10 November 1997

Federal Inquiry into Road Funding
Dissenting Report:
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Executive Summary

This submission dissents from two of the principal conclusions of the Majority Report.

Despite the absence of an explicit (or implicit) constitutional head of power, the Majority Report unequivocally supports a continuing, significant role for the Commonwealth in road funding. This intrusion by the Commonwealth on the domain of the States and Territories has led to bureaucratic duplication, waste, cost-shifting, politicisation of resources and a loose accountability structure. It invites opportunistic behaviour by the States and an under-allocation of funds to urgently needed urban road infrastructure.

As the Victorian Government's submission makes clear, the States' endorsement of the Commonwealth's existing role in road funding should be understood as a diplomatic acceptance of what is manifestly a second-best outcome. Economic efficiency and public confidence in the process would both benefit substantially from complete devolution of road funding and administration to the States.

The Majority Report also concludes that "build own operate and transfer [BOOT] schemes are unlikely to be the best method of delivering Commonwealth road projects...The Committee also considers that BOOT schemes are unlikely to be the best method of delivering State/Territory and local road projects". Much of the evidence sighted in support of this conclusion is either inaccurate or incomplete. By overlooking more recent BOOT projects, the Majority Report mistakenly formed the view that BOOT arrangements deliver an inadequate transfer of risk to the private sector and underestimated the efficiency gains from private investment disciplines and incentive effects.

A systematic analysis of the major criticisms of BOOT projects in the Majority Report supports a clear case for expanding (rather than limiting) the role of the private sector in delivery of desperately needed urban road infrastructure.

Basis of dissent

The Majority Report of the committee diverges from this dissenting report in two principal areas. The first flows from an opinion about the merits of federalism. The Commonwealth has overreached its natural and legitimate role in road funding. The Majority Report supports a continued extensive role for the Commonwealth in the roads field and much of the Report is directed to improving existing arrangements. This report contends that we should entirely vacate the field and leave matters of roads policy to its constitutional custodians, the States and, Territories.

The second point of variance is one of emphasis and factual accuracy in Chapter 6 of the Majority Report which considers the role of the private investment in road infrastructure. My view is that there is a powerful case for expansion of the private sector role in roads, and that the majority view is based on deficiencies in the evidentiary record which led to a fatal flaw in the Majority's reasoning. While rightly supportive of "contracting out", the Majority Report is dismissive of private equity participation in road funding both for the Commonwealth and the States.

This dissenting report therefore falls into two clear sections. Section 1 seeks to substantiate the view that we need to entirely re-engineer Commonwealth/State financial relations by reference to first principles and to our experience in road funding. Section 2 is a defence of private investment in road funding involving detailed examination of the principal of assumptions, propositions and conclusions in relevant section of Chapter 6 of the Majority Report.

Commonwealth State financial relations

Objection to Commonwealth involvement in roads largely mirror concerns about Commonwealth involvement in other State and Territory service sectors. A discussion of road funding should therefore begin by placing the subject in its wider context of Commonwealth/State financial relations.

A range of means have been employed by the Commonwealth and the High Court to centralise control in Canberra over matters which are the constitutional responsibility of the States. These means include:

- use of tied grants to interfere in State discretion over areas for which the Commonwealth has no constitutional warrant;
- continual expansion in the definition of exclusive Commonwealth powers, eg by recent curial decisions on the meaning of an "excise" tax; and
- use of the external affairs power as a lever to add to the concurrent powers of the Commonwealth in matters which are rightly the exclusive province of the States.

Opposition to these developments need not be based on a fanatical commitment to Australian federalism or the constitutional document as it existed at the turn of the Century. The above developments have undermined a basic objective of public finance which must be to achieve greatest possible community benefit from scarce resources. This can only be achieved if sufficient symmetry is maintained between the power to raise revenue and the responsibility to provide services. In our case, that means each level of government must, broadly speaking, have the capacity to raise sufficient of its own revenues to meet its own obligations.

The principle finds an echo in the practice of commercial risk allocation in the private sector when negotiating contracts. Good practice is that the party best able to manage a contractual risk, bears that risk. This approach helps ensure that parties are not assigned obligations or risks which they cannot fulfil or control. This symmetry between responsibility and capacity provides the only equitable basis of accountability for non-performance.

