarded as best practice, to be disclosed publicly which may be useful to other jurisdictions embarking on a privatisation program and serve to encourage good management techniques in later privatisations.

3.5 In view of the inability of the Auditor-General to question the merits of the Government's policy objectives, the issue of whether corporatised components of the electricity industry or any other GBEs should be sold to the private sector was not within the scope of this review or any other subsequent audit. In addition, issues associated with foreign ownership were also considered to fall within the definition of government policy and as such are outside the province of the Auditor-General.

3.6 Expert advice from Deloitte Touche Tohmatsu was used in the conduct of the review.

THE ORIGIN OF CENTRAL AGENCY REVIEWS

The Fergus Ryan Report

3.7 One of the key findings included in the Report (commonly referred to as the Fergus Ryan Report) covering the first performance audit of my Office in 1992 related to risk assessment and scoping. Specific comments centred on the following:

- before preparing an audit plan for an entity (be it a Government, a corporation or another auditee) the auditor needs to perform a review of overall audit risk or "general risk analysis";
- the process of performing a general risk analysis demands primarily an understanding of the pervasive risks which surround the Government which may include the management control environment and the impact of policy and regulatory changes;
- on completion of the general risk analysis the auditor would theoretically be in a position to identify the areas of highest risk and determine the entities within the total population which should attract the focus of audit effort;
- the audit process adds most value if it is directed at prevention rather than the cure i.e. the process fails to deliver maximum value if it continues to identify symptoms without ever addressing the cause;
- the Auditor-General can better identify the risks to be addressed by audit if more attention is devoted to identifying the causes of problems rather than their effects by giving greater recognition to the role of Central Agencies in ensuring that pervasive controls are in place and operating effectively;
- if the auditor is able to conclude that these controls are effective, then the amount of detailed audit work required at the operational level may be reduced; and
- there is a significant opportunity to enhance the risk identification process within the whole public sector if the Auditor-General, in the first instance, concentrates more on Central Agencies that have a responsibility to ensure that the pervasive management controls are in place (whether or not those agencies are doing their job in this area represents a significant influence on the development of the overall audit plan for the Auditor-General).

3.8 In view of these findings the performance auditor concluded that the Auditor-General should review the Central Agencies using his performance audit methodology to determine whether such agencies are achieving their objectives.

3.9 In recognising the magnitude of this task Ryan recommended that, as it would be clearly impossible to cover each of the agencies' objectives every year, the critical objectives should be examined annually and the less important, less frequently. He conveyed a clear warning that if policies and procedures in key policy areas are not in place and working effectively, the consequences may cascade into the Public Sector at large. Importantly, the Fergus Ryan Report signalled that "*in cause and effect terms, this is where the Auditor-General can better 'payback' in helping the Executive identify, and thus prevent, likely future problems*".

The Public Accounts and Estimates Committee report

3.10 The Public Accounts and Estimates Committee, in its Second Report to the Parliament in November 1993 titled *The Performance Audit of the Auditor-General of Victoria*, provided an important commentary on audit planning and risk assessment. The Committee stated that once potential risks have been identified by audit, a preliminary assessment can be made of the controls which senior management have put in place to identify and manage those risks. If the controls are absent or are not working effectively, there are likely to be recurring problems at the operational level. Although assessing risk is seen as an essential element of the audit planning process, the Committee concluded that the primary responsibility for risk identification and management within the public sector rests not with the Auditor-General, but with the Central Agencies. If these procedures (or controls) are inadequate, the Committee found that the Auditor-General has a responsibility to report any deficiencies to the Parliament and/or management so that action may be taken to rectify existing weaknesses.

3.11 On the subject as to the appropriate timing of assessments, the Committee found that early audit of risk identification and management processes within Central Agencies would increase the overall benefits derived from such audits and, in its view, remains a priority given the State's potential risks.

3.12 In relation to risk assessment the Committee concluded that it should contribute to the Auditor-General's risk assessment process within the public sector. The mechanism recommended to accommodate this finding involved the Auditor-General submitting a copy of his annual performance audit plan to the Committee, with the Committee given the opportunity to discuss the plan with the Auditor-General, and suggest, but not dictate, subjects for performance audits.

3.13 Subsequent amendments to the Audit Act, effective from June 1994, provided the legislative framework for the Office's annual performance audit plan to be prepared in consultation with the Committee.

Performance audit plan adopted for 1994-95

3.14 In June 1994, the Committee provided a list of possible performance audit topics based on its assessment of materiality and risk. Reform of GBEs, which was included on this list, coincided with views of my Office that a risk management audit in the then Department of the Treasury should commence during 1994-95.

Department of the Treasury - Risk management audit

3.15 The overall objective of the above audit was to assess the processes developed by the Department to manage the major operational issues arising from the implementation of key government policies, within the context of the Central Agency's key functional areas of responsibility.

3.16 At the time of commencing the audit, the Department had the following functional areas of responsibility:

- ensure responsible financial management;
- initiate effective financial and economic reforms;
- manage, prepare and monitor the State's Budget;
- generate and collect revenue;
- monitor and manage State debt and liabilities;
- ensure that Victoria has a value for money capital works program;
- conduct capital project evaluations and facilitate infrastructure development;
- facilitate the corporatisation or **privatisation of relevant GBEs** in consultation with portfolio agencies;
- provide on-going performance monitoring of GBEs;
- enhance the effectiveness of inter-governmental financial relations; and
- provide secretariat and bureau services to the Treasurer and Secretary.

3.17 As indicated in my May 1995 *Report on Ministerial Portfolios*, the Government's reform and privatisation program for the electricity supply industry involves arguably the most significant structural and resource management changes within the public sector in the history of the State.

3.18 Because of the importance of privatisation, particularly to the community, I developed specific objectives (refer earlier in Part 3 of this Report) for this area of review and determined that the preliminary results of my examination, which involved the identification of broad high level criteria for the management of issues associated with privatisation, should be reported to the Parliament.

Part 4

Criteria for the management of issues associated with privatisation

4.1 The size and complexity of a particular privatisation will influence the degree of flexibility required in applying the following high level criteria, which have been developed and agreed with the Secretary of the Department of Treasury and Finance as appropriate for the management of a range of key issues.

4.2 Certain of the criteria are considered relevant for the management, in a general sense, of economic, social and environmental issues associated with any privatisation whereas others relate specifically to the electricity supply industry.

Criteria for the management of economic, social and environmental issues associated with privatisation

4.3 These criteria are summarised below.

**Research
and analysis**

A comprehensive evaluation of a particular industry and operating environment should be undertaken to ensure decisions taken by the Government with respect to the available reform options provide the best prospect of achieving the reform objectives.

Prior to privatising a GBE, the model to be adopted should be extensively tested to enhance the likelihood of realising the intended benefits (e.g. establishing a competitive environment and the best cost structure for users).

The decision to privatise should be supported by a detailed cost-benefit analysis which takes into account commercial, social and environmental factors, including any possible losses in economies of scale.

In the process of privatising a GBE, sufficient analysis and evaluation needs to be undertaken by the Government to ensure that the method of sale chosen and its timing will lead to the most cost-effective result for the State.

**Management of
significant issues**

Appropriate risk criteria, management strategies and key success benchmarks need to be developed to enable significant issues facing the Government and the public to be adequately managed.

National market

The State reforms need to be compatible with the agreed national reforms if Victoria's GBEs in private ownership are to compete in a national market.

