Submission

No 11

INQUIRY INTO CROSS CITY TUNNEL

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Theme:

Summary

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Mr Simon Johnston
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Legislative Council
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Dear Mr Johnston,

Please find attached a short submission prepared for the consideration of the joint Select Committee on the Cross City Tunnel.

Yours sincerely

Tony Harris

Submission to the Joint Select Committee on the Cross City Tunnel

Introduction

On the front page of the late edition of the Sydney Morning Herald, December 23-25, 2005, two journalists, Jonathan Pearlman and Alexandra Smith, discussed a recently announced joint plan between the Commonwealth and NSW governments to develop the Pacific Highway. The journalists wrote, "It is expected the project will require private sector funding - and a series of electronic tolls - because the governments cannot afford to commit the $8 billion needed" (emphasis added).

2. This quotation was presented as fact, the piece was not comment or opinion, and was developed from a view expressed by the relevant Commonwealth minister, Jim Lloyd, "We may be able to get the job done a lot more quickly if the private sector is involved in the funding."

3. Government deception about what it can and cannot afford has become so ingrained in the community that the front page of a paper of record takes it for granted that governments can no longer afford to fund the construction of roads.

4. In fact, the funding of roads and some other infrastructure in NSW has been so badly enunciated and carried out that the Joint Select Committee could readily conclude that successive governments have acted capriciously, if not negligently, as well as deceptively.

5. It offers no solace that opinion polls indicate public acceptance of toll roads. Knowing the alternative, that governments will refuse to fund needed roads, the public has no alternative but to support tolled roads.

6. This submission argues that private funding of public roads, especially those in urban areas, has lead to higher costs for the public. This is a sufficient reason to find fault with the provision public roads by the private sector.

7. Perhaps more importantly, the franchising, leasing or sale of parts of the urban road network, including the Cross City Tunnel, has led to other sub-economic outcomes that have reduced the welfare of NSW residents.

8. While the arguments against private funding or regional roads are weaker, because the network implications are less strong, it is still true that there is no need for private funding of regional and rural roads and there are sound reasons against it.

NSW Road Funding Policies

9. There are multiple so-called policies adopted by NSW governments for road funding, so many that the government can be accused of operating in a policy free zone when it comes to the funding of public roads. The simplest approach involves the government funding roads with their cost being financed from road users and other general revenues.

10. The NSW government has also allowed the private sector to fund roads with repayments being funded from tolls. In a variation to this approach, the Cross City Tunnel, M7 and Lane Cove Tunnel are relevant examples, the government charges a franchise fee of several million dollars, including GST, said to cover all RTA costs. This fee is recouped from higher tolls imposed on road users by the private sector. On other occasions (the M2) the government partly funds the development.

11. In another variation, applicable to the M4 and M5, the government reimburses drivers of privately registered NSE vehicles for the cost of using privately-owned toll roads because, as the government explained it at the time, users of these toll roads could not afford the toll.

12. A further but contrary variation, applied to the Sydney Harbour crossings, is where the government adds a surcharge or tax on the toll to fund, as was explained by the Minister for Roads, Carl Scully, rural road developments.

13. Sometimes the government enhances privately-owned toll roads through the provision of toll-free additions to the motorways (the M5 and M1 are the best examples of this approach) sometimes the government allows the private sector to provide a tolled enhancement to an existing tolled road network (the Lane Cove Tunnel).

14. Sometimes the government removes tolls when or before the funding for the particular road has been recovered from tolls (vide the Sydney-Wollongong freeway) sometimes it will re-instate tolls when debt has been cleared (the Sydney Harbour Bridge).

15. No doubt among these variations is an approach which can be justified on economic grounds. But it is a matter of logic to suggest that not all of these approaches are economically sound or the best policy for road funding.

Role of the Private Sector

16. There is evidence to suggest that the private sector has added value to NSW road developments through their design and construction of public roads. Because these are competitive activities, it makes sense to allow market forces to work to provide an optimal design and efficient construction. However, the private ownership roads, especially where they are parts of a network, is inefficient.

17. There are respectable arguments - advanced inter alia by Professors John Quiggins of the University of Queensland and Bob Walker of Sydney University - that government can borrow money more cheaply than the private sector because the spread of government investments reduces the risks of lending to governments.

18. Australian governments can typically borrow more cheaply than the private sector, as is evidenced by public borrowing rates. But this might have more to do with the taxing powers of government than other factors.

