

**Submission
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INQUIRY INTO CROSS CITY TUNNEL

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Summary

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Joint Select Committee on the Cross City Tunnel

SUBMISSION TO
INQUIRY INTO
THE CROSS CITY TUNNEL

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Introduction

The NSW Legislative Council on 15 November 2005 and the Legislative Assembly on 16 November 2005 resolved that a Joint Select Committee be appointed to inquire into:

- (a) the role of Government agencies in relation to the negotiation of the contract with the Cross City Tunnel Consortium,
- (b) the extent to which the substance of the Cross City Tunnel contract was determined through community consultation processes,
- (c) the methodology used by the Roads and Traffic Authority for tendering and contract negotiation in connection with the Cross City Tunnel,
- (d) the public release of contractual and associated documents connected with public private partnerships for large road projects,
- (e) the communication and accountability mechanisms between the RTA and Government, including the Premier, other Ministers or their staff and the former Premier or former Ministers or their staff,
- (f) the role of Government agencies in entering into major public private partnership agreements, including public consultation processes and terms and conditions included in such agreements, and
- (g) any other related matters.

This submission comments briefly on the Terms of Reference set for this Inquiry. It should be read in conjunction with a broader submission prepared for the Public Accounts Committee Inquiry into Public Private Partnerships. That submission is currently available on the PAC's website.

(a) The role of Government agencies in relation to the negotiation of the contract with the Cross City Tunnel Consortium

- This should be considered in the light of government policies for the evaluation of PPPs (i.e. NSW Government guidelines, *Working with Government, Guidelines for Privately Financed Projects*, 2001)

Accounting treatments

- While claims have been made that off-balance sheet treatment is not a 'driver' of PPPs, the 2001 guidelines require that agencies, before entering into such arrangements, identify the accounting policies proposed to be followed; they are required to furnish copies of accounting rules upon which they rely; and they are required to seek the Auditor-General's advance agreement to those proposed accounting policies. One can only wonder why there is such emphasis on accounting treatments if these are not relevant to the decision to proceed through a PPP or conventional government procurement, via the tender process.
- In supporting claims that off-balance sheet treatment is not the driver of PPPs, Treasury officials have claimed that certain PPPs would be treated 'on balance sheet' if the government retains major risks. Yet the only PPP reported to be 'on balance sheet' in the NSW Public Sector Consolidated Statements as at 30 June 2005 was the Harbour Tunnel – and in this case it appears that only an 'asset' (the right to receive the tunnel in the future) was recorded. The accounting treatment had regard to form not substance.
- It appears that other PPPs were not recognised 'on balance sheet' in the NSW Public Sector Consolidated Statements as at 30 June 2005; nor (for example) were any PPPs identified in the Education Department's balance sheet as at 31 December 2004. Following enquiries, it is understood that the Department's balance sheet as at 31 December 2005 may treat relevant PPPs for the construction of schools as analogous to finance leases (i.e. the accounts may show an asset and a corresponding liability, representing the present value of sums payable to the operator for the provision of those facilities).
- It is difficult (from a technical accounting perspective) to see why certain PPPs are treated as giving rise to liabilities, and others are not. The standard rhetoric from public servant advocates of PPPs is that the accounting treatment is determined by (subjective) assessments of who bears the majority of risks. A preferred approach would be to ascertain whether contractual arrangements establish firm commitments on the part

of government agencies to sacrifice economic benefits (through cash payments, or alienated revenues) once the operators of BOO, BOOT or similar schemes have constructed and commissioned infrastructure that is thereafter to generate payments from government or from members of the community. Analysis of the limited number of PPP contracts available for public scrutiny confirms that while they may initially be regarded as executory contracts that are (to some extent) unperformed on both sides, they may subsequently evolve into liabilities.

Compliance with NSW Government Guidelines (2001)

- These Guidelines state (*inter alia*):

“7.1 The role of a Public Sector Comparator

A PSC is a model of the costs (and in some cases, revenues) associated with a proposal under a government financed method of delivery. A PSC:

- is based on the most efficient likely method of providing the defined output currently available to the public sector
- takes into account the potential impact of risks on the costs (and revenues) associated with a proposal over its life
- is expressed in terms of the net present cost (or benefit) to government of providing the output, over the life of the proposed concession.

The PSC reference project will be defined and costed to provide the same level and quality of service expected of the private sector. The reference project may include elements of private sector provision and risk transfer, such as provision of the facility under a design and construct contract or a maintenance contract, with the private sector. These approaches are consistent with current methods of delivery. However, the PSC will not include private financing of the project over its life.