***Commonwealth - State
Financial Arrangements***

The Victorian Government should endeavour to obtain compensation from the Federal Government for the transfer of revenue to the Commonwealth.

The Victorian Government should also endeavour to secure an appropriate share of the revenue growth that is anticipated to flow from the introduction of competition policy reforms.

***Business performance,
pricing and quality of service***

In terms of maximising the public benefit to be derived from privatisation, it is important that privatisation:

- promotes competition;
- enhances business performance and efficiency;
- provides the best cost structure for users; and
- improves quality of service delivery.

***Social and
environmental implications***

When embarking on the assessment and implementation of policy changes in industry reform, the Government needs to take into account the implications of the reforms for:

- social and environmental obligations;
- consumer protection;
- standards of service;
- access to supply;
- safety; and
- dispute resolution facilities.

Consultation

The Government should consult with all affected parties to outline the rationale for the reforms and to explain the consequences of the new arrangements for them.

Return on public assets

The Government should, in the context of the proposed structural and regulatory reforms, take all reasonable steps to maximise the return on public assets that are to be privatised.

Appropriate valuation methods should be applied prior to sale to optimise the return on public assets that are privatised.

In sale negotiations the Government needs to analyse the impact of trade-offs between retaining various risks and achieving a relatively higher sale price for the public retention of such exposures, compared to allocating risks to the private sector and thereby discounting the sale price.

Criteria developed to address the management of specific issues relating to privatisation of the electricity supply industry

4.4 These criteria are set out below.

Disaggregation

Research needs to demonstrate that Victoria, with a population of 4.5 million, will be able to sustain 5 generation companies to provide electricity in this market. The Government will also need to be assured that power generation companies will be able to attract an adequate market share to cover their fixed costs, the future level of investment in infrastructure will continue at an appropriate level and each generation company will be able to compete with other generators.

Procedures need to be in place to ensure that collusive practices do not eventuate between generators to ensure that artificial pricing from the trading pool does not occur.

Pricing

The Government needs to be reasonably assured that under privatisation retail prices for electricity consumption are not likely to increase significantly after the year 2000 when full competition will be in operation.

System security

Electricity generators need to be effectively coordinated in order that power blackouts are no more likely to occur in the event of a breakdown in one of the individually owned power stations.

Vesting Contracts

Vesting Contracts between generators and distributors should include *force majeure* relief provisions (a *force majeure* event may be broadly defined as circumstances which are beyond the control of the affected party and significantly limit the ability of the affected party to operate and earn revenue e.g. labour disputes or a major failure in the transmission network or the relevant distribution system) to limit the financial risks to such parties and ensure that sale prices under privatisation are not adversely affected.

4.5 As a precursor to subsequent audits of particular privatisations, the Department of Treasury and Finance has responded to these broad criteria in terms of the way the Government has addressed each to date and consequently has contributed in a positive way to enhancing public accountability at an early stage. Part 5 details the Department's position.

Part 5

Processes developed by the Government to manage the privatisation reform process

MANAGEMENT OF ECONOMIC, SOCIAL AND ENVIRONMENTAL ISSUES ASSOCIATED WITH PRIVATISATION

5.1 Processes implemented by the Government to address various issues connected with privatisation are set out hereunder according to the high level criteria established by audit.

5.2 Due to the relatively advanced stage of electricity sector reform, the responses from the Department of Treasury and Finance have drawn heavily on the Electricity Supply Industry experience to illustrate the steps in the reform process leading to the Government's privatisation program for the electricity industry.

Research and analysis

A comprehensive evaluation of a particular industry and operating environment should be undertaken to ensure decisions taken by the Government with respect to the available reform options provide the best prospect of achieving the reform objectives.

- **BACKGROUND INFORMATION** provided by Acting Secretary, Department of Treasury and Finance

The process of reform requires the detailed examination of the particular industry and GBE operating environment so that action can be taken to introduce or increase competitive pressures and, where appropriate, develop the industry structure to ensure an efficient and viable competitive industry. The process for reform therefore centres around the development of a mechanism which leads to a smooth transition from a public monopoly, to a contestable market.

Factors taken into account when investigating the feasibility of privatisation include the:

- *Creation of a competitive industry resulting in sustained benefits to consumers through lower prices than that of a non-privatised industry. This includes the analysis of the benefits of increased competition through structural disaggregation against any potential loss of economies of scale;*
- *Creation of commercially structured economically viable entities;*
- *Capacity to effectively regulate market behaviour of firms in the transition period when the conditions for full and open competition have not been fully established;*
- *Shape of a national market and the ability of Victorian businesses to effectively compete;*
- *Ability to cost effectively separate technical, health and safety regulations from economic regulation; and*
- *Lessons of privatisation effects overseas are used to assist in developing a more robust and workable process of reform which must precede the privatisation phase.*

The development of a credible, stable and predictable regulatory framework for each industry sector is an important consideration to protect the public interest, safeguard the State's ownership interests and minimise risk to Government and the community of business failure.

As many of the reform targets are vertically integrated monopolies (e.g. electricity), intensive work is required to determine appropriate transitional and longer term industry and market structures.

In consultation with the relevant portfolio Departments, detailed project briefs, identifying dimensions of the task, priorities (including transition), resource requirements, and timetables for specific key tasks and outcomes, have been developed.

The major steps in the process are:

- *formation of principal steering groups;*
- *examination of the business operating environment and options for reorganisation;*
- *a detailed review of industry and scoping studies using external expertise to identify and evaluate structural reform options which could eventually form the basis for the announcement of the next major steps in the reform process; and*
- *a framework and timetable with options and preferred model was submitted for review and endorsement by Government.*

The assessment of risks during the reform process and management of those risks has been a central matter in the industry review process leading to the identification and refinement of preferred reform options. It is important to recognise that, irrespective of ownership and structure, there are a number of risks associated with these businesses including forecasting of demand, investment, operational issues etc. Monopoly structures and Government ownership tended to obscure those risks and shielded those working in the enterprises from the consequences of poor management of risk. Disaggregation and privatisation make those risks more explicit and sharpens the incentives to manage it.

Drawing on electricity as an example of that process the detailed reform began in August 1993 when Government announced that it would create 3 new businesses from the existing State Electricity Commission Victoria (SECV).

The mandate for these bodies was to work with the Government to initiate further restructuring of the industry along competitive lines.

In October 1993, the Electricity Supply Industry Review Unit (ESIRU) was established within the then Office of State Owned Enterprises to advise Government on further reform. The initial tasks were to undertake a rigorous analysis of the status of the electricity industry as it then existed, ESI reform worldwide, and national considerations and to develop a set of appropriate recommendations. To achieve this, ESIRU:

- *Exposed all available information relevant to reform decisions and implementation. This was achieved by commissioning status reports on all relevant issues from the SECV and Municipal Electricity Undertakings (MEUs);*
- *Commissioned critiques of the status reports by a range of Victorian, National and international consultants and circulated the recommendations of the critiquing consultants to the industry and Government agencies for comment;*
- *Organised workshops on the draft recommendations involving key Ministers, Government officials, representatives from State bodies and independent consultants; and*
- *Distilled from the process an overall body of expert analysis that would underpin Government decisions on continuing reform.*

This process which occurred over a six month period resulted in legislation which broke up Electricity Supply Victoria (ESV) and 11 MEUs into 5 regionally based distribution businesses established under Corporations Law, and the separation of National Electricity into Victorian Power Exchange and Power Net Victoria. Generation Victoria was disaggregated on 31 January 1995 into 4 generation companies, and a gas business retained within Generation Victoria.

