

REPORT ON PROCEEDINGS BEFORE

**PORTFOLIO COMMITTEE NO. 2 – HEALTH AND
COMMUNITY SERVICES**

INQUIRY INTO ROAD TOLLING

CORRECTED PROOF

At Macquarie Room, Parliament House, Sydney on Wednesday, 12 April 2017

The Committee met at 10:00 am

PRESENT

The Hon. G. Donnelly (Chair)

The Hon. M. Faruqi

The Hon. J. Graham

The Hon. T. Khan

The Hon. Dr P. Phelps

The CHAIR: I welcome witnesses, those joining us on the web and everyone in the public gallery to the second hearing of the Portfolio Committee No. 2—Health and Community Services inquiry into road tolling. This inquiry will look into a range of matters relating to tolling regimes in New South Wales, including the processes for determining how tolls are set; how tolling contracts are negotiated, varied and scrutinised; and opportunities to increase assurances to the public that tolling arrangements represent the fairest possible outcomes. Before I commence I acknowledge the Gadigal people, who are the traditional custodians of the land. I also pay my respects to elders past and present of the Eora nation and extend that respect to other Aboriginals present or joining us on the internet. Today is the second of three hearings we plan to hold for this inquiry. This morning in Parliament House we will hear from Professor Graeme Hodge, Professor of Law at Monash University, and Mr Tony Harris, former Auditor-General of New South Wales. At the offsite public hearing this afternoon at Penrith City Library we will hear from representatives from local government and community action groups.

Today's hearing is open to the public and is being broadcast live via the Parliament's website. A transcript of this hearing will be placed on the Committee's website when it becomes available. We will have a large number of people in the public gallery, and we welcome them. I ask audience members to respectfully observe the discussions today. Please be aware that today's hearings are not an open forum for comment from the floor. Audience interruptions make it difficult for witnesses to communicate with the Committee. If there are interruptions from audience members I may stop the hearing and ask for quiet or for those making noise to leave the room.

In accordance with the broadcasting guidelines, while members of the media may film or record Committee members and witnesses, people in the public gallery should not be the primary focus of any filming or photography. I also remind media representatives that they must take responsibility for what they publish about the Committee's proceedings. It is important to remember that parliamentary privilege does not apply to what witnesses may say outside the evidence that they give at the hearing. I urge witnesses to be careful about any comments you may make to the media or to others after you complete your evidence as such comments would not be protected by parliamentary privilege if any person decided to take an action for defamation. The guidelines for the broadcasting of proceedings are available from the secretariat.

There may be some questions that a witness could only answer if they had more time or had certain documents to hand. In those circumstances witnesses are advised that they can take a question on notice and provide an answer back to the Committee within 21 days. I remind everyone that Committee hearings are not intended to provide a forum for people to make adverse reflections about others under the protection of parliamentary privilege. I therefore request that witnesses focus on the issues raised by the inquiry's terms of reference and avoid naming individuals unnecessarily. Witnesses are advised that any messages should be delivered to the Committee members through the Committee staff.

GRAEME HODGE, Professor of Law, Monash University, sworn and examined

The CHAIR: Thank you for your submission, which has been marked as No. 112 to this inquiry. You can take it as read, so there is no need to go into it in great detail in any opening statement you may wish to make. That is a matter for you. I invite you to make an opening statement and then we will proceed to questions.

Professor HODGE: I firstly congratulate the New South Wales Parliament on holding this inquiry. It is a very important issue and there are many things to say about tolling regimes and long-term infrastructure contracts. My submission essentially says that choices about tolling regimes and long-term contracts, levels of confidentiality, accountability regimes and so on are matters of public policy choice and ought not be misconstrued as being an inherent part of contract technology. Likewise, the relative role that you give private contract law and the relative role you give public independent regulators are matters for public choice and are not fixed. Having said that, it is clearly often sometimes difficult to separate those matters from what we think ourselves about long-term infrastructure contracts and their value for money and so on.

I observe that this inquiry is occurring at a time when there is increased distrust of governments, of experts and of many. Personally, I think politics through our Australian system has delivered fantastic benefits over the last century, but it is perhaps more difficult these days to govern when governments are increasingly constrained, citizens are increasingly active, well connected and educated and the media is on a voracious 24-hour media cycle looking for the next crisis.

I do think though toll roads and long-term infrastructure contracts are useful politically as well as perhaps technically. They are useful politically because they focus the attention of citizens on the timing of big projects. They allow governments to put things on the public agenda and they allow governments also to perhaps even stay in charge of the initial debate when it is done through a consortium. Equally though, I am on record as having criticised long-term infrastructures in Australia for being essentially two-way deals between government and business; they are not directly involving communities and accountability bodies. So when I see tolls being back-loaded I say it is yet another buy-now pay-later scheme. I guess the visibility of these arrangements is also up to the government of the day, is it not? So are our arrangements set in stone? I do not think they are.

Much of the academic literature on long-term infrastructure contracts, talking about scrutiny and transparency, talk about a democratic deficit but there are increasing numbers of people saying it is inappropriate language and these concerns about accountability are overstated and overplayed because there is a breadth of alternative accountability mechanisms available today. I personally believe that our systems are insufficiently transparent and too secretive. Again, I am on record as saying that. There is clearly a time before the conclusion of negotiations and contract signing when deals ought to be secret and contract information ought to be confidential, but in Australia what I do observe is that the material that remains confidential in our contracts is exactly that material that is required "to increase the assurance to the public that the tolling arrangements represent the fairest possible outcome", which is the Committee's terms of reference. So what can we do about it?

One option is to release all contract details, not just a summary or things that we approve of but all commercial information. Another is to allow access from someone like an independent regulator. The third might well be to undertake a study to find out what returns private investors do get on average from toll roads and other long-term infrastructure arrangements. Clearly we do get some hints and clues when a toll road fails—the Cross City Tunnel here, Clem 7 in Brisbane and Southern Cross Station in Melbourne. In those instances there has clearly been commercial failures. Private companies have rightly borne the risks under their private contracts; governments have stood firm. But what happens on average is a good question. What happens on average is something that I have been trying to get a hold of for perhaps 1½ decades and I am still looking. If we are going to make policy changes in this arena we really do need to know is what does happen on average with these returns.

So there has been a lot written about value for money and fair returns. It is sometimes difficult to tell the ideology from the scientific guidance but I would say there are thousands of ways of structuring contracts. It is difficult to get a general lesson but reviews increasingly are now saying the international evidence on long-term infrastructure contracts is "both weak and mixed". Academics are generally sceptical whereas governments and suppliers are not. Often the modelling that is done, particularly for things like public sector comparatives and so on, is error-ridden and able to be manipulated to come up with the conclusion that you want to push. Likewise in relation to the on-time and on-budget delivery evidence there is a lot of it that is repeated. What is

often repeated is the evidence that says consortium-led private financed projects are delivered brilliantly compared to traditional means. What is often not repeated is the opposing evidence that says the initial evidence has no scientific basis whatsoever if you can get the evidence out from behind commercial-in-confidence problems. That evidence as well is mixed, and I would say even our Australian evidence is doubtful.

The real issue though is perhaps not the on-time and on-budget evidence but very few, in fact, nearly all the studies that have been done do not tackle the fundamental issue. I am not fussed about on-time and on-budget—I pay my children's school fees on time and on budget even though they may well cost a lot more than an alternative school. No studies to date really tackle the issue of what does it cost per kilometre to provide a road that is privately financed or tolled compared to using traditional means. There is only one study that has been done through the European Investment Bank and that study said it was a line-ball call as to whether traditional means or private finance means was better. It was literally a line-ball call.

I do have some concerns about the capability of the public sector in looking after the interests of citizens. I guess in part because I had some concerns when I wrote a book about privatisation 15 years ago looking at some United States evidence. These days I have submitted an article to the *Australian Journal of Public Administration* which asks some of our leading Australian experts what they think about governing and whether they think we have the capability. They are concerned about the capability of governments to look after governing long-term infrastructure contracts as well.

What about the role of an independent regulator, which was part of the Committee's terms of reference? I presented to a Victorian parliamentary inquiry, gosh a decade ago, and one of the co-presenters there, Professor Colin Duffield, my colleague at Melbourne University said at that time the neutrality of a regulator would assist in protecting the interests of all parties, including the public interest. The concern about protecting the public's interest through a longer term device, rather than just the current parliamentary decision, was on the table a decade ago. The academic literature—which I referred to in my submission—talks a little about differentiating regulating through contract as against regulating through agency.

The interesting part of the paper that I referred to in my submission is that the author Jon Stern talked about regulatory agency arising in the nineteenth century as a result of an inability to properly control long-term infrastructure contracts. It is exactly the problem we are still left with. He comments that much of the economics literature is hostile to infrastructure regulation by agency for some reason. However, he sees them as equivalent; that is, regulating through contract and regulating through public regulator can be seen as equivalent. Why is that? It is because the regulator who issues a licence does so with many details—essentially contractual documents. He says that these two are equivalent, except that under the private contract it suffers from the fundamental problem of having huge certainties. His argument is that regulatory agencies have an important and continuing role to play in public infrastructure and that they are complementary, not substitutes. I find that interesting. I believe we can use regulators better than we have done in the past.