Because the PSC is a valuable tool for government in determining value for money, it is important that it is prepared carefully and comprehensively. However, the PSC is a quantitative benchmark with inherent limitations because:

- it requires costs (and revenues) to be forecast over the life of the proposed concession. It is difficult, even for the most skilled experts, to make accurate estimates over such a long time-frame
- estimating the impact of risks on costs (and revenues) over the life of an asset is a complex and often subjective exercise.

The PSC, therefore, can provide government with an approximate measure of the range of outcomes it is likely to face in delivering a project under traditional methods.

- The Guidelines also state that the results of the comparison of the likely costs of private sector delivery versus conventional government-financed service delivery would ‘ultimately be publicly available in ...[a] contract summary’ (NSW, 2001, p. 46). Contract summaries were also to include, *inter alia*, the results of a cost benefit analysis, and an analysis of risk sharing during construction and operational phases (pp. 27-28). After tabling, the availability of the contract summary would be advertised in the Public Notices (pp. 27-28).

- The RTA has plainly failed to comply with the 2001 Guidelines:
 - A contract summary was not tabled in Parliament within the specified time frame.
 - A revised contract summary was not tabled in Parliament after subsequent major changes in contractual arrangements.
 - The contract summary suggested that the PSC was expressed in terms of the net present value *to the RTA* of the proposed financial transaction (p. 11). In effect, the RTA was indifferent to whether the private sector operators were likely to make a profit from the deal (though the evidence of RTA representatives already presented to the Committee confirms their view that the CCT project is of low risk and will prove to be profitable).
 - It is somewhat disingenuous for the RTA to refer to net present value of the PSC *to the RTA* when the contract provided in effect that the RTA would recover all of its outlays in setting up the CCT project. In that context, RTA managers appear to have outsourced their jobs; they certainly faced no disincentives against spending up big on consultancies (since the cost of those consultancies would ultimately be charged to the operator, and passed on to motorists via increased toll charges).
 - The Guidelines require a PSC to refer to the net present value of a *government-financed project*, and to incorporate in the model not only costs but also revenues. That would have required the PSC to have considered the potential financial returns to government from toll revenues over the life of the project. Neither the limited PSC disclosures nor the contract summary for the CCT made any reference to these potential financial returns.
 - The PSC disclosures were limited to a few lines in a footnote on page 11 stating that 'the estimated net present value of the risk-adjusted financial cost of the project to the RTA was \$41.93 million. This was based on a calculation undertaken in 2001, with some adjustments. There was no disclosure of whether this was net of toll revenues, and there was no disclosure of basis of those estimates (if any). Nor was the discount rate used to calculate NPV disclosed.
 - It seems reasonable to suppose that the level of tolls currently being charged by the operator (and to be escalated by a minimum of 4% per annum in future years) would be significantly higher than the charges that might have been levied by government if it had 'owned' the project and outsourced construction via a simple tender process.
 - The contract summary for the Cross City Tunnel does not report the results of a cost-benefit analysis (let alone indicate the parameters of that analysis – e.g. was it a good deal for the RTA, or for the community?). (NB the PSC is solely concerned with financial aspects of a project, from the perspective of government; a cost-benefit

analysis should address both financial and non-financial impacts of the project from the perspective of the community).

- The probity audit apparently failed to recognize this fact – raising questions about the terms of reference for, the timing of, and the methodology followed in, so-called 'probity audits'.

(b) The extent to which the substance of the Cross City Tunnel contract was determined through community consultation processes

- We offer no comments on community consultation processes followed re the tunnel.
- However we do observe that community lobbying appears to have influenced major design changes – particularly re ventilation of the tunnel.
- As enforced 'users' of tunnels, it is of concern that the Health Department imposed higher standards for ventilation for the Cross-City Tunnel than were formerly required. This suggests that the existing Harbour and Eastern Distributor tunnels are operating at lesser standards i.e. standards that the Department of Health now apparently considers unsafe.

(c) The methodology used by the Roads and Traffic Authority for tendering and contract negotiation in connection with the Cross City Tunnel

- From a brief scrutiny of spreadsheets published for the tunnel, it appears that the methodology incorporates a series of basic steps. These are described in two stages: (a) initial analysis, and (b) analysis following client-directed design changes.

Initial analysis

Estimate cost of constructing tunnel to initially agreed specifications;
Estimate timing of cash flows involved with construction;
Estimate traffic volumes (say, annually, through the life of the contract);
Estimate operators' outgoings and costs of scheduled maintenance during the term of the contract (including rent of road corridor)

Estimate cash flows associated with a requirement that the operators reimburse the RTA for its costs in relation to design, consultancies, legal costs, etc

Assume that the operator requires a cumulative annual return throughout the life of the contract of 16% 'real' (i.e. before inflation) on its equity investment;

Estimate cost of debt finance utilised by the operators, assume gearing levels

Then

Calculate level of tolls that would produce the nominated return to the operators

These are the basic steps. There appear to have been some 'refinements' to this approach. e.g. use of sensitivity analysis. Possibly estimates of toll revenues considered whether a standard toll should be charged, or a differential toll for light and heavy vehicles.