The rigorous process adopted underwritten by acknowledged experts underpinned the reform from both an operational and intellectual perspective and ensured the reform was in line with the best national and international thinking.

It should be noted that the ESI reforms and privatisations have been the subject of previous reviews by the Audit Office as part of the "Report on Ministerial Portfolios" and in the "Report of the Auditor-General on the Statement of Financial Operations 1994-95" (includes evaluations of asset sales: GEB, BASS, United Energy, TAB, EITC, GFE Resources).

Also during the reform process reports on the perceived risks were commissioned which have been taken into consideration in the implementation of the reforms.

The model adopted by the Victorian Government was based on extensive analysis and critique by local and international expert consultants who clearly understood the strengths and weaknesses of similar reforms which had taken place worldwide.

The Victorian policy prescription and model for ESI reform (which underwent very rigorous analysis) has received both national (Victoria is the basis for national market) and international recognition. The value yield being experienced from the ESI privatisation program is vindicating the extensive system design work and planning which went into the reform process.

Prior to privatising a GBE, the model to be adopted should be extensively tested to enhance the likelihood of realising the intended benefits (e.g. establishing a competitive environment and the best cost structure for users).

□ **BACKGROUND INFORMATION** provided by Acting Secretary, Department of Treasury and Finance

Given the advanced nature of the ESI reform process the Department's response to this perceived risk draws specifically on that sector.

When determining the appropriate reform program for the Victorian ESI, lessons from the United Kingdom, New Zealand and other electricity industry reforms occurring world-wide, were taken into account.

Although overseas experience has demonstrated the dangers of failing to introduce the full rigours of competition in advance of sale, the United Kingdom reforms generally have been very successful in driving efficiency gains in the industry, in reducing overall prices and in providing benefits to shareholders:

- *Efficiency gains - number of employees in the industry has fallen 50 per cent in generation and 20 per cent in distribution;*
- *Price - prices for most customer groups have fallen since 1990 with falls of 10 per cent to 15 per cent in real terms for some customer groups. This outcome has been supported by independent studies in the UK;*
- *Service improvements - the disciplines of private sector ownership have led the companies to pay increased attention to the service they give to customers (i.e. fall in number of complaints); and*
- *Employee shareholding has significantly increased.*

In hindsight, 2 key structural mistakes were made in the UK reforms:

- *Effective duopoly in generation - while the wholesale market has provided an excellent mechanism for introducing competition, the UK Government failed to restructure the generation sector of the industry along competitive lines prior to privatisation. The duopolistic structure of generation has meant that generators can influence the pool price resulting in the regulator effectively applying a price cap on the spot price; and*
- *Failure to anticipate the large performance gains - both the UK Government and the capital markets failed to anticipate the large magnitude of the cost and efficiency gains that have now been realised which resulted in windfall gains to the privatised businesses.*

These mistakes do not reflect problems with the basic framework and mechanisms used to introduce competition, but rather they reflect avoidable choices made in the UK reforms. Victoria's reform program has clearly been influenced by the UK reforms. However, Victoria has had the opportunity to learn from these and other countries mistakes and as a direct result:

- *Implemented a more competitive market structure for generation;*
- *Lifted the performance of the businesses prior to privatisation to maximise the public benefit from any sales; and*
- *Introduced a franchise fee which is levied by Government on all parties licensed under the Electricity Industry Act 1993 to sell electricity to franchise customers. The fees are designed to capture the excess profits that would otherwise accrue to retailers as a result of the maximum uniform tariffs exceeding the forecast cost of supplying electricity to franchise customers. The franchise fee has been set by Government so as to allow a 2 per cent retail margin return on the franchised customers. In calculating the 2 per cent retail margin, Government has allowed for productivity improvements of 4 per cent for 1995-96 and 1996-97.*

The model has been extensively tested. Various trials have been conducted in relation to the national market reforms and throughout its restructure the major elements of the market model developed in Victoria have been trailed through practical application within the corporate structure adopted at the various stages of reform. The corporate structure has also been progressively introduced, as far as practicable, replicating the privatisation model while the industry is still in Government ownership.

The privatisation model put forward for the Victorian reforms was also extensively analysed by way of financial modelling. The financial models developed for the testing of the distribution businesses were prepared by KPMG and for the generation businesses by CS First Boston. Both models were reviewed and endorsed independently by Ernst & Young.

The decision to privatise should be supported by a detailed cost-benefit analysis which takes into account commercial, social and environmental factors, including any possible losses in economies of scale.

□ **BACKGROUND INFORMATION** provided by Acting Secretary, Department of Treasury and Finance

It needs to be recognised that the rationale and supporting analysis for reform is not always entirely driven at the state level (eg. Hilmer Report). The Federal Government's Agenda for Microeconomic commenced in 1988 with an Inquiry by the Industries Assistance Commission into Government (Non-Tax) Charges. This Inquiry examined the performance of Government Entities providing a range of services to the Australian community, and generally concluded that the cost and level of service achieved left much to be desired. Energy supply was identified as a particular area of concern, and led to a second Inquiry in 1990 by the Industry Commission into energy generation and distribution.

The Industry Commission Inquiry reported in May 1991 and identified many areas of poor performance, particularly in investment decisions and electricity pricing. The findings and recommendations of the Inquiry were reasonably summarised in the Preface to the Summary Report which stated:

"Governments and energy utilities agree that there is substantial scope for improving the efficiency of energy generation and distribution in Australia. The potential gains are large - in the order of \$2.4 billion a year.

*To increase competition and improve efficiency, the Commission recommends significant changes to the structure of the electricity and natural gas supply industries. This involves separating ownership of key functions in each industry and **progressively selling much of the publicly owned generation and distribution assets**. It would result in a considerable diminution on the dominant role traditionally played in Australia by publicly owned vertically integrated energy utilities.*

Most public utilities reject structural change. However, without it, many of the current inefficiencies may become even more deeply entrenched, significant change might never emerge and the nation could suffer the ongoing handicap of electricity and gas industries which are not performing to their full potential."

In relation to assessing the costs and benefits of privatisation for each GBE the general approach undertaken has been to assess the anticipated gains from industry restructure and reform against the possible loss of efficiency in scale or scope from disaggregation. However, as overseas experience indicates, it is very difficult to estimate with any precision the actual levels of efficiency that can flow from reform. (For example, in the UK experience, the efficiency gains were substantially underestimated and the pricing oversight was, as a consequence, too lenient). The gains to customers from reform will be measured in terms of real and sustainable price reductions. There has been substantial modelling of the ESI to demonstrate that price reductions are available from the reforms. In determining the cost/benefit of electricity privatisation, extensive financial modelling has been completed by KPMG (distribution businesses) and CS First Boston (generation businesses).

The assessment of the benefits and costs of privatisation include not only the assessment of the net benefits of the structural reforms (largely available without privatisation) but also an assessment of the benefits which are attributable from a change of ownership. As previously indicated a key reason for privatisation is to place true commercial disciplines on the management of business risk, rather than have commercial decisions of public enterprises underwritten by government guarantees (implied or otherwise).