The CHAIR: Thank you for a very clear and succinct opening statement and overview of your paper and related matters.

The Hon. JOHN GRAHAM: Thank you for your submission. I will address both of the aspects you have raised in your opening statement. I will deal first with transparency. It would help the Committee if you were able to translate your broad views to our situation in New South Wales. How does New South Wales compare to some of the other jurisdictions you have examined? How secretive are the arrangements in New South Wales compared to other places?

Professor HODGE: First, all jurisdictions struggle with the question of how transparent contracts must be. I have just read something that said contract transparency in the United States is not good and does not look after the public interest. Any jurisdiction that releases a summary of arrangements and the deal after it is signed is doing reasonably well. The debate really is about what happens prior to the deal being signed—that is, during the consultations—and what is left out of the information that is provided. As I said in my submission, no jurisdiction in Australia at the moment allows anyone to read a contract and, for example, to try to guesstimate what returns private investors are getting out of the deal. We know that when we privatise a utility that we install an independent pricing and regulatory tribunal or an essential services commission to look at the assets of the company and to work out a fair rate of return for those assets. Because these contract deals are internalised, they are done on an ad hoc basis and with the flavour of the time.

The Hon. JOHN GRAHAM: You have covered a lot of ground in that answer. It is remarkable that we do not know the average rate of return on these projects in Australia. Why have we not been able to do that work or study? That information is fundamental.

Professor HODGE: I cannot answer that question, despite the fact that I have been asking it for about a decade and a half. I am told repeatedly that we have it. My usual response has been, "Don't tell me, show me." I have never received that information. I am told that there are charts that provide that information, but I have never been able to get one.

The Hon. JOHN GRAHAM: But if we are to weigh up the question of public value for money, it is impossible to do so without that piece of information.

Professor HODGE: Absolutely. All we can say is that the returns to private investors vary from terrible when things fail, where clearly there have been hugely negative returns, to presumably terrific returns. One example of that is the Melbourne CityLink contract, which delivered fantastic returns for private investors.

The Hon. JOHN GRAHAM: There might be specific questions about specific projects, all of which is of interest. However, we are grappling with the system overall. Is that a fundamental missing piece of information from your point of view?

Professor HODGE: Absolutely.

The Hon. JOHN GRAHAM: Looking at transparency in New South Wales, how do we measure up on those specifics? You have raised two issues: when there is some transparency and what is left out. On the question of when we get access to some of this information, how does New South Wales measure up compared to other jurisdictions you have seen?

The Hon. Dr PETER PHELPS: Point of order: Mr Graham asked a valid question, but it may not be within the knowledge of the witness. He might not be aware of the specific details of individual contracts in New South Wales. It might be unfair to seek a comparator.

The CHAIR: I am sure the witness can answer the question, but he may wish to take it on notice. It is entirely a matter for him.

Professor HODGE: I am happy to take it on notice. That is a very honest answer. Thank you for that.

The Hon. JOHN GRAHAM: I certainly do not want to ask you to venture into areas about which you are uncertain. Feel free to indicate that. On the question of what is left out, would you be comfortable answering now or taking a question on notice about how New South Wales compares with what you have seen elsewhere?

Professor HODGE: My impression is that it is similar to other States in that it does a good general job of summarising the deal. However, when you ask what information we can get, I guess part of the issue is the definition of "we". If we are talking on behalf of citizens, an independent regulator could be seeing that information and holding it to their heart so that when they need to make a decision later it is taken into account. It could be open to the public or to an independent review committee of Parliament.

The Hon. TREVOR KHAN: What is "it"?

Professor HODGE: Private returns to investors.

The Hon. JOHN GRAHAM: I turn now to some of the other specifics you have referred to on the question of what we can do to let a little more light into these processes. You are saying that we could release all the contract details, but some things would have to be redacted. When you say "release all the contract details", how much information could we release?

Professor HODGE: There will always be a claim of commercial-in-confidence somewhere in the apparatus of the contract documents. It is simply a question of what the parties are happy to agree to, and different jurisdictions will have completely different rules about the degree to which parts of contracts should be redacted. Personally, I would have no qualms about releasing financial details, but other people would.

The Hon. JOHN GRAHAM: Is there a jurisdiction to which you can point that allows the release of that information in a way with which you are more comfortable?

Professor HODGE: If these arrangements are put up to a single new commercial body, they may well have to release those details to incoming investors and shareholders as part of our stock market arrangements. In general, most jurisdictions hold secrets of some sort. The only way of getting around that is to hold a formal inquiry. But you may not get all the commercial information in that case either.

The Hon. JOHN GRAHAM: Your second suggested intervention is allowing access to an independent regulator who might not release some of that information but who would be across it. In your view, what is the appropriate point in the deal for that access to occur? When is that scrutiny most usefully applied?

Professor HODGE: It probably depends on what sort of model you go with. If an independent regulator were to be set up following the French model, in which it is known there will be an independent public regulator, contracts are more flexible and less detailed, and there is a professional trust that the job of the regulator is to act in the interest of all parties. We tend to have far more detailed contracts here and we tend to have far less—we assume that more and more detailed contracts are required to knock out all possibilities. So, if you had that independent regulator you might actually invite them in at the start.

The CHAIR: The notion or concept of commercial-in-confidence is one that we have come up against time and time again in the submissions we have received and been passed over in evidence that we received yesterday. It seems to potentially mean all things to all people. I am wondering, in the Australian commercial context, arrangements involving the state and the private sector, where do we go to look for a definition that is as precise as we can possibly get of what that means?

Professor HODGE: I am struggling to give you a source.

The CHAIR: You may wish to take it on notice but it is just one that rolls off people's tongues time and time again.

Professor HODGE: I say that I am struggling because it does mean just about all things to all parties. It is a question of, under private contract law, both private parties agreeing what would be kept confidential within the contract.

The CHAIR: Because it seems to be a critical notion, is it not, in terms of where it sits and what that therefore means in terms of capacity for the interrogation by outside parties, if I could use that phrase, to understand and examine and comprehend what is being proposed.

Professor HODGE: But again, I am happy to take that on notice.

The Hon. JOHN GRAHAM: I was interested in your suggestion then about the interaction between regulation and long-term contracts because that is really one of the fundamental issues we have got here. These concessions now extend to 2048, 2060, we have got fixed toll prices, fixed escalations for that period, but really much of the development of the city around those fixed contracts is dramatically uncertain—where the jobs will be, where people will live. We have got some idea of it but out to 2048 and 2060 it is very uncertain—where the schools will be, where the sport will be played, what sports will be popular or not, what vehicles people will be driving, what fuel those vehicles will be using—all these things becoming progressively more uncertain. That is the sort of environment where you are really describing there might be a more productive relationship between a regulator and some of these long-term contracts, acknowledging all those uncertainties and providing a framework for them. That is really where your evidence seems to be heading.

Professor HODGE: Yes.

The Hon. JOHN GRAHAM: Have you got any views on that question?

Professor HODGE: I think that is spot on. I think relying on governments of the day, in a sort of patchwork approach, to be making decisions for long-term contracts that sometimes really need some serious steering, leaves the community open to exactly the problem that we had in the first instance, where one government took a decision that tied up the next 14 or 15 governments long term. I think that getting an independent regulator involved as a contract overseer is a sensible move.

The Hon. TREVOR KHAN: But you have not actually answered the question, at what point the oversight occurs, because if the oversight occurs after the contract is signed, you can take a bit of our time but it is an exercise in navel gazing, it does not actually produce an outcome.

Professor HODGE: Until conditions change. It depends—if you sign a detailed contract that has non-competition clauses in it that ties up the Government's hands for 60 years, you are right. We do not usually do that because contracts are never complete, there is always a situation where Governments will want to do something different, new technology will come in, we will want to introduce road pricing, something will change and someone will say it was not in the contract. That is the point at which I would be saying, you give the job to an independent regulator, in exactly the same way as we have done for electricity, gas or water.

The Hon. TREVOR KHAN: It is not quite the same as electricity, gas or water.

The Hon. JOHN GRAHAM: But your point is, if we are going to come back with these questions, we should do it in an informed, systematic way, with a body at the table that has really developed some expertise about this.

Professor HODGE: Yes, and at the end of the day I think you need a body that citizens regard as an independent governor for the long term.

Dr MEHREEN FARUQI: Thank you, Professor, for coming in to provide evidence today. We know that 13 out of 16, I think it is, tollways in Australia are actually owned and operated by Transurban and some have, because of that, called it a mega-monopoly. I am interested in your views of how it happened that one company now has the ownership of so many toll roads. Is it that Australia lacks competition in this area?

Professor HODGE: An excellent question. I would say, firstly, that Transurban is a very professional and extraordinarily capable and innovative company. I would also say that I personally have a concern that there is insufficient competition in markets, a point that I made to the Productivity Commission a few years ago. So there is another question perhaps which could do with some better research, some evidence, rather than a bunch of people sitting around a table with opinions. We still have the possibility to introduce far more competition than perhaps we have at the moment, but it is a good question.