Where that nexus is broken, a range of inefficiencies and abuses become more likely. In particular, it is difficult to maintain accountability where the duty to deliver a service (eg road maintenance and construction) rests with one party, while the power to raise the funds for that service rests with another. Bureaucratic duplication becomes inevitable. It is both illogical and unfair to hold State and Territory governments responsible for performance outcomes when they are robbed of the capacity to raise their own revenue, determine their own priorities and decide their own strategy for achieving those priorities

Mr Denis James, of the Commonwealth Parliamentary Library Research Service, has highlighted Australia's uniquely lopsided fiscal arrangements:

> *Australia is characterised by the largest degree of vertical fiscal imbalance between its tiers of government of any federal nation. In 1996-7 the Commonwealth raised $130.7 billion in revenue, representing 76 per cent of total Commonwealth and State general government revenues. On the other hand, Commonwealth outlays for its own purposes were only 58 per cent of total general government outlays. As a result, in the same year the Commonwealth provided the States with grants amounting to $34.6 billion ($15.9 billion in general purpose assistance and $18.7 billion in specific purpose funding.)...Overall, in 1995-6, Commonwealth assistance comprised 45.8 per cent of State and Territory revenues.* (Economics, Commerce and Industrial Relations Group, *Commonwealth Assistance to the States since 1976*, Background Paper No.5, 1997-98, p.i)

Vertical fiscal imbalance may be defined as the mechanism by which the Commonwealth reduces the States and Territories to a life of whingeing beggary. It guarantees an undignified spectacle of name calling at the conclusion of every Premiers Conference or meeting of the Council of Australian Governments.

Huge emotional and intellectual resources are expended - not in making Australia more competitive - but in haggling over whether the formula for distribution of funds among the States and Territories is fair, and whether the Commonwealth the aggregate amount of funds is sufficient for the States and Territories needs. In many instances criticism of the Commonwealth by the States and Territories has been valid. Whether valid or not, the fact of the lopsided relationship always lays the system open to charges of abuse. This in turn fuels electoral cynicism.

Captive High Court?

The High Court has been a willing, indeed the principal, accomplice in the unremitting expansion of Commonwealth fiscal power. What we have seen, virtually since federation, is a court which rules against State fiscal independence (and hence, accountability) at virtually every opportunity. Interestingly, it was a road funding case in 1926 that opened up a massive new front of Commonwealth's fiscal and policy power over the States and Territories.

State of Victoria v. The Commonwealth HC 38 CLR 399 (1926) dealt with the scope of tied grants to the States under section 96 of the Constitution, as that power sought expression in the *Federal Aid Roads Act* 1926 (Cth). The question before the Court was whether the Commonwealth could impose conditions through section 96 grants on matters which were within the exclusive control of the States.

The High Court rejected Victoria's argument that the conditional grants power was implicitly limited to areas over which the Commonwealth exercised an exclusive or concurrent power. Instead, the Court held that the Commonwealth could impose whatever restrictions it deemed fit on section 96 grants, thereby extending the reach of Commonwealth influence into any area for which the Commonwealth makes tied grants to the States.

The other sharp edged sword in emasculation of the States has been the external affairs (section 51 xxix) power which gives the Commonwealth capacity to pass laws giving effect to our international treaty obligations. It would, no doubt, have astonished the constitutional draftsmen to find that Australia is now a signatory to over 2000 international conventions and treaties on virtually every subject from the rights of the child to nuclear non-proliferation. While not directly relevant to road funding, the role of this head of power must be considered in any attempt to rectify fiscal imbalance.

It is no doubt possible to argue the case for each of those treaties on its merits. What is harder to argue, is that the external affairs power should have been used so systematically, without recourse to the electorate, to destroy the federal compact . There is now widespread anger in the community not only about individual treaty commitments but about the apparent slight of hand of the Commonwealth in the use of this external lever to realign the constitutional balance of power.

This fear and anger provides a cloak for the propagation of global conspiracy dogma and for other fringe theorists. They are remarkably durable, however, partly because of the kernel of truth in Commonwealth abuse of power. Certainly, if you ask a group of constitutional lawyers today to explain, by reference to the Constitution, what are the limits of Commonwealth legislative power, they might correctly respond *"What do you want them to be?"*.