Extensive analysis and modelling effort is undertaken in the course of developing options for reform, including critiquing reviews which test the validity of the key findings. In order to validate and confirm the financial analysis undertaken by the financial advisers, the major assumptions applied are confirmed by each of the businesses. The initial assumptions made in corporatising the electricity Distribution Businesses in October 1994 were reviewed and revised based on experience and development of improved data.

However, it should be noted that in the context of profound economy-wide changes (both in the State and National context) it is a difficult empirical problem to isolate the costs and benefits of any one reform, notwithstanding the empirical evidence which establishes the substantial benefits available from privatisation. This is particularly so for a small open economy like Australia that is heavily influenced by international events. Nevertheless, the Government has a very significant interest in monitoring the consequences of the reform program and has established a Monitoring Unit within the Department to maintain professional oversight of GBEs that remain in Government ownership.

The ORG has a very crucial and important role to oversee the performance of newly privatised GBEs that are subject to regulatory oversight to protect the interests of customers with respect to electricity prices and the safety, reliability and quality of electricity supply.

In the process of privatising a GBE, sufficient analysis and evaluation needs to be undertaken by the Government to ensure that the method of sale chosen and its timing will lead to the most cost-effective result for the State.

□ **BACKGROUND INFORMATION** provided by Acting Secretary, Department of Treasury and Finance

Government in looking to privatisation as the preferred model is likely to consider a trade sale, float, or a combination of these 2 methods.

In completing a sale transaction by way of float, the status of the financial markets is the key consideration. Government will not proceed with the float option if the financial markets are weak resulting in a loss of value. Other factors to be taken into account include the strength of management (ie. flotation requires strong management in order to maximise sale price) and the ability of the financial markets to absorb the float (i.e. will be dependent upon the number of floats that have occurred prior and during the float period).

As with the private sector these decisions are only taken after considerable analysis and evaluation and with the benefit of professional independent advice.

In respect of ESI privatisation the Government took the view that, having established a competitive industry model capable of delivering the longer-term economic objectives of the reforms, the sale process itself should be directed at maximising the proceeds so as to facilitate maximum public sector debt reduction. In looking to maximise that value the Government examined options for trade sales, floats or a combination of both and sought expert advice from its appointed advisors in analysing the method and timing for its privatisations.

Current analysis (and experience to date) verifies that trade sales for the electricity assets offer the best prospect to maximise returns based on:

- *A trade sale being most likely to achieve the highest value for the asset when measured against likely returns from a float;*
- *Analyst's advice that market conditions at the time of the sale were not generally conducive to floats which could lead to a loss in value in particular recognising the normal discount taken on an initial public offering and also taking into consideration the cost of conducting a float process;*

- *Government receiving very strong interest from potential trade buyers (research, roadshows and general expressions of interest) ensuring a strong competitive environment for the assets through a trade sale;*
- *The higher trade prices for the earlier sales set a valuation benchmark for subsequent distribution business (DB) privatisations and lead to more informed judgments on value;*
- *Trade sales offer the best prospect over a float to inform potential buyers of the newly restructured industry and the risk allocation decisions taken, through management presentations etc.;*
- *The demonstrated vulnerability of a float process (and hence proceeds) to political influences eg. TAB Corp; and*
- *Trade buyers would bring special expertise, international knowledge and work methods and product innovation to improve efficiency and service within the industry. That precedent had already been set in respect of Mission Energy's operation of Loy Yang B.*

Whilst adopting the trade sale approach in privatisations to date Government maintains the option of a full or partial float before actually committing to sale. The two processes run in parallel up until a point whereby the overall benefits can be compared and a final decision on the sales process is made by Government.

Management of significant issues

Appropriate risk criteria, management strategies and key success benchmarks need to be developed to enable significant issues facing the Government and the public to be adequately managed.

- **BACKGROUND INFORMATION** provided by Acting Secretary, Department of Treasury and Finance

Drawing on ESI experience risk assessment for that sector can be divided into 3 categories:

- *What risks will face the Victorian ESI in a competitive national electricity market as proposed by COAG? In particular, will the Victorian ESI on past practices be a competitive participant in the market;*
- *What are the underlying risks in the industry that needed to be identified and allocated as the industry is restructured; and*
- *What risks may arise in the reform process itself?*

In the first category, the key criteria are:

- *Building on the competitive position of Victorian generators; and*
- *Ensuring the establishment of a viable competitive framework so as to make the industry compatible with the proposed national framework and regulation under National Competition Law. Further background is provided in the Department's response to risks identified with national market considerations.*

In the second category there have been 2 major studies undertaken on which various reform decisions were based (and which were made available to the Auditor-General):

- *a study by KPMG Peat Marwick to identify potential risks in the reformed industry; and*
- *a study on risk allocation undertaken by the Vesting Contracts Working group for the purpose of allocating risk within the industry under the vesting contract arrangements.*

Some of the transition risks that have needed to be managed include:

- *industrial relations;*
- *load forecasting risk (where historic metering data is not available); and*
- *risks to continued achievement of System Security Standards.*

In respect to industrial relations ongoing expert independent advice has been retained to manage industrial relations (IR) issues and co-ordinate action with relevant Government agencies. The main risk in forecasting load arises from franchise customers on fixed maximum uniform tariffs. Mechanisms have been developed in vesting contracts to best share this risk between the DBs and generation companies. The risks associated with system security standards have been addressed through focusing clear accountabilities on VPX and ensuring it has appropriate powers.

National market

The State reforms need to be compatible with the agreed national reforms if Victoria's GBEs in private ownership are to compete in a national market.

❑ **BACKGROUND INFORMATION** provided by Acting Secretary, Department of Treasury and Finance

The reforms of the Victorian Electricity Industry are consistent with the proposed National Competition Policy principles as outlined in the 1993 Hilmer Report. The main National Competition Policy recommendations were:

- *Extension of the application of market conduct rules (in Part IV of the Trade Practices Act [TPA]) to the public sector, to unincorporated businesses;*
- *Separation of regulatory and commercial functions and potentially competitive activities from the natural monopoly elements of an industry;*
- *Guaranteed rights of access at reasonable prices to certain essential facilities. The terms and conditions for access will be regulated by the proposed Australian Competition and Consumer Commission (ACCC); and*
- *Prices oversight by an independent body.*

Victoria, being well advanced of other States in the reform of the electricity supply industry, has a strong advantage in creating a national framework which needs to give continuing commercial certainty for the operation and regulation of a market which now includes private operators. The Victorian legislative experience in this area and its understanding of the operational and commercial issues has placed the State in a strong position to lead the change process.

In view of the advanced nature of the Victorian reforms it was necessary to obtain a ruling from the Trade Practices Commission on the consistency of the Victorian access regime in the context of the access principles in the National Competition Reform Package. The Trade Practices Commission subsequently endorsed the Victorian regime "having assessed the Victorian access and related reforms, the Commission has concluded that they conform with the criteria in the CPA [Competition Principles Agreement] and can be assessed as effective in relation to their operation and effect within Victoria" (Review of the Victorian Electricity Industry Access Arrangements, TPC May 1995). The TPC pointed out that several issues relating to the transition to National arrangements remained unresolved, preventing a more complete endorsement of the effectiveness of the Victorian regime. In a subsequent exchange of letters, the Victorian Government clarified the transitional issues and the Assistant Treasurer, Mr G. Gear replied "Based on the above assurances [provided in a letter from the Premier to Mr Gear] it is the Commonwealth's judgement that the Victorian electricity access regime would be found to be consistent with the CPA".