Dr MEHREEN FARUQI: Given the lack of competition, if we think that is the case, and given that Transurban now has ownership of so many toll roads, do you think they have a much better negotiating position with governments when future toll roads come online or the idea of, let us say in New South Wales, which some have proposed, a whole network of roads that have a more consistent road pricing?

Professor HODGE: Yes is the short answer. I think companies—and Transurban is just one example—that do these deals, week in and week out, do have an advantage over all governments, not just the New South Wales Government, because that is their sole job. So I think in the initial stages they do have a professional advantage, if you like, and governments have to work hard to come equally to the table. Having said that, I think they are in the box seat for influencing public policy and doing things like offering road pricing solutions and so on in the future. Again, it is another reason why you would want a long-term governor, in the public interest.

Dr MEHREEN FARUQI: Do you think having this influence provides good value for money for the public, by not having enough competition?

Professor HODGE: I think Transurban, and many other companies, influence governments and it is part of their democratic right, if you like. I think we have to strive for competition, that is probably the answer.

Dr MEHREEN FARUQI: In terms of contracts we heard evidence from many people yesterday, and it is within the submissions as well, that private companies do take on quite a bit of risk and liability when they commit to building and operating toll roads. And part of the risk we saw has been with certain toll roads like the Cross City Tunnel, for instance in Sydney, the Lane Cove Tunnel and also the Clem7 in Brisbane and it was partly due to the predictability of traffic forecast which was much less than what actually happened and partly, in some of the contracts, due to some franchise agreement and profit-sharing sorts of agreements. So I am presuming that learning from those experiences, private companies who bid for these contracts and get them, have covered in the contract quite a bit of the risk and liability as well or have clauses. I am interested to know how you think that risk and liability is covered and what impact that has on value for money for the public.

Professor HODGE: At the end of the day, the technical success or the financial success of all toll roads or long-term infrastructure contract schemes depends on what is being paid to bear what risks, and it goes back to the question that I answered 15 minutes ago, which was it is actually unclear, apart from where there are huge successes and huge failures, what users and citizens have been paying for various risks to be borne. Everyone throws their hands up in the air and there is a theatrical display about huge risks, and of course large infrastructure projects are risky, and of course governments ought to be trying to do things better than we have done in the past. Those things are taken for granted, but I am less convinced about whether you need our current privately financed consortia arrangement with the various attributes that it has as the one best way. I understand completely that this whole game is about the risks that private companies take and the fact that they ought to be getting returns when they take large risks; I think that is perfectly reasonable. The issue is, we do not know what we have been paying for risks, and I wish we did, on average.

Dr MEHREEN FARUQI: Is there a way, given your experience, that the risks could be reduced, for instance in traffic forecasting, so that no-one has to take that risk or very little risk should be taken?

Professor HODGE: In Australia we have gone through a learning period. We have had multiple models of long-term infrastructure contracts. In one of our models we tried to outsource as much risk as possible, give the poor private company even the risk for traffic flow. So our management speak, as we were speaking in our Treasury department, said the parties ought to bear the risks that they best control and yet we gave the risks of traffic that was turning up on the day to the private company. That was really stupid. It was an ideological piece of policy that said, we will just try and get rid of all of the risks over to the private company.

We have learnt very quickly, have we not, that that is probably silly. Governments are far better placed to take the risk of traffic demand. Of course, the construction risks and various other risks are sensible for private companies to take. They are well managed; they do a good job in doing that. But taking on less risk means less return. There is another question. The ultimate fair price is a question, ultimately, for a regulator.

Dr MEHREEN FARUQI: What is your opinion of unsolicited projects that are deals done directly between government and private operators without any private competition and what value for money do they provide?

Professor HODGE: If you ask my opinion about unsolicited bids, I suspect they are dangerous because they are usually less visible in respect of the State's priorities than many other kinds of options. Having said that, many folk would believe that if someone comes up with a bright idea, it ought to be put up there, let us make it transparent and have a debate about it. What is usually missing with unsolicited bids is the reality check of where that unsolicited bid fits in the State's needs and, again, with returns going to the investors I am never quite sure what returns are going to whom.

Dr MEHREEN FARUQI: You have been critical for some time about these long-term infrastructure programs. You call them "buy now, pay later". In one of your articles I was reading that a new approach is needed so that we can make better infrastructure decisions, because it is only by doing this that we will avoid "burning so much of our money on stupid Taj Mahals", and I think you were referring to the East West Link in Victoria at that time. You have spoken a little bit about what that better approach is. With regards to PPPs, and the way that they are done now, what could be a better approach? Could there be a different approach altogether?

Professor HODGE: Yes, I think there could be a different approach. I am not saying we go back to having a public works department. What I am saying is there are many ways of mixing funding. Canada, for instance, takes on far less risky long-term infrastructure contracts than we do; they have for a decade. We have learnt the hard way that we ought to do that. Many of their projects are partly publicly funded, partly privately funded. We are yet to adopt that system fully. We have been operating to date that these things ought to be privately funded and that is the answer.

The Hon. TREVOR KHAN: For instance, NorthConnex has got, what, \$800 million of public funds in what is a \$3 billion project?

Professor HODGE: Yes. We are getting there, that is true. We have learnt that. The United Kingdom private finance inquiry said it was time that we looked at mixed funding for these things. I was saying that a decade ago. It has always been a policy option to mix funding, but you would want to do it very carefully. You might have to raise public bonds. You would still want to do it through a consortium. You would certainly want to keep governments away from the project so that you design a project and it is handled separately away from meddling—we all like to design things that we understand. There are lots of things we could do better, we just have to want to do it.

Dr MEHREEN FARUQI: The political will is needed.

Professor HODGE: It is policy choice.

Dr MEHREEN FARUQI: You also talk about project performance characteristics, which you say remain hidden in the long-term contracts. Can you give examples of a couple of project performance characteristics that you think should be apparent and transparent?

Professor HODGE: My example is the one that I have already given, which is returns to private investors.

Dr MEHREEN FARUQI: Are there any others?

Professor HODGE: These days we have become very good at putting in performance indicators for buildings, roads, hospitals, schools, and I think gradually doing that to a high degree of transparency, and I applaud that. The single area where we tend to miss out on is the whole question of financial returns.

Dr MEHREEN FARUQI: In New South Wales, my understanding is that quite a few of the toll road projects are done on a BOOT basis—build, own, operate and then transfer. What we are seeing more and more is that the tolling concession agreements get extended, like Mr Graham said, to 2060 or to 2048. In your opinion, will there ever be a time when these projects will be transferred back to the public, or will tolling companies be able to negotiate ongoing contracts and on what basis do you think that is done?

The CHAIR: And you have got 30 seconds.

Professor HODGE: If I am honest, I do not know the way that is done in New South Wales. All I will say is that it is clearly a political choice, and our question at this table comes back to: do we leave the political choice for the government of the day for another 20, 30, 40, 50 years or do we give it to a long-term governor or independent regulator?

Dr MEHREEN FARUQI: Thank you, Professor Hodge.

The Hon. TREVOR KHAN: A question was put to you with regard to the extension of toll contracts in a way that suggested it just happens. Did you look at the whole-of-government submission No. 109 prepared by Transport for NSW?

Professor HODGE: No, I did not.

The Hon. TREVOR KHAN: On page 11, I invite you to look at the 10 principles that are applied by the New South Wales Government with regard to tolling principles, as it is described. One of those, and I think it is seven—essentially the position is this: There is an extension of a tolling concession where there is a major change to the infrastructure so that essentially the extension occurs because there is more significant building going on on that motorway. That is a reasonable proposition, is it not?

Professor HODGE: Sure.

The Hon. TREVOR KHAN: That is different from simply saying that you are going to give a concession for an extended period of time for some non-specific reason or essentially out of charity to the operator, is it not?

Professor HODGE: Sure.

The Hon. TREVOR KHAN: If you look at the issue of contract performance in the engineering space, which these are in essence, the largest ones that we see in Australia are not road projects, they are the defence projects that we do. Is that not correct?

Professor HODGE: I am not sure about that.

The Hon. TREVOR KHAN: For instance, if you look at the submarine project that is being proposed, it dwarfs anything that we might do on a road, does it not?

Professor HODGE: Historically at the federal level we have steered clear of privately financed projects. I am not sure what is coming up, but historically infrastructure projects have been very big apart from the odd purchase of trains and so on.

The Hon. TREVOR KHAN: The problem that we have with those large engineering projects is in many ways the same as we are talking about here. For instance, it is very difficult for the customer to determine how much return Thales Australia is getting from those submarines being built?

Professor HODGE: Sure.

The Hon. TREVOR KHAN: You go through a tendering process and somebody wins for a number of factors—some may relate to cost and others to perceived performance issues. That is correct, is it not?

Professor HODGE: Sure.

The Hon. TREVOR KHAN: At the end of the day you really do not know how much the company is going to make or not make on that deal?