By contrast to the instincts of the High Court, when the Australian people have been consulted at referenda on a proposed expansion of Commonwealth power, they have, with a similar degree of consistency, ruled against the Commonwealth. Of the 38 referenda put to the Australian people since federation 30 have requested increased powers for the Commonwealth. 28 times out of the 30, the Australian people have said no.

Breakdown of trust

This coalition of the Commonwealth and the High Court against the States and Territories has produced two serious consequences for Australian public life. The first is a high level of disaffection from the public generally towards the Commonwealth. This is based on perceptions of Commonwealth remoteness and insensitivity to regional nuances combined with its aggressively acquisitive posture regarding State and Territory powers.

If we conducted a secessionist referendum in Western Australia, the Northern Territory and Queensland, it would at the very least be a real contest. The electorate is sufficiently suspicious and cynical that Governments find it increasingly difficult to provide meaningful leadership. This level of disaffection ought not to be tolerated by a modern liberal democracy - especially when it is largely avoidable.

The second consequence is distrust between the Commonwealth and the States. Almost every time the Commonwealth attaches conditions to a Section 96 grant there is an implicit criticism that the States are failing in their duty in relation to one area of policy or another - federal road safety programs is merely one example. As for the States, their response to the criticism is informed by the knowledge the Commonwealth has deprived them not only of sufficient revenue to discharge their duties but also of the power to raise revenue themselves.

In his recent book titled "*Trust*" Frances Fukyama examines the correlation between the level of generalised trust in the community (what he calls "social capital") and the creation of wealth. Fukyama makes a case for the proposition that the level of trust between the community and the political leadership, and between other key stake holders (eg each tier of government) is a critical variable in the economic performance of nations.

> *"Many of the cases cited in this book stand as a cautionary tale. More than former communist countries suffer from weak or damaged civil societies. Familistic societies with a low degree of generalised trust in China, France and Southern Italy were all products of centralising monarchies in times past...that undercut the autonomy of intermediate institutions in their quest for exclusive power. Conversely, societies exhibiting a*

> *relatively high degree of generalised trust, like Japan and Germany lived under relatively decentralised political authority for much of their late modern existences. In the United States, the weakening authority of civil associations has been connected with the rise of a strong state, through both the courts and the executive.*
>
> *Social capital is like a ratchet that is more easily turned in one direction than another; it can be dissipated by the actions of government much more readily than those governments can build it up again."* (Francis Fukuyama, *Trust - the social virtues and the creation of prosperity*, Penguin 1995, p.361)

The breakdown in trust between the Commonwealth and the States and Territories, and between the community and their political leadership, is now causing huge wastage of resources and inefficiency. At a time when national productivity is the critical variable in the global market, this is a self-indulgence Australia cannot afford.

A decision to make

There was a set of principles which guided the architects of the Australian constitution in their allocation of powers between the States, Territories and the Commonwealth. In particular, it informed their decision to make the Commonwealth a government of enumerated, specific powers and to the give the States and Territories a general law making power over the remainder.

Over the past hundred years, those principles have been almost entirely defeated by an aggressive legislative and regulatory posture of the Commonwealth which has been given the mantle of legitimacy by the High Court.

Perhaps there are good reasons for individual expansions of Commonwealth power. Certainly, Australia is much more externally oriented today than we were at the turn of the century with a commensurate need for coherent national leadership. Indeed it is arguable that one of our central challenges is to accelerate the integration of Australia into the regional economy in which we find ourselves. By the same token, external competition makes it all the more important that we achieve lean government and efficient distribution of public resources.

The relevance of the reasoning applied by the constitutional fathers to the allocation of powers is undiminished, including:

- the historical fact of the States inception as autonomous colonies;
- differing cultures and circumstances prevailing in each region;
- a relatively small population spread over vast geographic area; and
- concern at the potential for abuse of power if concentrated heavily at the centre.

Australians need to decide whether they want a federal system or not. At present we are getting the worst of both worlds.

Ode to roads...

In spite of my objections to the current funding arrangements I want to make it clear that I support an increased commitment of resources by the community as whole - whether by government or the private sector - to the provision of road infrastructure.