The major operating entity of the proposed national market, NEMMCO (National Electricity Market Management Company) will perform a function that will build upon the Victorian Power Exchange. The Commonwealth, New South Wales and Victorian governments have agreed to establish the Systems Development Joint Venture (SDJV) comprising TransGrid (the Electricity Transmission Authority of NSW) and the Victorian Power Exchange to progress the development of NEMMCO's function.

The Victorian Government has also sought preliminary advice from the Trade Practices Commission on the "effectiveness" of the Victorian ESI access regime in order to ensure the Victorian reforms are compatible with National developments. The Commission concluded that the Victorian reforms can be assessed as "effective".

The national market proposed by the National Grid Management Council (NGMC) is similar in many respects to the Victorian wholesale electricity market and has been developed in a close and co-operative process in consultation with Victoria, which is in the lead. Other states are restructuring to make their schemes compatible.

Victoria will not enter into the national market until it is satisfied that the structure of the national market provides sufficient market competition and does not allow any one market participant to dominate the market, and that efficient and effective mechanisms for regulating and administering the national market have been established, and there is agreement on the Code of Conduct and on States' transitional mechanisms.

Commonwealth - State Financial Arrangements

The Victorian Government should endeavour to obtain compensation from the Federal Government for the transfer of revenue to the Commonwealth.

The Victorian Government should also endeavour to secure an appropriate share of the revenue growth that is anticipated to flow from the introduction of competition policy reforms.

❑ **BACKGROUND INFORMATION** provided by Acting Secretary, Department of Treasury and Finance

Victoria has played a leading role amongst the States and Territories in seeking tax compensation from the Commonwealth.

With the assistance of a prominent accounting house and a leading academic commentator on tax compensation, the Department of Treasury & Finance is compiling a case for tax compensation from the Commonwealth for Victoria on the sale of TABCORP.

At the fifth meeting of the Council of Australian Governments April 1995, the Council agreed to a mechanism for sharing the revenue gains from National Competition Policy and related reforms. The competition payments are provided in three payments which will involve payments to participating jurisdictions of \$200 million in 1997-98 (1994-95 prices), \$400 million (1994-95 prices) in 1999-2000, and \$600 million (1994-95 prices) in 2001-2002.

The Victorian Government played a lead role in securing these payments to the States and Territories in recognition for their role in implementing the Hilmer reforms.

**Business performance,
pricing and quality of service**

In terms of maximising the public benefit to be derived from privatisation, it is important that privatisation:

- **promotes competition;**
- **enhances business performance and efficiency;**
- **provides the best cost structure for users; and**
- **improves quality of service delivery.**

❑ **BACKGROUND INFORMATION** provided by Acting Secretary, Department of Treasury and Finance

The following processes are in place to ensure that privatisation of the ESI leads to:

▪ *Promotion of Competition*

A key reform to facilitate competition is the separation of monopoly network and distribution functions from the competitive functions of generating electricity and the buying and selling (retailing) of electricity.

The new industry structure promotes competition through:

- *Wholesale market - a competitive market has been created involving multiple buyers (5 distribution companies (both private and publicly owned), large consumers and interstate purchasers) and multiple sellers (5 generation companies);*
- *Retail competition - the final retail price to contestable customers is subject to competition. Customers with the appropriate metering will be able to choose between different retailers. The number of customers with choice at the retail level will progressively increase towards the year 2000 at which time all customers will have choice;*
- *Competition in input markets - increased opportunities for outsourcing and competitive tendering for services such as maintenance and construction; and*
- *Improved quality of service delivery.*

Enhanced business performance, efficiency and cost structure for users:

The creation of a competitive environment will ensure enhanced business performance and efficiency. Also, Government has created independent regulation of the industry through the establishment of the Office of the Regulator General (ORG) which will monitor the industry and set maximum prices which the uncontested components of the industry, namely transmission and distribution companies, can charge to their customers.

The Tariffs and Charges Deed between the Government and each of the distribution companies sets out the annual price adjustments for distribution and retail prices. The Electricity Act details the power given to ORG to regulate prescribed prices, pursuant to the ORG Act.

The specific pricing arrangements for the distribution and retail arms of the business are:

▪ *Distribution*

The distribution businesses earn distribution revenue from connection charges and [volumes] based charges for usage of the distribution assets. These distribution charges for each distribution business have been initially set by Government, as have the 'X' factors for future price rises until the year 2000 based on a 'CPI-X' formula. From 1 July 2000, the ORG will regulate further price movements.

▪ *Retail*

One of the Government's primary objectives in restructuring and privatising the electricity industry is to provide real price reductions to consumers. Retail pricing to contestable customers is not subject to any specific constraints and will be determined by market forces, having regard to electricity purchase prices, transmission and distribution prices. However, during the transition to a competitive market, Government has established Maximum Uniform Tariffs (MUTs), comprising both fixed and usage based elements, in respect of franchise customers.

ORG has the responsibility to ensure the interests of consumers with respect to the quality of service delivery. Under the Supply and Sale Code, the minimum conditions under which distributors sell electricity to franchise customers are stipulated. The code obliges a distributor to provide the basic services to franchise customers, including supplying and maintaining distribution equipment to the point of supply, providing standard metering and to make reasonable efforts to supply electricity at the prescribed standard voltage and frequency.

Service standards with contestable customers are to be agreed upon by the retailer and the customer. The distribution licences stipulate that the retailer must establish, publish and maintain reference manuals and application standards for the design, construction and maintenance practices of their distribution network. ORG will ensure that certain minimum standards are maintained and it is anticipated that ORG will issue guidelines as to what constitutes the minimum guidelines.

Social and environmental implications

When embarking on the assessment and implementation of policy changes in industry reform, the Government needs to take into account the implications of the reforms for:

- social and environmental obligations;
- consumer protection;
- standards of service;
- access to supply;
- safety; and
- dispute resolution facilities.

Social and environmental obligations

- **BACKGROUND INFORMATION** provided by Acting Secretary, Department of Treasury and Finance

Government has established a policy on community service obligations (CSOs) to ensure that there is a framework for assessing and delivering agreed obligations of the government.

Government's CSO policy aims at providing a method to identify desirable social and community programs to make the programs visible to all and to make delivery of those programs accountable to the wider community.

The following 3 criteria are the basis for defining CSOs:

- *The CSO is provided for some identifiable community or social benefit;*
- *The CSO is the result of a specific Government directive regarding the provision of the CSO and the conditions of its supply; and*
- *The CSO would not be supplied if the recipient was acting primarily in its own commercial interest. Instances of 'good corporate citizenship', such as sponsorship, are not included as CSOs.*

In developing interim customer service quality standards in the electricity sector, the DBs have informed ORG that they will continue meeting the customer quality standards developed by the former Electricity Services Victoria and certified to the ISC 9000 series.

The concessions to low income and pensioner groups are being maintained with the continuation of the 17.5 per cent Winter Energy Concession. The Winter Energy Concession for low income and pensioner groups was increased from 15 per cent to 17.5 per cent when the Government took office. The fixed supply charge for Commonwealth concession cardholders who only consume small amounts of power will not exceed the amount they are charged for electricity consumption. This new benefit will flow to 40 000 concession cardholders who will pay on average 22 per cent less on their power bills.

Government addresses non-commercial issues associated with privatisation by separating economic regulation from technical, health and safety regulation (including environmental controls) and ensuring responsibility for non-commercial regulation is not compromised by the commercial objectives of new businesses.

