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HD Australia: Privatising poles & wires

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Global infrastructure funds could pay top dollar as Australia's electricity assets go under the hammer.

Under pressure to ease Sydney's snarling traffic jams by building more roads, the state government of New South Wales has set up an infrastructure fund and plans to sell assets. Last month it flagged the possible **sale** of its electricity distribution and transmission assets, with an enterprise value of around Adollars 40 **billion**. Added to similar businesses in the state of Queensland, where local politicians have signalled a preference for private sector participation, there is a total of Adollars 80 **billion** worth of poles and wires ready to be privatised in Australia.

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In New South Wales the planned asset disposal won't go ahead until government elections in March next year but given the state's need to raise funds it is likely to be voted through.

Up for grabs are three independent assets - Ausgrid, Transgrid and Endeavour **Energy** - that generated Adollars 3.6 **billion** in combined earnings in the year to June 2013.

The privatisation is likely to attract investors from far and wide, including overseas infrastructure and pension funds. The assets already operate like quasi-private businesses with clear opportunities to cut costs and boost efficiencies, and there isn't much to be spent on upgrades thanks to 10 years' of over-expenditure on network improvements.

'These assets are core to our investment mandate of providing long-term predictable returns and we will definitely take a look at them if they come up for **sale**,' said Angela Karl, principal in global infrastructure at QIC, a Queensland-based institutional investment manager with over dollars 70 **billion** under management.

Investors are keen to know if they will have majority control.

'Potential buyers still don't know if they will have enough influence over the operation of the businesses to maximise their returns,' said David Leitch, a utilities analyst at UBS.

'One scenario might see the government sell 100% of Ausgrid (the largest business by revenue) and a minor percentage in Transgrid and Endeavour,' said Leitch. 'Another scenario might see 60% of each **company** sold. We don't know yet.'

Karl at QIC said, in the absence of majority control, investors are likely to demand a water-tight corporate governance structure that allows them to 'drive the strategic direction' of the businesses. 'That might mean having influence and approval over board composition, executive appointments, strategic and asset management plans, and capital structures,' Karl said. QIC currently owns a 58% **stake** in New Zealand gas and electricity network Powerco.

Regime change

Another area of ambiguity is the regulation dictating how much operators can charge for transmission services and how much capital they need to spend. Such price-setting regimes haven't always been a concern in developed countries, which have a reputation for stability. However, in January utilities investors in the UK were shocked when the water regulator Ofwat dramatically altered its view on the cost of capital and other key financial parameters in a bid to trim returns to shareholders and pass further savings onto customers. Similar unexpected alterations to price regimes have been made in Scandinavian countries.

Graeme Browning, managing partner of transactions at Ernst & Young in Sydney, is confident the same won't happen in Australia. 'The regulatory framework is reviewed periodically in a very transparent manner,' he said. 'Any investor is going to understand exactly what they are buying into.'

The transmission companies are digesting a new approach to rates of return announced by the Australian **Energy** Regulator in December last year. They include new mechanisms for calculating return-on-**equity** and alter the way capital expenditure and operational expenditures are benchmarked.

Gordon Hay, principal in global infrastructure at QIC, said market participants know to expect occasional adjustments to the regulatory regime. 'When well-signalled rule changes are made in an evolutionary way, step-by-step, the market is comfortable,' said Hay. 'What the market doesn't like is when the changes are unexpected, substantial or politicised, as we have seen in some jurisdictions.'

Unless the political mood changes significantly between now and next March the New South Wales assets are likely to be sold under 99-year leases. The government has had a great deal of success with this long-term lease model, reaping Adollars 1.75 **billion** from the privatisation of the Newcastle sea port in April and another Adollars 5.07 **billion** from the combined **sale** of Port Botany and Port Kembla a year earlier. Both auctions were priced at a gobsmacking 25 times prospective earnings before interest, taxes, depreciation, and amortization and each attracted bids from four or more consortiums, underpinned by heavyweight offshore institutional buyers. Port Newcastle sold to Hastings Funds Management and **China** Merchant, while Ports Botany and Kembla went to a consortium of Industry Funds Management, Australian Super, Q Super and Tawreed Investments, a wholly owned subsidiary of the Abu Dhabi Investment Authority.

The electricity businesses are expected to attract the same type of institutional investors and similarly generous multiples. 'The assets will be hotly contested,' predicts Browning at Ernst & Young, pointing to a huge increase in the popularity of infrastructure as an asset class among sovereign wealth funds and pension funds. In the past four years, an estimated dollars 123 **billion** has been funnelled into dedicated infrastructure funds around the globe, according to investment research **firm** Preqin.

Funds will also compete with strategic buyers. **Hong Kong**'s Cheung Kong Infrastructure owns transmission assets in five different countries, including Australia where it has investments in SA Power Networks, CitiPower, Powercor, Envestra and Transmission **Operations** Australia.

Cost savings

The states of Victoria and South Australia sold off their entire electricity distribution networks back in the late 1990s. Since then operators like CKI have cut operating costs and capital expenditure while still providing cheaper electricity.

According to an Ernst & Young report released last month, the biggest savings are usually made in the early years after privatisation. 'Between 1996 and 2010 Victoria saw a drop of 23% in operating costs per megawatt hour, while Queensland and New South Wales both saw costs rise by 96% and 71% per MWh respectively,' the report said.

The first task for the new owners of New South Wales' assets will be to loosen the grip of powerful labour unions and jettison complacent management practices. In 2012, the NSW Auditor General found that Ausgrid paid more than one **million** hours in overtime to workers, with around 900 employees earning 1.5 times their annual salary in overtime concessions.

Managers, meanwhile, have spent copious amounts of money **gold**-plating their networks. Ernst & Young estimates approximately dollars 6 **billion** has been overspent on networks in New South Wales and Queensland in the past 10 years.

Leitch at UBS believes whoever buys the distribution and transmission assets must be content with slower growth. 'Electricity prices have nearly doubled in the past five years in New South Wales mostly due to network costs and the capacity for customers to absorb further price hikes has reached its limit,' he said. 'The era of big household price increases has passed. We think prices will fall by 5% in 2015 and, after that, they will grow at around inflation.'

- Dollars 80 **billion** of electricity poles and wires for **sale** Down Under

- Electricity prices have nearly doubled over five years in New South Wales Deutsche Bank, Goldman Sachs, HSBC, UBS (global coordinators); CIMB, Investec Capital Asia, Jefferies (bookrunners)

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