19. In any event, because economic risks are domiciled in projects, the relevant question is can governments borrow project finance more cheaply than the private sector? The answer depends on who can best manage the risks of the project. As discussed earlier, important road risks such as design and construction can be transferred by contracts to the private sector. But the major remaining economic risk in roads is traffic risk which is better managed by the public sector. It follows that the private sector must charge a premium for financing private ownership of public roads.

20. It is thus ironic that the former Premier, Bob Carr, in testimony to this committee, justified the Cross City Tunnel on the basis that the private sector was required to pay for all the costs of its development. Imposing this requirement on the development ensured that road users would be disadvantaged.

21. The relationship between risk and financing charges is well explained in literature. It can be seen even in the funding of the Sydney Harbour Tunnel. Although the NSW Government is obliged to fund the shortfalls in SHT revenues required to repay bond holders, the private sector still charged the private sector developers a premium because their debt was only indirectly secured to the government.

22. Merely on this factor alone, governments should fund all public roads where there is a traffic risk. If governments insisted on private financing, they should lease privately-owned roads under a formula which ensured that traffic risks were assumed by the government. But, as explained above, adding an unnecessary intermediary between the financiers and government will add to financing costs. Moreover, it is arguable that roads developed under such a scheme would be treated as a government asset and all financing would be classified as a government liability, thus frustrating the government's no-debt goal.

23. The private sector can rightly argue that integrating decisions about design, construction, financing and maintenance can reduce costs because considering related but sometimes conflicting options for these matters in the one body allows an optimal solution to be identified from the trade-offs between these factors. On the other hand, the private sector rarely, if ever, allows the one entity to undertake these functions. As a government can, the financing vehicle or owner contracts out tasks to specialists presumably because the benefits of specialists outweigh the benefits from integrating decisions.

Other Arguments against Private Roads:
Excessive Profits

24. For the private sector, a major task in negotiations with government on of privately-owned urban roads is to ensure that traffic risks have been moderated or eliminated. This is evident in issues of road design, see below, and in other clauses which require the government to treat the private road as an important and integral part of the urban network.

25. The transfer of risk from the private sector has been so persuasive that taxpayers or road users have provided significant and excessive profits to private road owners. Some of these profits have been generated by windfalls: the owners of the M4 and M5 have profited from the cash-back scheme. M5 owners also benefited from the unexpected early and toll-free extensions on the west and east of the private road. The owners of the M4 received massive profits from the government's decision to allow the toll gates to be located between Sydney and Parramatta notwithstanding that the private road is east of Parramatta. About a fifth of toll payers from Sydney do not use the privately-owned road.

26. The equity owners of the M4 were reported to invest $500,000 in the development of a simple road; the rest of the capital was apparently raised from borrowings. Yet the then AIDC paid $7.7 million for 10 per cent of the equity. That size holding in the M4 was valued in the accounts of UTA at $47 million in 2000 and $19.5 million in 2003. According to those accounts, the investment returned well over 13 per cent a year compounded over the last five years, significantly more than expected for low risk utilities.

27. The recent acquisition of the M2 for about $12 a share compares with share values of around $6 a share prior to the takeover.

28. If the Joint Select Committee were to ask RTA for its analysis of the profitability of private roads in Sydney, similar levels of profit would be recorded for other roads.

29. Much of these excessive gains occur because of the superior negotiating stance of the private sector and because of their better skills.

30. Another issue is the cost of negotiating these road deals. Their complexity can be seen from the images of contractual and financial relations published in the summaries of contracts by the Treasury. It has been estimated that negotiating these deals can add up to 7.5 per cent to the cost of the development.

Factors against Toll Roads:
Road Design

31. The above discussion suggests that governments should be the financier of public roads. It is also better that the funding for road developments, particularly when they are part of the urban road network, not be sourced from episodic tolls on these developments.

32. For a start, where tolls are to be collected mechanically or manually, there must be differences in the design of toll roads compared to un-tolled roads. The function of a toll road is to funnel users towards the toll gates. And because there is a cost in collecting tolls, toll roads must have a limited number of entrances after the principal toll gates and a limited number of exits before those gates. In short, toll roads are not designed to meet the needs of ordinary roads.

33. Moreover, private owners of public roads are reliant on the government to funnel users towards the toll gates by traffic manipulation which often commences some kilometres from the toll gates. This has been evident in the contract between the Cross City Tunnel owners and the government: road closures and restrictions have been seen as an essential feature for the financial viability of that Tunnel. It is also evident in the M5: the ramp allowing east flowing traffic to escape from the tolled M5 by joining the Hume Highway at the point where the M5 passes under that highway has yet to be completed, although the reservation has existed for many years. In short, a toll road adversely affects the road design for related roads.