Historian Paul Johnson has argued that "*The ability to build good roads cheaply is one of the magical keys to modernity*". Johnson goes on to describe Thomas Telford, the Scottish road and bridge builder, *as "Perhaps the most remarkable man of all in an age of great men*". (Paul Johnson, *The Birth of the Modern*, Weidenfeld and Nicholson, 1991, p.179)

Johnson's reverence was based on his understanding of the profound impact that a good road system has on the quality of life of the community it serves. Good roads enhance the efficiency of every other service in the economy. Road quality might be regarded as a signature of First World status. For those at the beginning of the path to economic development, good roads rank with power and clean water as the most coveted prize and much of the energy of the multi-lateral development agencies is consumed in designing and building roads in Asia, the Pacific and the former Soviet Union.

While the highway of the future is now being constructed out of optic fibre, microwaves and digital bits, the pivotal social and economic importance of asphalt, bitumen and concrete roads will remain unchallenged for at least another generation.

Commonwealth role in roads

We now turn more specifically to the question of how the principles of public finance should operate in the field of Commonwealth road funding and begin with the opening statement of the Victorian Government submission to the Inquiry:

> *As a matter of principle the Victorian Government believes that ideally all Commonwealth funds to the States should be provided in the form of financial assistance grants, enabling the States to determine the most appropriate means of providing services. Where this is not practicable funds should be provided as identified funding grants in the general purpose stream. Notwithstanding this, this submission has been prepared on the assumption that the Commonwealth will wish to retain certain specific purpose programs particularly in relation to National Roads."* (Submissions vol 7, p.1733)

This dissenting report is a defence of the first half of the paragraph but the second half is equally instructive. The Victorians are saying that as a matter of public policy, they don't accept the Commonwealth's justification for an ongoing management or policy role in road funding - implicitly, in the national highway, Black Spots, other safety programs or Roads of National Importance. They recognise, however, that the pattern of Commonwealth State relations is for the former to arrogate rather than devolve power. The balance of the Victorian submission proceeds on the (perhaps rational) assumption that the Commonwealth will preserve its powers whether or not this serves the public interest.

The Victorian submission then falls back in line with the other States, endorsing continued Commonwealth financial commitment to national road programs. In effect the argument is, if the Commonwealth is going to continue with its flawed policy of managing road systems and roads policy, we might as well get our slice of the pie.

One unvarnished view of the evidence before the committee is that the present arrangements are irredeemably flawed and can never be made to work.

> Constitutionally, the position is clear: provision of roads is a matter for the states and territories. In practice, however, the Commonwealth has a history of providing funding to the States for roads.
>
> Since the early 1990s various attempts have been made to clarify the respective roles of the three tiers of government. Heads of government agreed in 1991 that each tier of government should have a clear funding responsibility for a clearly defined set of roads. Essentially the agreement was that the Commonwealth would be responsible for funding the national highway system, the States would be responsible for State roads and local government would have responsibility for the local road network.

In practice, this division has not effective. Since less than 18% of fuel taxes is returned to roads, this leads to calls for further extensions to the national highway along low traffic volume regional routes. Which raises the question - where does the national highway start and finish?

The three tiered division is getting increasingly blurred. It was blurred by both the present and former governments in respect of the funding of the Pacific Highway. The Pacific Highway is not part of the national highway system but the Commonwealth has agreed to fund its construction over a ten year period. That decision was universally welcomed but it none the less demonstrates that the distinction created in 1991 are unworkable. Additionally the concept of a discreet national highway is of questionable utility. No matter how you designate it, no matter how you set it up, it is simply not independent of the rest of the road system. This is particularly so when you get to the vital connections at the points of interface with the urban road network. The idea that you can run one separately from the rest simply does not work.

Complexities in the Commonwealth further erode the potential for a meaningful role in roads. Commonwealth decisions on road funding are taken in isolation from decisions on matters which have a substantial secondary impact on roads. For example, decisions on levels of fuel excise are taken quite separately from any consideration of the national highway system. Vehicle size and mass limits that would directly impact on road maintenance and demand for additional investment may also be taken somewhat separately from considerations of the national highway system.

Commonwealth decisions about road investment, particularly in urban areas, have a major impact on land use and development. The States have primary responsibility for land use and the Commonwealth does not always, and does not specifically, address those issues. [

We need to ask the fundamental question is there a cogent rationale for Commonwealth direct investment in roads? In particular by direct expenditure of approximately $800 million annually does the Commonwealth add more value than would be the case if the funds were simply passed to the States for them to allocate as they see fit? The balance of evidence, and arguably of logic, fails to provide the cogent rationale required to support continuation of the Commonwealth role.