Professor HODGE: That is true and they are extraordinarily risky—probably two orders of magnitude greater risk than building a road.

The Hon. TREVOR KHAN: For instance, the Collins-class build was a perfect example of something that went extraordinarily wrong for both sides in terms of contract documentation. You talk about flexible contract documentation but one of the problems that arose there was that design drawings and the like were not available to the customer, they were retained under a variety of contractual terms that did not allow us access to those. Is that correct?

Professor HODGE: I will believe you.

The Hon. TREVOR KHAN: Essentially the contractual negotiations in all these cases are extraordinarily difficult and, indeed, evolving over time?

Professor HODGE: Sure.

The Hon. TREVOR KHAN: If one looks at the contracts that have applied in road infrastructure in New South Wales there has been an extraordinary development from the early contracts to the latter ones.

Professor HODGE: Sure. I am not saying that negotiation with government is a bad thing. All governments on major changes to road arrangements or at the end of an existing concession will clearly go through negotiation. That is a perfectly valid way of structuring your arrangements. The question is: How do we assure the public that they are getting a good deal? I am not sure how the debate is in furthering that answer at the moment.

The Hon. TREVOR KHAN: In terms of any of these projects there is always a requirement for parties on the two sides to go into the deal and try and reach an agreement that each side thinks is reasonable. Is that not right?

Professor HODGE: Right.

The Hon. TREVOR KHAN: The problem is introducing a third party, which I think is what you are suggesting. Is that any more likely to produce a better outcome?

Professor HODGE: I am not sure that the third party would be doing anything other than watching what is going on so that if they are called on in the future to make a decision on the return on capital they are aware of the deal that was struck in the first place.

The Hon. TREVOR KHAN: So we have a detailed contract that is purportedly binding on both parties but with a variation clause exercisable by a third party. Is that what you end up with?

Professor HODGE: That is not what I said. Any contract can have a renegotiation clause after five, 10, 15 or 20 years if you want.

The Hon. TREVOR KHAN: You actually do not need a renegotiation clause. By its very nature, if the parties agree, they can renegotiate?

Professor HODGE: Okay. When it is time to renegotiate, the contract will remain as it was. If you are dealing with an issue that is not covered by the contract then I would expect an independent regulator to make some headway in furthering discussions.

The Hon. Dr PETER PHELPS: At the bottom of page two of your submission you say:

... LTIC deals in general terms are useful in putting forward the favoured project on the public agenda in an era where government is competing with many others for attention space and news coverage.

That is a rather cynical thing to say. Is it not also important to remember that we are also competing for a limited use of scarce taxpayer dollars on a wide variety of interests? For example, the same dollar that we use to construct a road through government could just as easily be used to construct a hospital or a new school. It is not merely attention, space and news coverage, actual government finance is a scarce resource as well that has to be allocated?

Professor HODGE: Sure, and I do say that. Can I just respond to that? What I was trying to say was, I have said for a decade that one of the great things about long-term infrastructure contracts is that they do allow governments to control the agenda. Instead of governments struggling to pay maintenance for schools, they can put 20 schools together and say, "We are going to sink \$1 billion into this new area." You raise the flag and say, "Infrastructure is important, folks. I know it was out of fashion but it is important." That is what I am trying to say there.

The Hon. Dr PETER PHELPS: You said further:

LTIC deals, including toll roads, have also assisted governments historically to strengthen their relationship with city financiers and demonstrate they were not anti-business.

For many years State Liberal governments around Australia have engaged in large-scale capital works. Presumably that was not because they were not antibusiness, presumably that was because the nature of the capital markets in Australia prior to the 1980s were relatively primitive?

Professor HODGE: Sure. That comment in particular related to the United Kingdom where it has been demonstrated—in fact, it is down as part of Labor policy at the time.

The Hon. Dr PETER PHELPS: On page three of your submission you also speak about higher than consumer price index [CPI] increases through the long life of a project. Would you agree that the return on capital that is expected by companies is generally higher than the CPI anyway? It would be unusual for a company to say that their expected rate of return on capital should be less than the CPI.

Professor HODGE: I am confused by the question. If we had a CPI of zero, you would want some kind of return on capital as an investor. It has probably got very little to do with CPI.

The Hon. Dr PETER PHELPS: So returns on capital higher than CPI increases through the life of a project are not unexpected; they would be expected by any rational decision-maker in a company. Otherwise what is the point of investing in a project—

Professor HODGE: The word that has been left out is "increased" returns by more than the CPI. You start with a certain toll, \$10, and you would put your toll up by CPI. Presumably you have started with that toll of \$10 because you expect a return on capital. If you are then on top of that putting up your toll increases by more than CPI you are getting an even better deal than you initially estimated.

The Hon. Dr PETER PHELPS: Unless, of course, you choose to structure your arrangements in such a way that you backload the return on capital towards the end of the project?

Professor HODGE: That is true.

The Hon. Dr PETER PHELPS: Which is a legitimate business decision, is it not?

Professor HODGE: Sure.

The Hon. Dr PETER PHELPS: You also say on page three of your submission: "This direction is also possible in Australia." The direction that you are talking about related to an earlier quote from a professor at the University of Toronto. I continue to quote from page three:

'Since then governments across the country have tended to retain control over toll rate setting and demand risk on most toll roads, to protect the public interest and avoid political risk.'

This direction is also possible in Australia ...

That we retain control over toll rate setting. Is that correct?

Professor HODGE: We could retain control if we wish.

The Hon. Dr PETER PHELPS: How is entering into a deed that is legally binding for some 40 years where the escalation is set and cannot be adjusted, not retaining control over toll rate setting?

Professor HODGE: If you enter into a contract with the details we have got you have no capacity to have any role for a regulator.

The Hon. Dr PETER PHELPS: That is correct, but you have set toll rates—you set them at the commencement of the contract. What you seem to be suggesting is that we should have the ability to reset tolls at different levels at different periods of time on the basis presumably of the arbitrary judgement of an independent regulator.

Professor HODGE: And that might be written into the contract.

The Hon. Dr PETER PHELPS: What does that do to the existing contractual relationships? Surely that leads to an immediate problem of sovereign risk for an investment on the basis of a contract which has already been negotiated.

The Hon. TREVOR KHAN: Take out sovereign, just risk.

Professor HODGE: Yes, you are right that the public will pay for that option. If the public wants governments to control tolls and for them to be taken out of that private contract domain you are right, it involves a risk to the public and it involves a payment.

The Hon. Dr PETER PHELPS: On page 4 you say.

... I am on record for criticizing Australia's LTIC arrangements as being insufficiently transparent and for arguing that the commercial deals done on behalf of voters have been too secretive.

You have sort of answered that and said in what way that affects the publicly announced deeds on New South Wales toll roads. Could you take that on notice and see to what extent they violate the principle which you have enunciated here?

Professor HODGE: Sure.

The Hon. Dr PETER PHELPS: You also say on page 4:

... I have consistently argued that after the deal is signed and the decision has been made on behalf of the public, the details of the contract ought to be made transparent.

In other words, you are saying that after the contract has been negotiated but before it has been signed there should be some sort of public consultation, or what do you mean by that?

Professor HODGE: It probably should have said "after it has been negotiated and signed".

The Hon. Dr PETER PHELPS: It is just being made public, not subject to some sort of public veto or review?

Professor HODGE: No.

The Hon. Dr PETER PHELPS: That is fine. But if it were to be made public, would that address your concerns?

Professor HODGE: Yes, it would.

The Hon. Dr PETER PHELPS: For example, if you learn that the current contracts for New South Wales toll roads are, apart from minor redactions, public documents would that satisfy your concerns?

Professor HODGE: It depends on what those minor redactions are. We all have slightly different versions of what is minor.

The Hon. Dr PETER PHELPS: You say:

Put simply, citizens still do not know what price is being paid to private financiers to bear which risks, and citizens do not know what returns on investments the private financiers are expecting to earn from this public infrastructure. In my view, they should.

Why should they?

Professor HODGE: Because I think it is part of what citizens expect of governments. For instance, if tolls are set low and they rise at greater than CPI throughout the life of the project you are spot on that it is a legitimate business decision but it might not be a democratically legitimate decision unless the public is aware of that from day one.

The Hon. Dr PETER PHELPS: Surely we already know the rate of return on investment for Transurban because it is in its annual report. It has \$22 billion in assets and it receives \$1.7 billion in road tolling, which is a pre-tax rate of return on assets of roughly 8.5 per cent.

Professor HODGE: We might know the returns for the company. We do not know the returns for individual projects.

The Hon. Dr PETER PHELPS: Also on page 4 you say:

Governments in these instances were shielded from both initial construction financing and whole-of-life financing problems. But policy changes on LTICs desirably require an evidence base of what happens on these projects on average and we simply do not know the average return to private investors for these projects in Australia.

We do, because I just gave you the figures.

Professor HODGE: And I said we do not know the returns for individual projects; we know them for companies. It is a little bit like saying my deal with a particular commercial bank is very different to the profitability of the bank as a whole.