34. There has been a concerted push in NSW to the electronic tolling used in Victoria as the exclusive toll collection device. Electronic tolling reduces the costs of toll collection and allows numerous toll gates. This was proposed for the Cross City Tunnel which planned to impose an additional administrative fee for vehicles not equipped with a transponder or e-tag. But owners had to abandon this policy in the face of public resistance. Although details are not available, it might be proposed for the Lane Cove Tunnel. The owners of the M7 propose to charge an additional fee for vehicles not equipped with transponders or not registered with their automobile recognition and invoicing system, but this has yet to be tested.

35. Another disadvantage from private ownership is that the government losses control of the design of public transport. Private developers are correct to be concerned that additional public transport and additional alternative roads can reduce their traffic and revenues and profits. Accordingly, they require governments to provide compensation for any action that reduces traffic.

36. While understandable, this constricts government action over the design of public transport for the life of the deal. Had the government developed the road, it too would suffer a loss in the value of an asset from the development of alternative public transport facilities. But that loss would not require negotiations – with all of their costs to government - and cash compensations.

Factors against Toll Roads: Pricing Issues

37. Economists argue that efficient pricing - that is, the pricing policy which will maximize social welfare - requires tolls to be set at the marginal cost of production. In this case, the long-run marginal cost of urban roads would require pricing levels significantly below those charged.

38. It is also true that pricing should be set at a level which, all else equal, would lead to equivalent use of toll roads and their non-toll alternatives. There is little point (more precisely, there is a loss of welfare) in developing assets and then not using them to their potential. As is evident from the Cross City Tunnel, drivers have been diverting from the Tunnel to alternative surface roads. The same condition exists for most urban toll roads in Sydney: they are underused in absolute terms and compared to their non-tolled equivalents.

39. Because not all roads are equal, there is a greater benefit from a more intensive use of motorways and a lesser use of alternative routes. This can be seen from the cost-benefit figures provided by RTA for the Cross City Tunnel. Reduced use of William Street would provide property owners and pedestrians with significant benefits, in addition to the ignored environmental benefits from diverting traffic to a more efficient, traffic-light free Tunnel. Of course, charging for the latter while the former is toll free does not allow these benefits to be captured.

40. A government road investor should sensibly assess all of the benefits for their network from a Cross City Tunnel, as well as external benefits, before deciding whether it should be constructed. Its pricing of a Tunnel would reflect the need to obtain these benefits. However, the owner of the Tunnel is only concerned with direct costs and benefits. This means that transferring parts of the network to the private sector gives rise to multiple externalities which are ignored by the private sector.

41. These inefficiencies are compounded by the requirement that the toll recover any franchise fees and additional taxes added to the economic cost of the toll road. And because private road owners are required to transfer their assets to the public sector at the close of the contract, users have to meet all of the capital costs of the road, notwithstanding that assets of significant remaining value are transferred to the government. This means that the tolls are higher than is justified by economic principle.

Aversion to Debt

42. Given the economic arguments against urban toll roads and urban privately-owned toll roads, it is fair to ask why Sydney, almost unique in the Western world, has placed so much reliance on privately-owned toll roads. The principal reason rests on the government's antipathy to debt, a stance which has distorted the provision of numerous infrastructure facilities in NSW in the last decade or so.

43. In the first NSW Carr government, the state treasurer, Michael Egan, introduced the General government Debt Elimination Bill with its commitment to eliminate general government net debt by 2020. Using Government Finance Statistics, NSW had no net debt as at June 2004. In the nine years from 1995, the NSW government eliminated $17 billion of debt and built up a negative net debt position of $2 billion, mostly from its operating surpluses.

44. The Commonwealth has had a similarly successful debt elimination campaign following the last recession in the early 1990s. The Treasury estimates that Commonwealth general government will have no net debt by June 2007. From the peak net debt position in 1997, it would have taken ten years to reduce net debt and build up deposits to a total of $110 billion, mostly funded through underlying cash budget surpluses.

45. Perhaps because of their aversion to debt, Australian governments have generally been reluctant investors in the future. Between 1998 and June 2005, the Commonwealth general government recorded negative net capital investment. National Accounts published by the Australian Bureau of Statistics show that since 1996-97 general government investment in gross fixed capital formation - that is before depreciation and disposals - has grown by about 5.5 per cent a year. This has barely accommodated inflation and population growth. It has not allowed capital deepening and it is much less than the nearly eight per cent annual growth recorded for private fixed capital formation.