At a more general level the non-commercial objectives of government (e.g. environmental objectives) are met using a number of mechanisms. First, it is important to separate and clarify technical (including environmental) regulation from economic regulation. As a general rule the new businesses established by Government and those in private ownership must operate and be subject to the regulatory arrangements established by the Government and other jurisdictions. In fact adherence within the electricity industry will be increased under private ownership given that the SECV enjoyed a number of exemptions to regulatory and monitoring arrangements. The industry through a range of regulatory (EPA etc.) and co-operative mechanisms will be required to ensure that environmental objectives are achieved and that businesses move towards best practice environmental management. These aspects will be oversighted by the EPA and ORG which have the necessary regulatory and licensing powers.

Consumer protection, standards of service, access to supply and safety

□ **BACKGROUND INFORMATION** provided by Acting Secretary, Department of Treasury and Finance

Throughout the planning for a privatised electricity industry, protection and enhancement of consumer interests has been a prime consideration. Embedded in the new electricity industry structure are several levels of regulation and protection - all geared to ensuring the rights and interests of the electricity consumer as a class and individually are safeguarded.

For the electricity industry service levels are expected to improve with the creation of competition and the opportunity for customer choice. Retailers will compete to supply customers and will offer the best possible service to win business.

Where competition is not considered an adequate mechanism to protect consumers, the ORG will ensure that service standards are met in accordance with the Supply and Sale Code. The Supply and Sale Code applies to distribution businesses, retailers and customers. The code sets the minimum conditions under which distributors sell electricity to franchise customers.

The code obliges a distributor to provide the basic services to franchise customers, including supplying and maintaining distribution equipment to the point of supply, providing standard metering and to make reasonable efforts to supply electricity at the prescribed standard voltage and frequency.

Furthermore service standards with contestable customers are to be agreed upon by the retailer and the customer. The distribution licences stipulate that the retailer must establish, publish and maintain reference manuals and application standards for the design, construction and maintenance practices of their distribution network. ORG will ensure that certain minimum standards are maintained and it is anticipated that ORG will issue guidelines as to what constitutes the minimum guidelines (refer to clause 14 of the distribution licences and clause 11 of the retail licences).

In the transition period the Government has monitored the levels of service standards provided by the new businesses and where there is evidence of problems in relation to customer service, the Government has worked with the new businesses to reduce perceived deficiencies.

Dispute resolution measures

□ **BACKGROUND INFORMATION** provided by Acting Secretary, Department of Treasury and Finance

For the electricity supply industry customer service during the period to free market method of control are guaranteed pursuant to the terms of the relevant licences, and by the Statement of Government Policy as gazetted, which provides as follows:

Customer Empowerment and Customer Standards

While all Victorians will ultimately benefit from competition in the Victorian electricity industry, in particular from the empowerment that choice will give them in their dealings with their suppliers, the benefit of choice will not be immediately available to all customers. To ensure that no customer is disadvantaged in the transition to competition and choice, this statement declares that it is Government policy that the Office of the Regulator General should require each distribution company, by way of a licence condition, to:

- *develop and publish its own:*
 - *customer guaranteed and overall performance standards which will be at least equal to existing standards;*
 - *complaint handling, escalation and resolution policies, practices and procedures;*
 - *credit, security deposit and disconnection policies, practices and procedures which will be at least equal to those now applying;*
 - *procedures for compensating customers for a company's failure to comply with its customer guaranteed standards; and*
 - *report to the Office its performance against those standards, policies, practices and procedures.*

As competition develops within the electricity industry, it is expected that distribution companies and other retailers will offer innovative price/service mixes tailored to individual customer's needs. In order to promote the development of such innovative offers it is Government policy that the Office of the Regulator General should monitor, and report on, compliance by the distribution companies with their standards, policies, practices and procedures and intervene in the setting of standards only where:

- *there is a demonstrated failure by a distribution company to comply with its standards, policies, practices or procedures; or*
- *there is a clear need for an additional standard or procedure to prevent abuse of monopoly power.*

There are numerous measures available to the Office of the Regulator-General to monitor consumer issues, needs and concerns irrespective of ownership. Some of these measures are listed below:

- *The Electricity Industry Ombudsman will have a direct reporting responsibility to the Office of the Regulator-General to keep it informed of the nature of complaints and enquires being received. This will enable the Office to take action where companies are in breach of codes and licence conditions;*
- *It is in close contact with the Office of Fair Trading to learn the nature of the complaint received by that Office, particularly those of a recurring nature; and*
- *It has established a Customer Consultative Committee to enable it to hear the needs and concerns of all customers, domestic through to industrial and commercial and examine specific issues eg. disconnection policies, security deposits.*

The Committee's members represent the following peak organisations:

- *Australian Chamber of Manufacturers;*
- *Australian Federation of Consumer Organisations;*
- *Building Owners and Managers Association of Australia;*
- *Consumer Advocacy and Financial Counselling Association of Victoria;*
- *Environment Victoria;*
- *Victorian Council of Social Service;*
- *Victorian Employers' Chamber of Commerce and Industry; and*
- *Victorian Farmers Federation.*

As indicated above an Electricity Industry Ombudsman (EIO) Scheme has been established. The aim of this Scheme is to protect the interests of individual domestic and business consumers and provide an appropriate avenue for dispute resolution. All five electricity companies are voluntary participants with all new electricity retailers expected to join this Scheme. The Electricity Industry Ombudsman will enjoy total independence and autonomy and will be able to make legally binding decisions. These decisions will be made in individual cases by reference to canons of fairness, good electricity industry practice and the law. The Scheme and the procedures adopted by the Ombudsman will avoid the use of legalistic approaches, and will not affect in any way the powers of other agencies (such as the Office of Fair Trading) or the rights consumers and property owners otherwise have.

Consultation

The Government should consult with all affected parties to outline the rationale for the reforms and to explain the consequences of the new arrangements for them.

- **BACKGROUND INFORMATION** provided by Acting Secretary, Department of Treasury and Finance

The Government has engaged in a wide process of consultation with affected parties before making the decision to privatise a GBE. A number of discussion papers have been prepared to identify the issues and to stimulate public debate. Subsequently, members of the Government have met with representatives of interest groups to discuss the reform plans. In some cases (eg port reform), formal submissions were sought from interested parties prior to a series of meetings between the Minister for Roads and Ports with interest groups to discuss the Government's preferred option for reform. The consultation process provided valuable feedback to the Government on the reform options and provided useful information in the determination of the Government's final position.

During the reform of ESI, Government negotiated with the relevant union groups prior to completing major structural changes.

**Return on
public assets**

The Government should, in the context of the proposed structural and regulatory reforms, take all reasonable steps to maximise the return on public assets that are to be privatised.

- **BACKGROUND INFORMATION** provided by Acting Secretary, Department of Treasury and Finance

It should be reiterated that the objective of privatisation is not to maximise sale value per se, but to ensure maximum public benefit - which is a combination of a return on public assets, a contestable market structure and lowest possible prices to consumers.

The reform process has been predicated on establishing an industry structure that is robust and competitive and capable of participating effectively in the emerging national market.

The establishment of separate reform and privatisation units has allowed the clear separation of valuation and disposal phases of the overall reform processes.