The Hon. TREVOR KHAN: But did you not say the issue was to determine the average return?

Professor HODGE: Average return for projects, not average return for companies. They are two different things.

The CHAIR: Thank you very much, Professor. We appreciate your submission and the opportunity to ask you a range of questions. The Committee has resolved that answers to questions taken on notice be returned within 21 days. The secretariat will liaise with you about that. There could also be some additional questions. I hope that will be agreeable to you. Thank you very much for coming along.

(The witness withdrew)

TONY HARRIS, Former Auditor-General of New South Wales, affirmed and examined

The CHAIR: Thank you for your submission, which has been received and marked as No. 111. You can take it as read by the Committee and you do not have to refer to it in great detail in your opening statement. Do you wish to make an opening statement before I pass over to the first questioner?

Mr HARRIS: Yes. The modern history of toll roads in New South Wales now runs for nearly 40 years and I still do not think we in New South Wales have a strategy about toll roads. We have tactics and we have serial tactics but we do not have an overview of what we want out of it. That overview is missing and so are the principles which inform it. I could give you probably nine or 10 tactics that governments have used over time, each one presumably argued on the basis of the particulars but, as I said, not having any view overall about what we want to do with toll roading. The second thing I would like to say is you can take the opportunity for toll roading to fix public transport and if you do not fix toll roading you will never fix public transport. They are intricately interwoven together and we are looking at them in piecemeal approaches. The third thing I would like to say is that there is confusion about this issue of finance and risk taking and because of that confusion motorists in New South Wales have paid significantly more than they should have for the toll road services being provided. That can be demonstrated in part. I agree with the former witness that we do not have a very solid basis for that comment but we do have anecdotal and theoretical bases to make that comment that motorists pay more than they should. That will be enough for the beginning.

The Hon. JOHN GRAHAM: I note you were in the gallery for the previous discussion with Professor Hodge. I will start on that question we were going round on about toll escalation rates higher than the consumer price index [CPI]. I ask about that for two reasons. First, this issue is in focus because the WestConnex tolls will be put up by 4 per cent or CPI, whichever is higher. That is a very generous escalation rate that has focused the public discussion. Secondly, this has been the subject of a former Auditor-General's report, not your own, which said about toll escalation rates that escalation factors should do no more than reflect underlying cost movements or inflation. Do you have any views on that toll escalation question?

Mr HARRIS: This is quite an interesting question and I suppose it starts from the fact that, as some members of the Committee have averted, there are very significant costs incurred at the beginning of the wind up of traffic on a toll road. I suppose Macquarie Bank was one of the first people to realise this and to structure themselves properly so that they make significant economic losses in the early stages of a toll road and as the traffic winds up to more profitable levels they can start to recoup the losses that they have incurred. So the indexation of the toll is not so much because maintenance costs and the like are going up; it is in order to recoup past losses. You can set your toll at a low enough level that your indexation has to be higher than CPI or you can set it at a higher level, meaning that your indexation can be lower. The only way to work out whether the indexation is at an appropriate level is after the fact.

The Hon. JOHN GRAHAM: The Hon. Dr Peter Phelps is right, there are a couple of variables in a deal that might be struck to end up with a certain amount of profit so whatever you might do, you can structure the deal this way. However, the former Auditor-General drew attention to the principle that this violates. I will quote the report:

This action distorts inter-generational equity between tunnel users. If it was appropriate for tunnel users to fund these costs, this should have been done by changing the base tolls. Escalation factors should do no more than reflect underlying cost movements or inflation.

The deal might stack up either way but the principle of intergenerational equity is violated when you escalate tolls, particularly if you escalate them at a large amount above CPI. Do you agree with the Auditor-General's report?

Mr HARRIS: I would like to think about that a little more carefully because you would think that the lack of use of the toll road in its early years suggests that the price is already too high for those users. The fact that you have an under-used piece of capital because the traffic is under-using it suggests that they are getting a good deal from it, certainly, but it also suggests the price is higher than it should be. In other words, in an ideal world you would want the facility to fill fairly quickly and not over an extended period of time. I can see some merit in the comment but it is not one that I have thought about very carefully.

The Hon. JOHN GRAHAM: In your view what are the best protections, given what you have described about these contracts in your submission, that could be put in place to ensure public value for money?

Mr HARRIS: The best protection is that the Government be the financier and owner of the road and take the risk because, as the previous witness said and as every economist says, the person bearing the risk

should be the person who is best able to manage that risk. Quite clearly, the owners of toll roads are not the best people to manage the traffic risk that they have taken on or that they have been given.

The Hon. JOHN GRAHAM: What is your view about the discussion which has happened about having IPART at the table in some of these deals?

Mr HARRIS: I have some sympathy for the view that by the time the contract is signed it is all over. What is more, we have empowered the owner of the road in any subsequent variation to the contract. So when the Government says, "My gosh, the M5 is a bit full, can we expand the M5?" you are dealing with a monopoly provider. You might be the monopsonist, the only person able to make the deal, but you are dealing with a monopoly provider. You have a public interest. The Roads and Maritime Services has a public interest certainly. They do not have a public interest, they have a private interest. They are not going to agree to anything that does not give them more than adequate cover for the risk that they are going to undertake, and they can exert that because they are in a monopoly position in the negotiations. You can bring IPART along but it is too late.

The Hon. JOHN GRAHAM: Your evidence is really that for New South Wales until 2048 or 2060 it is all over given we do not have options—

Mr HARRIS: You would have to have a very significant set of negotiations and that set of negotiations will not treat the public interest very well. The outcome of those negotiations will not be in the public interest.

The Hon. JOHN GRAHAM: That was the point of Professor Hodge. We are going to be come back on these issues, given all the uncertainties and development of both public transport and road infrastructure that will be required between now and 2060; we are going to be talking about these contracts again. This is now about what are the terms on which we will have that discussion and who should be around the table. Do you have any views about who should be around the table?

Mr HARRIS: I have said when Transfield was negotiating its multi deals in New South Wales it was a superb negotiator. That is its job. That is its life. It lives and dies by its ability to write good contracts. When they leave the room they take the Laminex with them. They do not leave anything on the table.

Dr MEHREEN FARUQI: Is that Transfield or Transurban?

Mr HARRIS: Transfield that is now broken up with family disputes and the like. These people are very, very skilled in ways that the public service is just not skilled. The second advantage they have is they do not have to do the deal. I do not want to do the deal unless there is good money in it. We, in the public sector side, say we want this deal more than they want the deal so we are in a second disadvantage. That is just a starting recipe for super returns for the private sector. Thirdly, we do not have very good competition in these kinds of arrangements. Fourthly, where we might have good competition we decide to give it to an unsolicited bidder so that there is no competition. I can give you instances to illustrate each of those. We have been as a public sector hopeless in this arena, and we have been hopeless for 40 years.

The CHAIR: Mr Harris, you are very clear about your analysis of where we, both sides of politics, are after 40 years of trying to put together, to use the vernacular, deals for road construction. Looking ahead what are your reflections about advice to government with respect to meeting the challenges to provide a framework of roads for the citizens of this State?

Mr HARRIS: If they have any dispute with the theory of transport economists and the like they could do one simple thing: put out a tender for a toll road, if you like, and have it on the one hand where the government is the financier and on the other hand where the private sector is the designer, the builder, the maintainer, the financier and the owner and see what the difference is between the two tenders, given the Government's interest rate for its own borrowings. Considering that the Government borrows far better than the private sector the deal should be quite clear just to start off with. But there are added issues, as we have talked about, called risk and that makes it hugely much more expensive to have the private sector in the deal. Although it has done very well in past deals, the private sector has failed occasionally. I am talking about New South Wales. They failed on Lane Cove Tunnel, probably because of the cumulative impact of tolls.

The CHAIR: By "cumulative impact", do you mean that customers or drivers baulked at using it because they made a judgment that the rate struck was too high?

Mr HARRIS: Yes. Most of them are not getting any tax deduction. The ramp up would have taken far longer than expected. The private sector also lost on the Cross City Tunnel, principally because the risks they contracted out to the Government were abrogated unilaterally by the Government. The Government passed the risk back to them.

The CHAIR: Can you elucidate on that?

Mr HARRIS: The traffic diversions to use the toll road were abrogated by the Government at a time when the users of the road received only half the benefits of the road. I will put that more simply. The beneficiaries of the tunnel were split between the road users and the people on the surface. It ended up that the road users were bearing the entire cost but were receiving only half the benefit. They did not believe that was worthwhile and they chose not to use it, especially when the Government chose not to funnel the traffic towards it. The private sector also lost out on the railway to the airport. We know that because the companies and financiers lost significant capital and debt money in those deals.

On the other hand, the M4 was established by the former commissioner of Main Roads with an equity capital of \$500,000. He sold a portion for \$20 million and another portion later for another \$20 million. His \$500,000 worth of equity turned into more than \$60 million worth of profit. We also know that the M5 became extraordinarily profitable partly because of the cashback scheme, when the use of the road was reduced to zero for New South Wales private drivers. When the M5 was extended each way without any toll it was much more valuable for the owners. We know that Transurban has bought out the M2 and the like at a significant surplus to their original investment, meaning that those people also made money. We know that the original investors in the M2 got their capital back in the first year and again in the second year, partly because of Commonwealth tax arrangements, and they made a huge return on it. We have a very clear understanding that they have made a motza out of these toll deals.