Note that assumptions were made that the operator's borrowings would be refinanced through an 'initial public offer' (IPO) two years after the tunnel was commissioned.

Subsequent analysis

A series of design changes required by the RTA necessitated re-calculation of the above estimates of cash flows associated with construction, and projected traffic volumes (including the amount to be refunded to the RTA).

The incremental construction costs to be factored into the equation were estimated and agreed in advance between the RTA and the operators, with each design change. (The pricing may have been on a cost-plus basis – providing additional returns to the operators over and above the returns contemplated by the main agreement.)

The core assumption remained the need to balance increased costs with the rate of return agreed with the operators – the level of tolls was the dependent variable.

One of the more startling outcomes of these negotiations following design changes was the agreement that tolls would escalate at **4% or CPI, whichever was the greater (NB not 'whichever was the lesser')**.

This was primarily a capital-intensive project with a high level of sunk costs – operating costs over the life of the project were relatively trivial. Such a formulae to generate toll increases has no substantive commercial justification from a public sector or community perspective – one can be confident that increases in gross toll revenues will far outweigh increases in operating costs. In other words, this provision has no justification other than that of escalating the revenues of the operator over the life of the project.

(d) The public release of contractual and associated documents connected with public private partnerships for large road projects

- There is no reason why all such documents are not made available for Parliamentary and public scrutiny.
- Claims have been made about 'intellectual property'. It is suggested that this has no substance. The Committee's attention is drawn to a submission prepared for Unions NSW that addressed this issue in some detail, citing a recognised authority on intellectual property law (Dean).
- The manner in which documents relating to the Cross City Tunnel were made available is not a good precedent. They are only available for inspection in hard-copy form by parliamentarians. Electronic copies distributed to journalists, but these are in PDF format and are not numbered and effectively indexed, or electronically 'searchable'.
- Agencies are expected to prepare 'contract summaries' (per NSW 2001 Guidelines). In fact, there may be a host of contracts and trust deeds and side agreements.
- In practice, the RTA has contracted out to a consultant, the work of preparing a contract summary. That suggests that the RTA lacks the capacity to understand the key elements of these contracts, and to summarise them succinctly.

(e) The communication and accountability mechanisms between the RTA and Government, including the Premier, other Ministers or their staff and the former Premier or former Ministers or their staff

- Ministers are largely reliant on technical advice from agencies. However it would seem appropriate that Ministers recruit staff who have the technical skills to evaluate that technical advice. It is not clear that many ministerial staff have the skills to evaluate complex financial and contractual issues.
- The NSW Government Guidelines were intended to ensure that PPP proposals provided 'value for money'. The failure of the RTA to publish a meaningful Public Sector Comparator, and to report the content of cost-benefit analyses, suggests that the agency has failed to adequately inform Ministers about the merits or otherwise of major proposals. Nor (it appears) was the contract summary, PSC and cost-benefit analysis updated after major changes to the project.
- The evidence available suggests that agencies may lack the skills necessary to properly evaluate such proposals. Evidence consistent with this contention includes:
 - Documentary evidence re the Cross City Tunnel which shows that agencies lacked confidence to undertake basic appraisals themselves, and outsourced those responsibilities to the private sector.
 - The content of the contract summaries regarding a series of PPP contracts entered into after publication of the 2001 Guidelines – as noted above, these contract summaries were prepared by consultants not by the agencies themselves.

(f) The role of Government agencies in entering into major public private partnership agreements, including public consultation processes and terms and conditions included in such agreements

- Under the Westminster system, the general principle is that the government of the day is required to submit Budget bills for Parliamentary approval – before funds are allocated to departments for expenditure during the fiscal year. There are some minor modifications (e.g. supplementary budgetary allocations may be made, and the Treasurer is provided with funds for contingencies (to meet e.g. costs arising from natural disasters, or to accommodate possible wage increases arising

from award negotiations). Historically, state governments have chosen to define the 'budget sector' in a manner that has not been consistent with international definitions of the 'general government sector' for national accounting purposes.

- To a large extent Parliamentary control over public sector finances has been eroded through the establishment of statutory authorities or state-owned corporations that are empowered to raise funds from fees or charges. That means that government revenues are not all paid into the consolidated fund, and are therefore not subject to Parliamentary oversight.
- The operation of public-private partnerships is arguably the greatest challenge to the Westminster model of parliamentary accountability to arise in the past century. PPPs may involve the alienation of revenues (that otherwise would have been received by general government agencies) to the hands of private sector operators of BOO or BOOT schemes. Private sector operators seek to make a profit from these schemes (and they are particularly attractive to long-term investors because they typically involve monopolistic arrangements that lock in high rates of return). The profits of operators represent the effective cost to government of choosing to finance these arrangements through private sector financing.