46. This debt fetish has meant that the current generation has had to finance all general government investments for the future as well as retiring debt used for past investments. It has also led to an underinvestment in capital works. Though some researchers suggest that there is no infrastructure crisis in Australia, there are significant opportunities for

47. Because of the aversion to debt, governments have argued for a decade or more that they did not have the funds to invest in needed infrastructure and that the private sector should fund important infrastructure investments. International and domestic airports, major metropolitan roads, prisons, public hospitals, schools, railway locomotives and police stations are some of the physical assets the responsibility for which has been passed to the private sector.

48. But these arguments have been grossly misleading. The NSW government, for instance, could have financed all eight of the private urban roads built in that state in the last two decades and still have reduced its net debt by more than half.

49. The report on road infrastructure recently prepared by David Richmond for the NSW government (the Richmond Report) states that privately financed public roads in NSW over the last five years amounted to $3.3 billion. The NSW general government cash surpluses for those five years exceeded $5 billion.

50. The argument that states did not have the money is also false because it suggests that the private sector had the necessary capital. But published agreements relating to privately owned toll roads show that the private sector issued new securities to fund its road program, with the servicing of debt and capital to be met from tolls imposed on users of its roads. Had the governments taken the same attitude to tolling for these arterial roads - as they had done for many roads in the past - they too could have borrowed (not that that was necessary) and serviced the capital needed for these works from tolls or general revenue. This used to be the practice in NSW prior to its aversion to debt.

Possible Solutions

51. Some might argue that it is too late to reverse deals done in the past. It is true that parliaments should not lightly use their powers to legislate against contracts which their governments have entered. But there are other ways to solve the dilemma faced by RTA: a lack of funds to undertake necessary work.

52. A poor option is that RTA itself be the financier of all new works in place of private developers. This means that RTA would levy tolls and repay finance raised on its behalf by Treasury.

53. A better option is that the government identify new sources of funds which equate to those being raised by tolls. These funds could finance new works and replace tolls levied on existing roads. The latter would require new agreements with the owners of existing toll roads so that, instead of their collecting tolls, they would be reimbursed by the government for the use of their roads from the newly identified revenue sources.

54. Shadow tolls, the term used to describe payments made by a government to a developer for each vehicle which uses the privately provided road, are used in the United Kingdom. Because they increase demand for the road (all else equal) this would need to be reflected in new agreements. There are no reasons why the private sector would decline such agreements – as long as taxation policies can accommodate these arrangements and there are no hidden agenda, such as windfall gains.

55. The difficult question is to identify a suitable source of revenue which is consistent with the revenue restraints imposed on states by the Australian constitution.

56. If the Commonwealth allowed, a new tax - which raises revenues only to the extent raised by existing and prospective tolls – on vehicle consumables such as petrol. The tax

could be graduated so that it reduces as the metropolitan area fades into rural and regional areas.

57. If the Commonwealth was not disposed to this, the state could introduce a mileage charge which would be collected as part of the vehicle registration process. This mileage charge would be set to raise an amount equivalent to tolls and would likely be less than a cent a mile. This charge could also be variable, reducing in rural and remote areas.

58. Alternatively, the government could introduce a metropolitan-wide tolling scheme which imposes a small toll on all major roads, with the proceeds subsidising the removal of episodic tolls on existing toll roads. For practical reasons this would have to be an electronic based toll.

59. Other arrangements could also be developed which have the same features as the above examples: a wide spread, small charge which allows existing tolls to be removed.

Equity Issues

60. The introduction of a small but widely applicable charge to replace tolls would have many economic advantages. It would also have equity advantages. It does not seem possible that a government could justify the imposition of significant tolls on residents of Sydney's north-west who use vehicles to travel to the CDB when residents travelling from the western suburbs face much smaller tolls which are eligible for cash-back.

61. Tolls for the former category include the M2, the Lane Cove Tunnel and the Sydney Harbour Crossings, none of which is subject to cash-back, amounting to some $73 a week compared to the net $2 a week for users of the M4. Even without cash-back, users of the M$ would face a $22 weekly bill, less than a third of the charges facing those living in the north-west of Sydney.

Conclusion

62. The economic adage that the part best equipped to handle an identified risk should handle it, when applied to the network of urban roads, indicates that roads should be owned by the government. It is a second order question as to how these roads are financed.

63. By conceptually separating government from the people it serves, NSW governments of different persuasions have made major mistakes. Users of roads do not care too much who collects their funds, they seek the most efficient provider, but the efficiency advantages from government ownership are important. And the Treasurer, Michael Egan was quite wrong when he said that the state could not afford roads. If the private sector could afford them so could government. He was also wrong to suggest that construction risks could only be avoided by private development.

64. In fact, there is so much wrong about the government's position that no economist I know has supported it, either in public or privately.