The Hon. JOHN GRAHAM: The previous witness gave evidence that we might suspect that but we do not know that; we do not know exactly what the returns are on these projects for these companies. Do you have any reflections on that—on the views of the previous witness?

Mr HARRIS: I agree, and I would add that you cannot find out those returns by looking at their financial statements.

The Hon. JOHN GRAHAM: It may well be worth completing the research described to the Committee.

Mr HARRIS: What you could do if you wished to contemplate it—this is contained in the Commonwealth Audit Act—is where public moneys are involved you could allow the auditor to audit their use by the private sector. It is not a power available in New South Wales, and I do not think it is often used in the Commonwealth either. However, one way we could find out the return made on the initial investment in those roads is to have that kind of searching inquiry.

The Hon. JOHN GRAHAM: Putting aside the merits of any individual project—you have made some observations about a range of them—that average rate of return is important for government in weighing the long-term issues you are raising. Do you agree?

Mr HARRIS: Yes, it is. Theory tells you that it will be much more costly than a government-financed project. But we do not know in practice to what extent the risks that have been costed have occurred.

Dr MEHREEN FARUQI: Thank you for appearing before the Committee today. We were talking about how it might be difficult to renegotiate contracts set in stone for a long time. However, Australia's largest toll road is now being built in Sydney—the WestConnex. We still have time to look at what sort of tolling arrangements might be put in place. Would you make any specific recommendations to the Government in respect of that and how those agreements are put in place?

Mr HARRIS: One of the things that happens in these negotiations is that there is a contest of some sort and there is a winner. That in itself is very difficult. You might recall that when the Eastern Distributor was the subject of a two-party contest, the Roads and Traffic Authority [RTA] at the time awarded the contract to one party and changed its mind and said it should have been awarded to another party. In those days the RTA did not have a sound grasp of the basis upon which it could award contracts. Having picked the winner, it then negotiated the details of the contract. Of course, that is another occasion that allows the private sector, which has already won the tender in some senses, to exert pressure on the government negotiators to extract a better deal. If you can do it, it is nice to have the whole contract decided before picking a winner. I doubt that that is possible.

I will use the Eastern Distributor as an example of the second thing that happened. When we did decide the contract and tidied it up, we had an environmental issue, in this case relating to the Art Gallery of NSW, which required amendment to the contract. That gives the private sector another mechanism to extract super profits. In that instance, they asked the Auditor-General to check that the fee being charged for the additional work not contemplated in the original contract was reasonable. We do not know anything about building roads,

so we hire someone to find out. If you want the cost to be reasonable, he will not know either. He might know that it is not outrageously expensive, but he will not know whether an efficient price is being charged. He will know that within 20 per cent it looks okay. Tying up everything before awarding a winner, including dealing with environmental issues, is important.

The Hon. TREVOR KHAN: But impossible

Mr HARRIS: Yes, and impossible. The more you can do, the less the risk.

Dr MEHREEN FARUQI: You said that you doubt it is possible, but it could be possible to tie down as many things as you can.

Mr HARRIS: Yes.

Dr MEHREEN FARUQI: Would that help in terms of providing value for money for taxpayers as well?

Mr HARRIS: Yes, it would. It would also be nice for the Government to say, "By the way, we are not going ahead with it because it is too expensive." I have heard of that happening only once.

Dr MEHREEN FARUQI: One of the problems in my mind about toll road projects going ahead became apparent yesterday when we heard from Transurban that its calculations of travel time saved are done based on comparing the situation now with a toll road. No comparison is done of other alternatives, such as public transport, which could save time. Do you think it is the Government's role to look at alternative scenarios before making a decision to go ahead with a toll road?

Mr HARRIS: Yes.

Dr MEHREEN FARUQI: Do you think that that has been done historically?

Mr HARRIS: No, we have compartmentalised public transport away from private transport, if you call that private transport. Therefore, the crossover is very limited.

Dr MEHREEN FARUQI: You spoke earlier about Transfield and what good negotiators they were. In your experience, how would you rate the negotiating prowess of Transurban, for instance, which runs 13 out of 16 toll roads at the moment in Australia?

Mr HARRIS: I think they have done that, in part, by taking over previous winners.

The Hon. TREVOR KHAN: Or losers, as it turned out.

Mr HARRIS: Or losers. And they have done so, I presume, in the knowledge that we have an aggressive population growth figure. These roads that they want to buy have prospective improvements that can be done to them to accommodate greater traffic, they will be the monopoly in that discussion, so they will make monopoly profits out of it and that is very smart.

Dr MEHREEN FARUQI: One of the reasons that Transport for NSW has given in its submission on not limiting price escalations for tolls to the consumer price index [CPI], for instance, is that they say it would make it more difficult to attract private investment and would actually reduce competition in the market. From your experience and in your view, it seems to me there is not much competition in the market at the moment. Do you think that would help with competition?

Mr HARRIS: No. Typically I prefer to have an outcome basis. So, set your outcomes, what outcomes you are looking for, put that into the tender and try not to define or delineate it too much because you will reduce the prospects for innovation and the like. I can give you an example of that. Again, it is the Eastern Distributor [ED]. Originally the Roads and Traffic Authority [RTA] was specifying that there had to be six lanes—it is on this principle at least—one each for the surface and two each way for the two ways for the underground part. And the successful winner said: Look, we can do better than that, why don't you just, when you are putting it out to tender, leave it open, what you want, and then let us work out how best to provide your outcomes? And that was a very successful way of looking at not delineating every aspect of your deal. So yes, it might not be CPI, it might be a figure per annum, it might be related to the traffic already achieved. There are many, many ways to index a price and I would leave it. If you thought that the public sector were half good negotiators, I would leave it to the private sector to come up with a competitive deal.

Having said all of that, in the absence of competition you are not going to achieve much by what I have just suggested. If there is not much competition, then you might have a powerful case for saying: This is going to be CPI plus one or CPI only. The thing that I really dislike is when people propose an index—and we have one in New South Wales where it is 50 per cent CPI and 50 per cent is average weekly earnings [AWE].

The Hon. TREVOR KHAN: It is 37.5 or something; it is the Eastern Distributor requirement.

Mr HARRIS: Yes, I stand corrected. It was done on the basis that AWE and CPI were the same.

The Hon. TREVOR KHAN: Or not.

Mr HARRIS: And they weren't and they aren't. So Macquarie was able to get quite a good deal by persuading the Government that really AWE was the same as the CPI, just a little bit different. So that kind of argument I dislike intensely.

Dr MEHREEN FARUQI: We heard from Professor Hodge that he was recommending an independent regulator because transparency is a big issue and many submissions have raised that. What is your view on that and how would that help with the current situation?

Mr HARRIS: Firstly, about transparency. I do not think there is anything in a contract after the event that should be held back for commercial-in-confidence reasons. So the whole essence of the contract as you have in New South Wales should be there in its entirety. Secondly, having a regulator after everything is tied down seems to be a little odd. The only time that the regulator can help is when you are going to renegotiate the contract; so who is going to renegotiate it, the regulator or Roads and Maritime Services? There can only really be one lead negotiator at least, although it might be useful to have experts, it is not necessary that it will be a regulator who is the expert.

Dr MEHREEN FARUQI: Also yesterday we heard quite a bit about—and we do all the time—government having a fixed bucket of money and there are so many other competing priorities.

The Hon. TREVOR KHAN: You are going back to your magic pudding, are you?

Dr MEHREEN FARUQI: I listen and learn. This makes the pie bigger in a sense than if you hand over the building, development and operation to private investors. In your view, does the New South Wales Government have the power also to increase that pie in a similar way that private industry does and what is that?

Mr HARRIS: The private sector has limited money too and indeed, they do not have any money, they have to go out and get it for these projects. They have to borrow it and they are going to have to have equity injected into it. The principal issue is, their costs are going to be higher than our costs because A, they do not have our triple-A rating and B, they cannot manage the risks as well as we can. And in any event, if you want a toll road you are going to get the tolls just as they are going to get the tolls. More than that, you actually have given up—this is quite interesting because there was some discussion about this earlier—when you have settled a negotiated price you have given up significant flexibility about the future. So, for example, when the Government added to the M5, without a toll, both on the eastern and the western sides, significantly increasing the profit of the proprietor, they got no benefit out of this. So you say: Okay, well let us have a super profit-sharing thing. Well, that is awfully complex, again, to negotiate.

If the Government finds itself short of money, do things in other spheres where the cost of using private sector money is significantly less than it is in using it in roads. Roads is the only area of infrastructure in New South Wales where the risks are taken by the private sector. They are not taken by the hospitals or schools or, throughout Australia, prisons or government office blocks. It is only roads where the private sector takes the risk and because of that, we pay for it.

