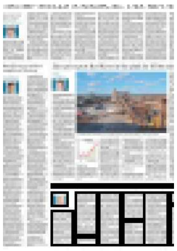

05 Dec 2016
The Australian, Australia

Author: Paul Kerin • Section: Business News • Article type : News Item
Audience : 97,419 • Page: 26 • Printed Size: 352.00cm² • Market: National
Country: Australia • ASR: AUD 7,113 • Words: 954 • Item ID: 695905318

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Partial privatisation of Western Power just political window-dressing

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If the West Australian government was a listed company (not named WA Inc, of course), its share price would have jumped when it proposed an initial public offering of 51 per cent of Western Power last Wednesday.

On average, a parent company's share price jumps when it announces a carve-out (an IPO of a portion of shares in a large subsidiary) because investors expect it to improve the subsidiary's future performance.

However, while the Western Power carve-out would generate some value, political compromises will limit both sale proceeds and the post-sale performance improvements.

Those political compromises include the ruling out of a trade sale, retention of a 49 per cent government stake and "indicative targets" on IPO sales to particular parties. Of course, the government would rather achieve a sale in practice than see a value-maximising deal shot down. But were these compromises necessary and how costly are they?

Businesses are divested through trade sales (to other businesses) or IPOs (to sharemarket investors), either fully or partially.

For example, last year the NSW government completed a full trade sale of electricity transmission business TransGrid. Recently, it announced a partial (50.4 per cent) trade sale of electricity distribution business Ausgrid.

Which divestment option maximises value depends on whether trade buyers exist who could add significant value to the business that couldn't be realised if the business was stand-alone. If so, a trade sale is likely to maximise sale proceeds as trade buyers will be willing to pay a premium for effective control to ensure they can capture that value post-purchase.

That's why full trade sales are the most frequently used divestment vehicle by both private sector and governments globally. That's particularly so when regulated infrastructure businesses like electricity networks are divested, unless political constraints dictate otherwise. Indeed, the majority of the world's privately-owned electricity network businesses are not stand-alone.

The level of interest shown by trade buyers in Australian electricity network divestments and the prices they have paid provide strong evidence that a trade sale would maximise value.

Many examples, including Ausgrid and TransGrid, show that it is politically possible to divest electricity networks through trade sales and capture the control premium.

The cost of not considering a trade sale is substantial. Assuming a conservative 20 per cent control premium, a 51 per cent trade sale would deliver WA taxpayers $2.2bn more than the $11bn the government expects through the 51 per cent IPO.

Even if sellers think an IPO would maximise value, they often run a dual-track process — preparing for an IPO and inviting trade buyer bids. This enables them to make a fully informed decision, knowing the opportunity cost foregone if they proceed with an IPO.

Even if we accepted that an IPO is the value-maximising strategy, the government retaining a 49 per cent stake is unlikely to be. Economic research shows that, in general, both the share price reaction when a parent announces a subsidiary's IPO and the subsidiary's post-sale performance are higher when the IPO is a spin-off (full sale), rather than a carve-out — unless retaining a stake enables the parent to continue to add substantial value to the subsidiary.

However, it's hard to see that the government could add any value post-IPO, but easy to see how it could destroy it.

Nevertheless, part-privatisations do generate some value, for the same reasons that private sector carve-outs do — they create a clear measure of management's performance (the share price), expose the business to investor scrutiny, and enable alignment of management incentives with shareholder value creation.

However, as research shows, they generate less value than full privatisations, investors will build lower value expectations into IPO share valuations — another reason why full divestment (even via an IPO) would generate higher sales proceeds per share.

Despite its substantial costs, the government hasn't explained why retaining a 49 per cent stake is beneficial, other than "to protect the interests of the West Australian community".

However, the only way in which it could use that stake to protect the community would be by influencing the decisions of what must be an independent board and management that will be legally obliged to act in the interests of all shareholders.

Further, the argument that the government has made as to why its partial IPO won't affect electricity prices, safety or reliability-also demonstrates why retaining a 49 per cent stake — or indeed the rule-out of a value-maximising full trade sale — is unnecessary to protect the community.

Therefore, the only possible reason to retain the stake is political window-dressing. But the government has hung up the window-dressing before even trying to explain to the community why they would be equally protected — and much better off — if it divested all 100 per cent. Why not make the case and capture substantial extra value?

The government also announced "indicative targets" for IPO uptake by super funds (31 per cent) and retail investors (20 per cent), which apparently shut out all other investors. These targets are simply further window-dressing, but if they're actually applied, they'll simply further reduce IPO proceeds by dampening demand while serving no purpose. They won't affect who ultimately owns the shares, as post-IPO trading will occur anyway. Taxpayers will simply be handing money to the investors given IPO access.

Politicians often make compromises, but making very costly ones and hanging out the window-dressing before making the case for better alternatives fails to serve the public interest.

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