Selling ESI as a whole business was one of the options available to Government. It is acknowledged that the selling of a monopoly business would generate a higher return than selling a disaggregated industry. However, Government's main objective was to create a pro-competitive environment for the electricity supply industry and therefore the disaggregation of the industry was an important pre-condition for competition. Moreover, there was the view that in the current climate of reform, including the Hilmer principles, that buyers would have considered an integrated business as unsustainable and subject to heavy regulatory intervention - discounting the values accordingly. Consequently, Government 'maximises' value by establishing a stable regulatory regime that is considered credible by industry participants.

Government has allocated debt to the businesses to commercial levels based on industry benchmarks. By allocating it on a commercial basis, Government is providing the potential purchaser with the option of taking on the debt facilities negotiated by Government. This will reduce the risk of the sale value being discounted by a potential purchaser for the unknown ability to get the debt facilities.

The Government has structured the ESI sales process to ensure the maximum flexibility is available.

Appropriate valuation methods should be applied prior to sale to optimise the return on public assets that are privatised.

- **BACKGROUND INFORMATION** provided by Acting Secretary, Department of Treasury and Finance

- *While a substantial amount of analysis is undertaken to value GBEs to be privatised, it is important to recognise that the ultimate arbiter of value is the market place. Moreover, decisions taken by the Government to create the conditions for contestability may reduce the value of the businesses, to the extent that the capacity to earn monopoly rent has been eroded.*
- *The methodology used to value the GBEs was price/EBIT multiple and discounted cash flows.*
- *The main objective of the reform is to create a competitive environment and therefore the focus has been on disaggregating the industry.*

- Audited financial statements were used by government in acquiring the 11 MEUs owned by local councils. Audited statements for SECV and its successor bodies and the MEUs are used when compiling historical financial information.
- The level of debt and other contingent liabilities such as superannuation will be taken into account by government and the purchaser when determining the sale prices.
- Any use of derivatives in relation to debt have been taken into account in the valuation of the businesses by recording the debt at marked to market value.

In sale negotiations the Government needs to analyse the impact of trade-offs between retaining various risks and achieving a relatively higher sale price for the public retention of such exposures, compared to allocating risks to the private sector and thereby discounting the sale price.

□ **BACKGROUND INFORMATION** provided by Acting Secretary, Department of Treasury and Finance

The Government's approach to allocation of risk in the context of sale negotiations is based on the following principles:

- Risks should be allocated to the party best able to, and with the incentive to, manage the risk; in most cases this means that the risk will lie with the businesses to be sold rather than the Government;
- Risks relate to "unknown" events and outcomes. Wherever possible the Government's approach is to seek to gain an understanding of significant risks by undertaking appropriate due diligence investigations. Steps can then be put in place, by Government or the businesses as appropriate, to manage any exposures;
- The trade-off between sales value and retention of risk is most effectively assessed by assignment of a "dollar value" to any risk retention.. This is most evident in the case of warranties, where increasing the cap for warranty claims translates to an effective reduction in sales value received by the vendor; and
- In assessing the "value" of risk retention, the Government, with the assistance of its advisers, has assessed the likelihood of the risk occurring and the monetary implications.

In the case of the sale of the electricity Distribution Businesses these principles have been applied as follows:

- In negotiating the sales agreements for privatisation of the Distribution Businesses, the Government sought to minimise the scope and dollar value of warranties;
- The warranty limits and areas were determined based on advice by the Government's legal, financial and accounting advisers and taking account of the materiality limits used as a basis for the Government's due diligence process and the scope of this due diligence; and
- During negotiation the Government's principles on risk allocation were explained to potential bidders. In particular the following position was taken:
 - the Government believed risks should be allocated to the party best able, and with the incentive, to manage the risk;
 - in the event the bidder chose to allocate risk to the Government through the sales agreements, the Government assigned a negative value to the risk in assessing the bid; and
 - risk thresholds were to be consistent with the materiality levels considered in the Government's due diligence.

MANAGEMENT OF SPECIFIC ISSUES RELATING TO PRIVATISATION OF THE ELECTRICITY SUPPLY INDUSTRY

5.3 The way in which specific issues have been managed in terms of the audit criteria are outlined below.

Disaggregation

Research needs to demonstrate that Victoria, with a population of 4.5 million, will be able to sustain 5 generation companies to provide electricity in this market. The Government will also need to be assured that power generation companies will be able to attract an adequate market share to cover their fixed costs, the future level of investment in infrastructure will continue at an appropriate level and each generation company will be able to compete with other generators.

- **BACKGROUND INFORMATION** provided by Acting Secretary, Department of Treasury and Finance

Level of Investment

The question of what is an appropriate level of investment in infrastructure is problematic. Under Government ownership, many GBEs have engaged in capital expenditure programs that have led to 'gold plating' and in the case of electricity excess capacity. The costs of inappropriate investment ultimately being borne by consumers. An example of poor planning occurred in 1980, where the SECV presented a report to the Government on power station siting, which foreshadowed the need for 21 future power station sites in the Latrobe Valley, to meet anticipated load growth to the year 2030. This followed earlier commitment for the 8x500 MW Loy Yang Project.

After privatisation, investment decisions will be based on a commercial assessment of the returns available from new infrastructure. Market risk in future will be carried by market participants, rather than consumers. This will place pressure on intending new generators, or retailers seeking contracts for new generation, to ensure that such capacity is of the correct cost profile to meet market needs as indicated by pool price patterns. This is expected to drive plant selection towards optimum mix and supply/demand balance. Private sector discipline should ensure that the capital cost of future projects meets Worlds Best Practice benchmarks.

A key aspect of the regulatory regime which will influence investment in infrastructure is the establishment of an access regime to essential facilities. In some markets the introduction of effective competition requires competitors to have access to facilities which exhibit natural monopoly characteristics, and hence cannot be economically duplicated. The access regime must strike a balance between creating effective competition and protecting owners rights and the incentive to invest in new infrastructure.

Generation Environment

In deciding the optimal number of generating businesses to be disaggregated Government undertook extensive studies to determine:

- *the size required for the generating businesses to achieve world class economies of scale; and*
- *the number of units required to create a competitive framework.*

Those studies concluded that disaggregation into five separate business entities would be desirable because of the:

VIABILITY OF COMPETITION - creating a competitive environment for generation in Victoria;

SUSTAINABILITY OF COMPETITION - disaggregation creates a structure with strong incentives for long term competition; and

UNITED KINGDOM REFORM EXPERIENCE - an effective duopoly of generation companies was established in the United Kingdom. Analysis of the United Kingdom electricity market showed that a greater level of disaggregation would have substantially enhanced the effectiveness of the market. Recently, regulation has been introduced in the United Kingdom so that the electricity price set in the market is subject to a regulatory price cap.

Victorian generators are not small companies and are sufficiently large to operate efficiently and competitively in the Australian market. This is illustrated by the following comparisons.

- Loy Yang Power would rank between Santos and ICI in terms of net profit. These companies currently rank 24 and 25 respectively in Australia.
- On an international perspective, Loy Yang Power would rank closely to Utilicorp (in terms of net assets and profit). Utilicorp is a successful international utility operating in the United States and abroad.

Very few economies of scale are achieved through large generation companies with international experience suggesting that very few (if any) economies of scale would exist through a less disaggregated generation industry. Experience since disaggregation of the Victorian generation industry has demonstrated that the disaggregated generators have performed well in terms of increasing productive efficiency, increasing availability and reliability, reducing costs and achieving reduced prices.