Dr MEHREEN FARUQI: So because they take the risk, they obviously cover that risk as well, as you are saying?

Mr HARRIS: Yes.

Dr MEHREEN FARUQI: In my view there are different mechanisms that they might cover the risks which include non-compete clauses, probably an agreement or they get afternoon toll extensions or higher than CPI increases.

Mr HARRIS: Yes, or larger initial tolls than are necessary. And if I am right and they have made super profits in all but a couple of instances—I am sorry, there is another area of risk-taking and that was the railway line to the airport—if they have super profits, then of course you can see that we have done the wrong thing.

Dr MEHREEN FARUQI: Obviously, in taking these risks, the value for money for the motorist or the taxpayer is becoming less and less?

Mr HARRIS: Yes.

The Hon. Dr PETER PHELPS: Is it fair to say that your general view is that there should be no private toll roads in Sydney and that government should build and own any necessary infrastructure for freeways?

Mr HARRIS: Yes.

The Hon. Dr PETER PHELPS: So government should not only build but also own and run?

Mr HARRIS: Just own.

The Hon. Dr PETER PHELPS: So the private sector can build?

Mr HARRIS: As I mentioned before, it would be interesting to see two tenders, one where the private sector designs, builds, maintains and finances and another tender where the private sector designs, builds and maintains and see what the price differences are and whether those price differences are warranted in view of the cheaper cost of finance that the Government can obtain and the better value that the Government can extract by better managing the risks.

The Hon. Dr PETER PHELPS: You are not suggesting that we move back to a system of large-scale government departments building roads, like the old Department of Main Roads?

Mr HARRIS: No.

The CHAIR: You have said that in your evidence.

The Hon. Dr PETER PHELPS: In that regard, what is the difference between contracting out a roads building and simply contracting out the building and then the subsequent cost recovery, because one way or other the costs have to be recovered; either the government does it or the private sector builder does it.

Mr HARRIS: Are we talking about a building now?

The Hon. Dr PETER PHELPS: Building a road.

Mr HARRIS: The difference between the private sector owning the road is that the private sector is not as able as the government to manage the risks. Therefore, the price will be higher than if the government owned it.

The Hon. Dr PETER PHELPS: But the risks are the same on the same project. The only difference is, if you like, the risk is hidden for the government in that any potential loss will have to come out of consolidated revenue. In other words, it does not marketise the risk in the way the private sector does.

Mr HARRIS: The big difference in ownership risks between the government owning a road and the private sector owning a road is the traffic.

The Hon. Dr PETER PHELPS: Yes.

Mr HARRIS: The government can better manage that traffic risk than the private sector can manage that traffic risk.

The Hon. Dr PETER PHELPS: In what way, other than using the coercive power of the State, for example, to close off Park Street and William Street to force people into a tunnel?

Mr HARRIS: Yes, that is one way. Another way is—

The Hon. Dr PETER PHELPS: You are saying the coercive power of the State should be used to materially funnel people into a profit-making exercise for the State?

Mr HARRIS: When you say profit-making exercise, if you mean covering economic costs, I will agree with that term—efficient costs. Yes, because, as I said, on that particular matter half of the beneficiaries were on the surface, and there was no way of getting those beneficiaries to pay for the road, so there are two options. One is that the Government pays for the benefits obtained by people on the surface, allowing the traffic to pay their own costs for using the tunnel, and that is the model you should use, actually, and you would divert—

The Hon. TREVOR KHAN: That is a contribution by the State.

Mr HARRIS: Yes. Instead of imposing all the surface benefit costs on to the motor user, you say, okay, the taxpayer generally, or Sydney generally will pay for the surface benefits and the motorists will pay for the motorist benefits.

Dr MEHREEN FARUQI: There would be a lower toll, in fact?

Mr HARRIS: There would be a lower toll, yes.

The Hon. Dr PETER PHELPS: Because you close off an alternate access route—

Mr HARRIS: You would not have to close it.

The Hon. Dr PETER PHELPS: That is exactly what was proposed for the Cross City Tunnel—a reduction in service via William Street and Park Street.

The Hon. TREVOR KHAN: That is because there was not a contribution by the State towards the cost of the tunnel.

Mr HARRIS: Correct.

The Hon. Dr PETER PHELPS: Following on from that, the original lending required for start-up, or the original amount of money required for the construction of a new infrastructure project has to come from one of three locations. It either has to come from existing reserves and consolidated revenue, the sale of current assets and the use of that money in the creation of new assets, or deficit spending. In other words, going into debt to cover those.

Mr HARRIS: Or tolls.

The Hon. Dr PETER PHELPS: Or higher levels of tolls.

Mr HARRIS: Or the same levels of tolls or even the same level of tolls and the private sector might—

The Hon. Dr PETER PHELPS: No, the initial cost of building—

Mr HARRIS: Initial cost, yes. Yes, you are right, they will come from borrowings or from revenue.

The Hon. Dr PETER PHELPS: Given that the private sector is willing to pay the capital cost of early construction and governments have repeatedly shown that they are not willing to pay the costs of capital construction, why should the private sector not be allowed to do it?

Mr HARRIS: If the Government insists that it is not going to follow the most efficient option, then you look for another option, but you will have to have the Government saying, "Look, it will be better for us to do this, but we do not want to."

The Hon. Dr PETER PHELPS: But there are competing priorities on that same dollar. You cannot have the same dollar spent on a road as that dollar spent on a hospital without going into debt. Are you saying that debt is a good thing to have?

Mr HARRIS: Well if debt is not a good thing to have, savings is bad because the corollary of debt is savings. If debt is bad, savings is bad. Someone's savings is someone's debt. Debt can be good. Of course debt can be good. I have not recently looked at the debt-laden budget for the State, but from an economic—

The Hon. Dr PETER PHELPS: How much debt is good?

The CHAIR: Let Mr Harris answer the question.

Mr HARRIS: From an economic point of view, from a State point of view, does it matter very much in broad terms whether the private sector borrows for this project or the public sector borrows for this project, because they are going to be funded—

The Hon. Dr PETER PHELPS: Well, yes.

Mr HARRIS: Sorry?

The Hon. Dr PETER PHELPS: Yes it does, because you marketise risk when you go to the private sector and otherwise the risk entirely accrues to taxpayers if you keep the potential for risk on the books for consolidated revenue.

Mr HARRIS: Yes, but if we agree that the Government is the best manager of the traffic risks, it will mean that it is cheaper for the Government to do it than the private sector.

The Hon. Dr PETER PHELPS: It is only the best manager if it uses its coercive power to materially affect the current traffic arrangements.

Mr HARRIS: No—it is true that if it does use its coercive power it can do it, but it can also do it in many other more subtle ways, and it does do it in many more subtle ways. For example, the owners of the M5 prevented the Government from putting an exit road on the eastbound lane so that cars could come out at Liverpool. In fact, it is still there. The ramp is still there, it just has never been completed because the owners of

the M5 said, "That will reduce our traffic tolls and that is not really sensible." A government could say, "We are working for the motorists and not for the shareholder and if the motorist wants to leave before the toll gates, fine, let them leave before the toll gates." Alternatively, you could say, these days we could extend the tolling system so that it does not cover just episodic roads, as it should not; it should cover all major roads.

The Hon. Dr PETER PHELPS: Going back to risk, you said that hospitals and prisons do not have any risk, but there are certainly private prisons and private hospitals in New South Wales that have been constructed by the private sector that operate for State Government contracts, which bear risks. Is that not the case?

Mr HARRIS: I suppose when I said they do not bear risks, after the construction period they do not bear risks.

The Hon. Dr PETER PHELPS: There could be a risk that we have a substantial change in the laws, for example, complete decriminalisation of recreational drugs, and the prison is empty and that prison no longer has any—

Mr HARRIS: They have take or pay.

Dr MEHREEN FARUQI: That is not going to happen under a Liberal-Nationals Government.

Mr HARRIS: They have take or pay contracts. They do not set themselves out to bear that risk.

The Hon. Dr PETER PHELPS: In relation to the setting of tolls, you have agreed that, for example, after the contract is signed, assessment of a particular contract—the horse has already bolted by that stage.

Mr HARRIS: Until renegotiation, yes.

The Hon. Dr PETER PHELPS: If there were to be some sort of independent assessment, is it the current Auditor-General's job to do that assessment, or should they be only looking at performance management afterwards?

Mr HARRIS: I can envisage that a performance audit could be undertaken to see what were the actual returns from an investment in a privately owned toll road.

The Hon. Dr PETER PHELPS: It gets more to my question: Do you believe that having an additional public servant or an additional body oversighting the creation of a contract will in any way materially result in a better contract in respect of value for money for the people of New South Wales?

Mr HARRIS: I would sincerely hope that those Commonwealth officers who are negotiating a contract would procure the best advice they can from the private sector to assist them in that negotiation.

The Hon. Dr PETER PHELPS: That is exactly what you found in your reports between 1994 and 1997, did you not, that there has been a better arrangement "in the balance of risks to be borne by the developer and the RTA in particular contractual arrangements", so you found that public servants, over time, learnt from their mistakes—thank heavens—and got better at writing contracts. Why do you not believe that that progression, whether it be linear or exponential, has continued to the present day?

