THE GOVERNMENT AS A VENDOR — CAVEAT EMPTOR

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INTRODUCTION

Firstly thank you Cam for your contribution to the legal debates which surround the privatisation process. The privatisation process is still relatively young in Australia. Despite the hype and political rhetoric there have been relatively few privatisations, although many are in the State and Federal pipelines. Perhaps a major reason for the long time delay between government policy directives and implementation of privatisation is the vexed issues raised in the paper.

As the paper correctly points out the purchase and sale of any business — either by way of a trade sale or a flotation involves a negotiation or allocation of risks. Most of us here today will have been involved in negotiating indemnities and warranties in a purchase and sale contract. The buyers list of standard warranties demanded can now extend to over 70 (there seems to me to be a competition amongst law firms to have the longest list) while the negotiated position may be half that number. When the government is the vendor, not only is their list of warranties and indemnities that they are willing to provide close to zero, but also as Cam Johnston correctly points out, it is doubtful that you will have much luck in taking legal action against the Crown.

Because of these exposures buyers seek to:

- find other parties against which subsequent legal action could be taken — eg advisers and directors in a float; or

- encapsulate protective measures in legislation.

Legislation obviously provides a significant comfort factor to both lenders and investors in privatised entities. However, legislation can be changed (unlikely if such changes undermine proprietorial rights), legislation cannot accommodate or envisage all potential changes in commercial circumstances and other government initiatives may "discriminate" against the privatised entity — eg gaming machine venues versus a casino or gas prices relative to electricity prices.

RISK ALLOCATION

It is in the area of risk allocation that I would like to focus my comments today, in response to Cam's paper. Cam Johnston correctly points out that governments as vendors are risk averse. In his paper he goes on to say that with this aversion to risk "the purchaser will seek to protect its return by either reducing the price that it pays for the asset or demanding a higher price for the service it is to provide to the public. Either way...the public, as the original

owners of the assets and the ultimate consumers of the service, will be disadvantaged by the risk averseness of the government."

Certainly privatisations in the UK have been followed by progressive price hikes for consumers — eg gas, electricity and communications. However, I wonder whether these services are now priced at a realistic economic cost which will lead to a more efficient allocation of resources — rather than at prices which reflect regional, social or political initiatives by governments as owners of such activities. In any event, I doubt that "caveat emptor" is a major factor in determining the ultimate price of a good or service provided by a privatised entity to the public.

In fact, based on privatisations implemented to date (especially in Australia), I have quite a contrary view. Governments have over-compensated for either their risk aversion in a sale, their requirement to maintain continuing controls (regulatory or ownership) over the privatised entity or their need to retain an ability to deliver political initiatives through the privatised entity. **In short, privatisations have generally been good deals for the buyer.**

Pricing — both acquisition cost and the pricing of the good or service to be provided (eg Loy Yang B electricity supply contract) — has been so attractive as to overcome any disadvantages to the buyer arising from "caveat emptor". In addition, governments as vendors have met the demands of bankers and investors by encapsulating protections for the buyer in contracts (eg again the Loy Yang B electricity supply agreement) and in legislation (many examples, but for instance the Victorian Casino project).

Why has the buyer — either through trade sales or floats — had enough leverage over the government as a vendor to achieve attractive deals? In Australia I believe the reasons are as follows:

- As I indicated, there have been few privatisations in Australia. Consequently, governments cannot afford early failures as vendors — especially in floats where the man in the street (read the voter) is the direct or ultimate buyer. This was demonstrated by the first tranche of the Commonwealth Bank of Australia float, which, even without the benefit of hindsight, looked good buying at $5.40 per share. Mr and Mrs Joe Citizen had no interest in the finer legal points of the prospectus — they bought with their ears back.

- Secondly, some State governments have been driven by the need to reduce debt rather than by economic efficiency or public sector reform. The 51 per cent sale of Loy Yang B raised $1.5 billion for the Victorian Government but committed the Victorian public to a long term electricity supply contract in a dramatically changing energy market — both on a State and national basis. In addition, the Victorian Auditor-General has recently pointed out that Loy Yang B was sold at a price which has proven to be less than the final construction cost of the generator.

- Governments have been concerned about the depth of funds available for investment in privatising GBEs — incentives were required to shift money for savings into equities, to make the man in the street a shareholder.

- Many governments have not had a clear electoral or party mandate to privatise GBEs. This was particularly apparent when the reformist Greiner government sold Graincorp to a growers co-operative — the Prime Wheat Association. Political circumstances meant that growers could be the only buyers. Not only did the government lend virtually 100 per cent of the acquisition cost to the purchaser through a leasing type deal, but two years later Graincorp was independently valued at approximately $145 million compared to an acquisition cost of $90 million.

- Finally, governments have been willing to sell businesses at less than optimal prices to establish privately owned vehicles through which they can continue to achieve policy objectives. Usually this can be achieved by way of flotation. For instance, the current

flotation of CSL is a prime example. This is an important sale for the Commonwealth Government as it represents the first major 100 per cent sale by way of a float — the sale of a company in an industry which the government wants to prosper in Australia, under Australian ownership, the sale of a company which has a significant role to play in public health — through the supply of blood products and vaccines.

Although foreign pharmaceutical and health care companies may have paid much higher p.e. multiples to acquire CSL, a float was the best way of maintaining Australian ownership and governance of the company and ensuring the continuation of supply of blood products from the company.

CONCLUDING COMMENTS

In concluding, whilst I understand Cam Johnston's comment that the public (as the vendor) may pay the price for a "caveat emptor" approach by governments as a vendor, the experience in Australia to date indicates that governments are willing in other ways to provide comfort to the buyer and the banks. Typically by long term contracts back to the government, eg Loy Yang B and the blood products supply agreement for CSL, or by selling on attractive terms to the buyer, or both.

If over time the government has sold too cheaply or has committed to overly generous contracts then there is undoubtedly a "value shift" from the taxpayer to the new owners of the privatised entity and provide for attractive banking business for the banks. As indicated, I suspect this has been occurring in Australia. However, I also suspect that the Australian public (as the vendor) has incurred the cost not because of "caveat emptor" leading buyers to increase their return, but through political expediency. Time will tell whether future privatisations will be tougher deals for the buyer and the financiers to the buyer.