Such gains are unlikely to have been achieved if the industry had not been as highly disaggregated.

The competitiveness of generators in the national market will be largely determined by their capacities and relative cost positions. The interconnected three state structure will have incentives for generators to maximise returns. In an interconnected market, the effective demand for Victorian generation increases. This is primarily because of Victoria's low cost brown coal capacity becomes the low cost supplier to all three interconnected states and the efficiency of the generators.

Procedures need to be in place to ensure that collusive practices do not eventuate between generators to ensure that artificial pricing from the trading pool does not occur.

- **BACKGROUND INFORMATION** provided by Acting Secretary, Department of Treasury and Finance

The national market will be regulated by the National Electricity Code Administrator (NECA) which will administer and enforce a code of conduct subject to the oversight of market conduct and pricing aspects by the Australian Competition and Consumer Council. That role is currently undertaken by VPX.

In addition to this proposed regime the experiences of VPX, ESIRU and ORG will be applied. It should be noted that collusive practices are less likely where private ownership is predominant (Vic) in contrast to a situation where full government control is in place (NSW).

Pricing

The Government needs to be reasonably assured that under privatisation retail prices for electricity consumption are not likely to increase significantly after the year 2000 when full competition will be in operation.

- **BACKGROUND INFORMATION** provided by Acting Secretary, Department of Treasury and Finance

Assuming full contestability at the year 2000, prices beyond that time will be made up of 2 components, being:

- the energy component; and
- the grid component.

The energy component will be unregulated, and will rely on the competitive market to place downward pressure on prices.

The grid component, which comprises transmission and distribution fees, will be subject to regulatory review and setting by the Office of the Regulator General.

Arrangements put in place that impact on prices are:

- for franchise customers, Maximum Uniform Tariffs (MUTs) have been set during the transition period and a price path has been established; and
- for contestable customers before and after the transition period, the regulatory regime (ie. ORG which is an independent body) will oversee any price increases for monopoly components of the industry and set maximum price levels based on the impact of the distribution businesses cost structure (ensuring that only reasonable costs are taken into account).

In order to ensure that profits do not increase substantially, Government has levied:

- A franchise fee designed to capture excess profits that would otherwise accrue to the distribution companies as a result of Government setting MUTs across Victoria which are in excess of the cost of supplying electricity to franchise customers, including a fair return on assets; and
- An energy levy to partially or completely recover expected losses by the SECV Shell arising from the Loy Yang B trader and from sales to the Portland Smelter. The rate may not be increased other than CPI, but may be reduced by the Treasurer. The Treasurer may increase the cap once only and only after 31 Dec 2000. It is expected that the levy will be reduced or eliminated as electricity prices under the Loy Yang B contract reduce in July 2011.

If the distribution companies are able to generate excessive profits by decreasing operating costs while maintaining the standard of service, ORG will pass the benefits through to consumers at the next price review by reducing the maximum distribution price that a distributor can charge a customer.

System security

Electricity generators need to be effectively coordinated in order that power blackouts are no more likely to occur in the event of a breakdown in one of the individually owned power stations.

- **BACKGROUND INFORMATION** provided by Acting Secretary, Department of Treasury and Finance

While the competitive structure of the industry allows the market to determine energy prices and power station investments, the industry framework retains a number of important areas requiring some centralised co-ordination for reasons of efficiency, security or commercial neutrality.

The Victorian Power Exchange was created as an independent State Government owned statutory business on 3 October 1994, established under the Electricity Industry (Amendment) Act of 1994. VPX is required by legislation to “ensure the reliability of the supply of electricity in the State”. This important role is being achieved at a cost less than 1.2% of the total industry operating expenditure.

VPX’s key activities include:

1. *Power System Security*

VPX, through its System Control Centre and Regional Control Centres, operates Victoria’s power system to the delivery points in the transmission network. VPX facilitates safe access to the transmission network for maintenance and restoration of supply.

It manages operation of the power system in accordance with the Pool Rules and System Code which define power system security standards, operational quality and the arrangements for scheduling generation to meet demand. It also manages the maintenance co-ordination process of the system.

VPX procures and administers ancillary services and establishes appropriate operational arrangements at the interface with generating companies and distribution businesses.

2. *Market Development and Operations*

Following establishment of the rules for the operation of the wholesale electricity market VPX is responsible for developing and managing the market according to those rules. It must also monitor and report on market behaviour and the effectiveness of Pool Rules, administer the Wholesale Metering Code, administer the metering and settlements system, and plan and co-ordinate interstate trading.

3. *Network Planning and Development*

VPX is responsible for planning the augmentation of the transmission network, including control and stabilisation schemes, to meet growth in demand and generation. VPX is also responsible for the development and implementation of a network pricing structure to charge out the costs of the distribution network (presently owned exclusively by PowerNet) to market participants.

VPX administers the aspects of the System Code which ensure compliance with the technical requirements for connection to the power system and the technical quality of supply standards. Contracts for the use of the network by market participants and contracts with PowerNet for leasing of the network by VPX are prepared and administered.

Vesting Contracts

Vesting Contracts between generators and distributors should include force majeure relief provisions (a force majeure event may be broadly defined as circumstances which are beyond the control of the affected party and significantly limit the ability of the affected party to operate and earn revenue e.g. labour disputes or a major failure in the transmission network or the relevant distribution system) to limit the financial risks to such parties and ensure that sale prices under privatisation are not adversely affected.

- **BACKGROUND INFORMATION** provided by Acting Secretary, Department of Treasury and Finance

Force Majeure

A Force Majeure event is an event which results in the reduction of either the amount of electricity which is generated by a generator or the amount of electricity which is supplied by a DB to a franchise customer. These events, referred to as generator and DB Force Majeure events respectively, are addressed in more detail below.

DB Force Majeure

The Vesting Contracts allows a DB relief of its obligations under the two-way Vesting Contracts in the event of a Force Majeure event within the DB.

Force Majeure Events

Generator and DB Force Majeure events are separately defined in the Vesting Contracts. They include the following:

- *industrial disputes or accidents;*
- *network transmission system failure;*
- *Acts of God (e.g. fire, flood and other natural disasters);*
- *sabotage and vandalism;*
- *significant plant or equipment failure; and*
- *failure of an external fuel or service supplier.*

The Vesting Contracts set out the conditions which must be met before an event is considered to be a Force Majeure event. The event must generally last for at least six hours and must cause a reduction in capacity of at least 20% of generator or customer capacity. In addition, it is required that the event could not easily have been avoided by the application of "Good Electricity Industry Practice", and that the party which had suffered the Force Majeure event had no right to adequate compensation resulting from the relevant event.

Generator Force Majeure

In the case of a generator Force Majeure event, the affected generators are relieved of their obligation to make two-way Difference Payments, to the extent permitted by the Regulator General.

All else being equal, relieving a generator of its obligation to make difference payments would result in an increase in the electricity purchase costs to DBs. The ORG will only determine a generator's Force Majeure event if it simultaneously allows a pass through of increased costs to franchise customers. Therefore a DB would be able to pass through any costs due to generator Force Majeure events, including the cost of purchasing electricity from the Pool for franchise customers, to the extent that the purchase costs are in excess of the contract strike price.

The risk allocation, technical aspects and integrity of data were independently reviewed and critiqued by William M. Mercer (US Office). Legal review was conducted by Mallesons Stephen Jaques.

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