

**Submission
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INQUIRY INTO ROAD TOLLING

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Toll Roads in NSW

Summary

The development of the intermittent toll road system in metropolitan Sydney since the first such road, the M4, has been poorly based and poorly organised.

This has led to motorists paying the private sector significantly more than the economic or efficient cost of those roads. It has also meant that the government has not been able to introduce a soundly based system for pricing the use of tolled roads.

It is difficult to see how subsequent governments can readily remedy the mistakes of the past so that a comprehensive soundly based toll system can be introduced in Sydney. But, as difficult as that correction may be it would offer important gains to Sydney motorists and residents.

The First Toll Roads

The M4, a toll road commencing west of Parramatta heading to the Blue Mountains, was the first metropolitan toll road in Sydney's modern times. (The first commenced in the colonial period and tolling has existed in one form or another for many years. Tolls were collected for vehicles using the privately built Roseville Bridge, for example. Vehicles using government built roads from Sydney to Wollongong and Sydney to Newcastle were subject to tolls until recent decades.)

The advent of the M4 established a model for the modern tollway. Firstly it was built and owned by the private sector. (A former commissioner of main roads organised the provision of \$500,000 in equity capital with the remaining costs funded by bank loans in order to develop the project.)

The M4 tolling gates were established on government roads east of Parramatta. This was said to be necessary in order to mitigate traffic risk by garnering the higher revenues from the larger number of vehicles travelling between Sydney and Parramatta. The M4 thus incorporated the road – and charged for its use – that had been gifted to NSW by the Commonwealth Government for the states bicentenary.

It is no surprise that the owners of the M4 made a massive return on their equity investment.

The M2 – the road leading from around Ryde, west of the Warringah motorway, to Sydney's nor-western suburbs - was the second example of the modern toll road. The developers of the M2 also sought to mitigate their traffic risks by imposing on the government stringent conditions concerning the new public transport or other developments that might adversely affect M2 toll revenues.

As with the M4, the returns obtained by the M2 developers were significantly above those required to justify the project, notwithstanding lower initial traffic than had been forecast.

The M2 was marked by a missing link – a motorway linking the Warringah freeway to the M2. The then RTA advised that it had no plans for this important road even at the time the M2 was being built. The subsequent development of the link – it included the Lane Cove Tunnel – was marked by controversy.

The capacity of each of these toll roads was subsequently expanded under arrangements that extended the owners' capacity to collect tolls. As expected, the negotiating position of the road owners would have allowed them to obtain favourable terms.

The M5, a toll road from west of the Kingsford Smith airport to west of Liverpool was also developed with missing links, on the east and western sides that were subsequently provided by the government. These additions added significantly to M5 revenues.

These toll roads can be distinguished from the development of the Cross Harbour Tunnel. The complex funding model used for the latter was provided or underwritten by the government. The developers – Transfield Kumagi – faced no financial risks. Thus the NSW Audit Office determined that the tunnel was an asset of the state and the debts were a state liability. (Until early in the 21st Century, this Audit Office conclusion was rejected by the government because it wanted to maintain the taxation advantages provided by the Commonwealth to private developers and to avoid massive penalties that the Commonwealth could impose, penalties that would be borne by the state, for falsely claiming those tax advantages.)

Although the tunnel was developed with public monies, funding for each of the M4, M2 and M5 was structured so that the government avoided increases in state debt. At the time, the governments held to the ideology that debt, and especially increases in debt, was “bad”. This became starkly evident when the first Carr ALP Government introduced the Debt Elimination Bill. The subsequent Act aimed to eliminate all state debt over a specified period.

Ratings Agencies, Accounting standards and Debt

To understand better the NSW governments' rationale for private funding of toll roads, an exploration is needed into rating agencies and accounting standards.

Toll roads were not the only type of infrastructure – broadly defined – that relied on private funding. State Governments were using private funds to develop schools, hospitals, government office blocks, prisons, police stations, electricity generators and water treatment plants, among other types of infrastructures.

At the time, accounting standards did not require that the financial arrangements underlying these developments should be recognised in government accounts,

even though the state had accepted the financial and other post-development risks entailed by these arrangements. Subsequently, standards were changed to require that the assets and liabilities of many of these “private provision of public infrastructures” – PPPs - should be accounted for in the states’ financial statements.

However, these arrangements are still attractive to governments facing pressure from ratings agencies. This is because the financial liabilities flowing from PPPs are not characterised as debt but as non-debt financial liabilities, And rating agencies, at least in past years, were concerned only with debt and unfunded superannuation liabilities. (The deficiencies of rating agencies and their practices are now better known following their role in creating the Global financial crisis.)