Mr HARRIS: Because it is not their day job.

The Hon. Dr PETER PHELPS: No, but you have admitted yourself that there was—

Mr HARRIS: There have been improvements, yes. As you say, choosing A and then saying, "No, let's choose B" if there were not improvements then there would be problems, but it is not their day job continually to live and die by their contract in negotiating skills. These contracts are episodic.

The Hon. Dr PETER PHELPS: If the problem lies in the failure of public servants to be effective contract managers, is not your argument about the contracting out of the construction of roads just as fraught as the contracting out of the construction and then subsequent tolling of roads to the private sector?

Mr HARRIS: It could be except that the construction of roads is significantly less complex than doing a toll road negotiation. If you have a look at the complexity of the Cross City Tunnel contracts—that is available in one of my reports I believe—you will see that there were 30 or 40 parties involved in the deal. If you are looking at building—

The Hon. Dr PETER PHELPS: But that was 20 years ago. The whole idea of having multiple parties like that has gone the way of the dodo.

The Hon. TREVOR KHAN: Can I just ask in that regard? When you talk in terms of 30 or 40 parties, one assumes that on one side there is a government entity. Are you saying there were therefore 29 contracting parties?

Mr HARRIS: In that particular case there would have been more than one government entity affected by the Cross City Tunnel.

The Hon. TREVOR KHAN: There would have been a lead negotiator for the Government I assume?

Mr HARRIS: Yes, there was always a lead negotiator for the Government. In those days the contract costs were sometimes 10 per cent of the total project cost, just doing the contracting and negotiation—hugely complex. Now, certainly we have come some way in that period of time but the theory again says there are problems with negotiating with anybody in the private sector but the more often you do it the simpler the task, the easier it is. Looking at toll roads, which are episodic and very complex conceptually, that is another reason against having the private sector involved as owners.

The Hon. Dr PETER PHELPS: If we assume that no likely government in New South Wales is intent on returning to a system of either the creation of a Department of Main Roads or engaging in large-scale deficit spending to fund infrastructure projects—I think it is fairly clear from both sides of politics that that is the case—surely the only option then is to have private contractors own and operate roads? It is undeniably a policy decision on both parties not to go into a high-debt situation and not to recreate a significant infrastructure creation bureaucracy. The only option then really is to have a toll road arrangement, is it not?

Mr HARRIS: Put aside the infrastructure bureaucracy because it is not relevant to either of the two options we are looking at—we are not looking at a Department of Main Roads building roads, we are looking at who will own the road. If you say no government wishes to extend its triple-A borrowing capacity in order to reduce costs for its citizens, but they would prefer the private sector to increase its borrowings in order to impose a higher cost on motorists, then that is a policy decision. Yes, I accept that. Then you would look to see, given that constraint, is there a better way of doing it than the way we are doing it now? For example, why do we not say to the private sector, "You own the road and we will rent it from you at a price that enables you to have the profit that a utility should have. We will take the traffic risks."

The Hon. Dr PETER PHELPS: The problem with that is, if you set the rental rate too low we will have a situation like we had in New South Wales where, despite the fact that we had the County of Cumberland Plan formulated in 1951, only the Wakehurst Parkway was ever actually built by government. You had the north-west link, which was never built; you had the western link, which was never built; you had the south-west link, which was never built; and the southern link, which was never built. Since that time north-west has been done by tolling, the western has been done by tolling, the south-west has been done by tolling and presumably when the M6 comes on line it will also be done by tolling. In other words, governments for 40 years had the option of doing this but they never did it.

Mr HARRIS: I did not say that there would not be a toll, I said that the risk of the traffic would be taken by the Government. The Government would be the toll collector. So all you are asking the private sector to do is to design, build and maintain this road; we will take the traffic risk. If you want to get really sophisticated, you can say if more trucks use this road, thus causing you more maintenance costs, we can put that into the formula as well. We take the traffic—I do not think this is the best solution but given your hypothesis it might seem to be a better solution than the one we have at the moment. You put it out to tender and say, "What kind of return do you want? You have got all these cost issues, maintenance and the like, but what kind of return do you want? You can own the road because we do not want the debt on our books. You have it on your books, even though it is more expensive. What kind of return do you want?"

The Hon. Dr PETER PHELPS: But effectively we do that anyway. Other than for unsolicited tenders but for open, competitive tenders is that not what we get? We say, "This is what we want. Give us the best price that you can do it for."

Mr HARRIS: No, because they take the traffic risk under current arrangements. The only road that does not take the traffic risk in New South Wales that has a toll—let me be very careful about this, I will put it another way. The cross-harbour tunnel—

The Hon. Dr PETER PHELPS: And the Sydney Harbour Bridge.

Mr HARRIS: The Sydney Harbour Bridge is owned by the Government. I argued for many years that the cross-harbour tunnel was owned by the Government and several years after I left the Government came to agree with that proposal. Why is that different? Because the Government takes the traffic risk on the tunnel.

Transfield and Kumagai built the tunnel and they had big risks in the building of it, that is fine, but after that it was all over. We took all the risks and we can manage those risks better than anybody else.

The Hon. Dr PETER PHELPS: What if we had to take the risk of the Lane Cove Tunnel and we had to take the risk of the Cross City Tunnel? Is that not a situation where the risks were, thankfully, outsourced to the private sector and they bore the economic consequences of that?

Mr HARRIS: If you expect the private sector only to have losses then your theory is right. If you expect the private sector to have profits then my theory is right.

The Hon. Dr PETER PHELPS: I do expect them to. The point is that when government saw itself as the primary creator and controller, main arterial roads in Sydney were never built. Presumably they were never built because capital markets at that stage were inadequate and presumably because there were competing priorities on the existing revenue of government.

Mr HARRIS: And as I say, if you wish to curtail my options I would propose the one that involves us renting the road owned by the private sector.

Dr MEHREEN FARUQI: Would you not say that with governments, as Dr Phelps has said, refusing to borrow money or to take this other option, they are basically not giving the public value for money? But that is the role of government, is it not?

The Hon. Dr PETER PHELPS: Up until the moment we lose our triple-A credit rating and then have to pay higher returns on—

Dr MEHREEN FARUQI: Where are the facts that we will lose our triple-A credit rating if we borrow money?

The Hon. TREVOR KHAN: Go and have a look at Western Australia.

Dr MEHREEN FARUQI: We can do it in a wiser manner. Just because someone else cannot do it, does not mean that we cannot do it.

The Hon. Dr PETER PHELPS: As you have asked, if you borrow too much you lose your credit rating. That is the way it works.

Dr MEHREEN FARUQI: That is such a flawed argument.

The CHAIR: A final question: Inside the executive of the government of the day, it does not matter which side of politics, are the best and sharpest minds when it comes to matters finance and the capacity to negotiate the best possible deal on these types of propositions found within Treasury? We just do not know who is at the table in these sorts of negotiations. We assume Treasury has some pretty sharp operators to go head to head on matters like econometric modelling and the escalation of payments and what have you. We assume they are there. Are they elsewhere in other departments?

The Hon. TREVOR KHAN: Or outside government?

The CHAIR: Perhaps and then they are brought in on a contractual basis. Or are they domiciled in other departments as well?

Mr HARRIS: Certainly in my time Treasury's involvement in these deals was far too little to please me. I thought that Treasury's involvement should have been much more significant. In fact, I will put it more broadly: I thought that the New South Wales Treasury was far weaker in its role in New South Wales than it was in the Commonwealth and that having a stronger Treasury and a more involved Treasury would have helped the State significantly. Having said that, I have seen lots of mistakes made by Treasury as well. I am not all that rapt in consultants because they do not own the outcomes in a way that an organisation like Treasury and RMS would own the results. I would like it in-house and I would like Treasury to be much more involved. We did do very well with the Olympics. Perhaps too well, because the private sector lost money on the stadium and the private sector lost money on the multipurpose arena under deals negotiated by Transfield's negotiator, whom we hired.

The Hon. Dr PETER PHELPS: You might be aware that after the outsourcing of IT debacle in the Federal sphere in the late 1990s the Department of Finance actively sought to either bring contract managers on staff or alternatively to have a list of private contract managers. Is that the sort of system you would envisage to provide a great deal of surety in relation to contract management?

Mr HARRIS: I suppose it would, to answer that question. Yes, it would. But if Treasury were involved not only in roads but also in maritime and hospitals and the like, because we have infrastructure,

broadly defined, provided in a number of outfits—if Treasury had an area that specialised in this no matter which department was involved it would have continuing exposure and expertise.

The CHAIR: The axe would be kept sharp. Thank you very much, Mr Harris. We appreciate the opportunity to ask you some questions on a very important subject matter that is exercising the Government and the Parliament. We have resolved that answers to questions taken on notice be provided within 21 days. There might be some supplementary questions as well. I hope that is agreeable to you.

(The witness withdrew)

(The Committee adjourned at 12.03 p.m.)