(g) Other related matters.

Can the government finance infrastructure projects more cheaply?

- We note that this issue has been raised several times during this inquiry (and that being conducted by the PAC).
- We maintain that capital intensive infrastructure projects are best funded by the public sector because the cost of capital to Australian governments is currently far lower than the investment returns sought by private sector firms.
- One rather unsophisticated response to this proposition has been to use the classic fallacy known as a *reductio ad absurdum* – reducing to absurdity. Hence the suggestion that the cost of capital to Australian governments is lower than that of private sector firms has (supposedly) been reduced to absurdity by suggesting that 'if government's cost of capital was lower than the private sector's, the government should own everything'.
- Because NSW government debt is very low, relative to its revenue base, it is plain that NSW could readily support substantial borrowings to fund infrastructure development. The conventional indicator is to relate

borrowings to Gross State (or National Product). NSW currently has virtually no debt. In contrast, Europe's Maastricht Treaty enjoined member states to seek reduce their indebtedness to 60% of GDP.

- If NSW's debt was (say) 100% or even 1000% of GSP, then the cost of debt financing would be far higher than at present. But that is hypothetical.
- It seems ironic that governments utilise highly-expensive PPPs (providing projected 'real' returns of 16% per annum) simply to avoid the *illusion* of borrowings – while on the other the private sector operators of PPPs regard it as good commercial practice to borrow to fund the construction of long-lived assets. The extra cost of financing projects through PPPs is borne by taxpayers (or, in the case of transport infrastructure, by motorists).
- In effect, government borrowings reflect the market's perception of capacity to meet its commitments. This would not vary significantly if government borrowed to fund new transport infrastructure that would be of long-term benefit to the community, and would contribute to economic development.

Claim that PPPs reduce risks to government

- It is often claimed that PPPs avoid risks to government – citing the experience of cost over-runs on public-funded capital projects.
- Yet the major sources of cost-overruns are (a) incomplete planning and specification of requirements (b) subsequent changes in specifications.
- The CCT project is a classic example of the latter – the cost of the project blew out because the client changed the project's specifications.
- Governments can avoid such risks by more detailed preparatory work, and by sticking to the specifications - and could readily do so through conventional procurement rather than via PPPs.
- In the CCT case, the financial risks were not incurred by government but will be passed on to motorists through increased tolls.

Confusion between the PSC and the 'base case model'

- We note that there appears to be some confusion about the distinction between the PSC and the 'base case model'.
- the PSC – as originally devised in the UK per the Ryrie Rules, supposedly represents an estimate of the cost to government of delivering a project through conventional forms of procurement.
- The original aim of compiling a PSC was to establish a pass-fail test for proposed PPPs versus government delivery.
- In concept, publication of a sensibly-constructed PSC could provide assurances to the community that PPPs provided value for money.
- But the original approach to compilation of a PSC has been altered through changes in government guidelines that fundamentally bias the analysis against conventional government delivery.
- NSW 2001 Guidelines propose that the PSC represent the 'risk adjusted cost' of conventional government delivery (in other words, estimates of project costs should be inflated by the possibility of cost-overruns – even though these may arise because of changes in project specifications).
- NSW Treasury officials also support the use of relatively high discount rates to reflect 'high risk'. This approach is technically invalid, and is criticised in standard texts on business finance as 'fudging the numbers'. A more appropriate approach would be undertake sensitivity analysis in which estimates of projected cash flows are adjusted to reflect those risks. The UK Treasury was forced to recognise this, and abandoned prescribing a 6% discount rate in favour of a rate of only 3.5%.
- Use of a high discount rate also involves double-counting (given the use of 'risk adjustments' to projected cash flows).
- The PSC reflects a (biased and overstated) estimate of the cost of conventional government delivery. What is known as the '**base case financial model**' incorporates the projected costs and returns to be derived from a project, if undertaken by the private sector.
- The base case model may be used to determine revenue sharing arrangements between government and private sector operators. (We have not aware of how it was used in the CCT project, beyond setting tolls and negotiating sums to be rebated to the RTA.)
- Operators of PPPs have typically resisted publication of the base case financial model for projects e.g. the Bracks Government sought to publish a series of PPP contracts but the private sector partners did not consent to publication of the base case model on grounds of commercial confidentiality.

- Possibly this is because the base case model enables analysts to assess the prospective rate of return to be earned by those operators from involvement in a PPP.
- We would argue that the key assumptions incorporated in a base case model should be published in contract summaries, that are to be tabled in Parliament.