Having made this aside, it should be noted that the typical arrangement between the private provider of toll roads and state governments do not entail governments accepting any material financial risks. Accordingly, the assets and liabilities of the M4, M5, M2 and M7 are not recognised – nor should they be recognised – in the state’s accounts. However, the emerging values to the state arising from provisions that require ownership of the toll roads to be transferred to the state are recognised

Setting the Toll

The amount of the toll to be imposed on toll road users is a vexed matter. I presume that the known primitive nature of the science of traffic forecasting for toll roads and the inability of developers to manage traffic risks effectively has led developers to negotiate higher tolls than were economically required to justify their investments. Having said this, developers and banks funding the Cross City Tunnel – see below – and the Lane Cove Tunnel lost significant capital.

The general approach to setting toll rates takes into account the extended period over which traffic grows. Thus, the toll charges in the early years do not recoup sufficient revenues to pay for all costs. As traffic builds and the indexed tolls increase the resulting revenues become sufficient to meet the accumulating costs. Indexation is typically linked to the CPI but the M1 – funded by Macquarie Bank – uniquely indexed the toll by an index based on CPI and Average Weekly Earnings. The inclusion of the AWE index was justified on the (false) argument that wages and the CPI moved in tandem. The government’s acceptance of that argument has led to a super profit for the M1 developers.

As noted earlier, the tolls collected by developers of the M4, M2 and M5 also resulted in super profits. The NSW government tried to redress the balance by requiring a “franchise fee” from those developing the Cross City Tunnel and by requiring – to no avail - a sharing of any super-profits.

A Better Model

Economics portrays Sydney's (and other) metropolitan road systems as a network. This means that an enhancement to one part of the network has flow-on impacts for other parts. For example the building of a bridge that links two otherwise separate road networks will have repercussions throughout each.

Another feature of a road network is that it shares the characteristics of a natural monopoly. This means that the entity that can most economically enhance the network is the owner of the network. It follows that allowing the private development of incidental toll roads is theoretically an inefficient – more costly – policy than having the 'owner' undertake the development.

This does not mean that the private sector is excluded from designing, building and maintaining the enhancement. That can and probably should be allowed under a tender process. It means that the government should be the owner of the entire network and it should take the traffic and financial risks associated with the entire network.

Another economic maxim is relevant to this discussion. Economics holds that the entity that can best manage the risks entailed in a project should manage those risks. To outsource the management of those risks to another is an inefficient, more costly, policy. The government is the party best able to manage the traffic and thus financial risks associated with Sydney's road network. The government thus should not tender out the management of those risks to those who are less able to manage them.

The application of this maxim can be seen in the development of the Cross City Tunnel. The developers of this part of the road network realised that the level of toll needed to justify the investment would not be welcomed by motorists. This is because the majority of the benefits of the Tunnel went not to motorists but to those who benefited from reduced traffic on William street – business owners, pedestrians etc. And although motorists received only a share of the benefits from having the Tunnel, they were required to pay all of the costs. The government's agreeing that relevant traffic would be diverted to the Tunnel solved resulting dilemma. Although the developers had mitigated the known risks with this arrangement, the government unilaterally abrogated this part of its agreement. This abrogation at least contributed to the liquidation of the company that had developed the Tunnel.

If it is accepted that the state should be the risk-taker for road network enhancements, the remaining question is how should this be effected. The simple solution is that the government should be the owner and funder of the enhancement. After all, its borrowings would typically be cheaper than those obtained by any private sector developer.

But if the government feels constrained in its ability to borrow another model would allow the private sector to fund, maintain and develop the enhancement, which it would lease to the government for a periodic payment. The payment could reflect traffic volumes – especially trucks – if it could be shown that traffic volumes affect maintenance costs. Under this model, the resulting non-debt

financial liabilities - and the assets - would be reflected in the government's accounts.

These approaches would have an important advantage over current models. It would allow the government to alter tolls to reflect demand (as occurs with the Harbour Bridge and Cross Harbour Tunnel). The constant price charged by private toll road owners is clearly inefficient because it does not allow demand to be affected by price changes. These models also allow the government to collect super profits, which, as we have seen, are a common outcome for Sydney toll road owners. The secured income available from government ownership of toll roads would better enable the road authority to plan the funding of future enhancements. Finally, government ownership of the entire network would better allow the government to extend road prices to all major roads thus enabling tolls to be set at a more uniform level across the network.

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