States dissembling

It may be argued that the balance of testimony before the Committee favoured a strong Commonwealth role in roads policy. With the exception of the Victorian Government submission, one State after the next served up to the committee a glowing tribute to the Commonwealth's leadership role in forging national road priorities, national standards and a "national vision" for roads.

Such language has a seductive quality but it is a curious thing to hear State bureaucracies giving voice to the importance of Commonwealth involvement in their affairs. It may be overly cynical to suggest that the States and Territories only argue this way when their is an additional dollar in it for them.

Behind the rhetoric is this self-interested reality. Each State road authority operates from one budget cycle to the next in relatively intense competition with State budget agencies for a share of State own revenue and of Commonwealth tied and untied grants. The attractions of the Commonwealth hiving off a zone of State responsibility (such as the national highway and Commonwealth Black Spots Program), and guaranteeing to provide recurrent funding for that sphere are clear. It gives the State road agencies a source of revenue for roads for which they don't have to compete with other State agencies.

When you strip away the bureaucratic dissembling, much of the State and Territory evidence to the Inquiry could be summarised as follows. "Our road networks are suffering from chronic underexpenditure in both construction and maintenance over several decades, especially in urban areas. You have starved us of the funds we need to remedy the problem and robbed us of the capacity to raise our own revenue. We don't expect this situation to change. For additional road funding we are therefore prepared to beg, to flatter you, and to tolerate any level of duplication, waste and political opportunism, in order to get access to the Commonwealth coffers.

Evidence of inefficiency

The Committee received evidence, speculation and hearsay about inefficiency and frustration under the current arrangements.

There was speculation that the State road authorities tend to "guild the lily" when acting as head contractor for the national highway construction. With the knowledge that the cost of any Black Spot or stretch of national highway will have no impact on their own budget, the State or Territory road agencies have little incentive to economise - in fact there may be an incentive to build a Rolls Royce solution when a Ford Falcon would be sufficient. There would also appear to be opportunities to shift costs of the State road network to the national highway under the present arrangements. There were also suggestions that where a State arterial road was a candidate to become a future Road of National Importance, the States or Territories might downgrade maintenance funding to force the Commonwealth's hand.

It should be stressed that these reports were not given as sworn testimony or in a formal submission to the Inquiry and their credibility should be discounted to that extent. This is a concern to the extent that the Commonwealth lacks the expertise and resources to adequately assess and monitor the contracts, (which is why we contract the State and Territory road authorities to administer the contracts in the first place).The problem is that the current system leaves itself wide open to that sort of allegation.

From the States we heard a litany of problems which flow from the structure of the current funding arrangements:

- insistence by the Commonwealth on roads on a recurrent annual budget cycle makes it impossible for the State road agencies to conduct the longer term planning which is essential to an efficient road program;

- the Commonwealth routinely takes 6 months to make a decision on individual road projects with each project requiring personal Ministerial approval; and

- the lack of co-ordination among Commonwealth agencies whose decisions affect roads, and the lack of awareness by the DTRD of the impact of its decisions on other State agencies, such as those responsible for public transport and land use planning.

Politicisation of resources

> "*Every backbencher likes to have a new road project...It has been my experience that as the Commonwealth, if you like, has moved directly out of a lot of section 96 programs* (tied grants) *there has been less for federal politicians to be able to point to in their own electorates and say that the federal government directly funded*

this and is providing it to the community. Generally speaking, I think there have been distortions in investment caused by what I would call political decisions..."
(Mr David Anderson, Manager - Transport Policy and Economics, NRMA, Public Hearing, Sydney, 4 April 1997, CTMR 130)

A further objection to Commonwealth maintenance of separate or shared spheres of road responsibility is the increased potential for funding decisions to be made on the basis of political benefits, rather than on the needs of the road network. To be fair, this problem is just as present in State and Territory road agencies as it is with the Commonwealth. By adding a separate Commonwealth sphere for roads, however, we double the capacity for abuse.
One result in the Commonwealth sphere is an irrational bias in favour of regional and country roads. The evidence before the committee indicated that:

- the nation has suffered over a long period, and to an increasing extent, from a lack of investment in road infrastructure generally; and

- the area crying out for greatest attention, and which will return greatest community benefit, is in the urban arterial roads.

A study by the Allen Consulting Group for the Australian Automobile Association (AAA) indicated that there would be substantial gains to the economy from increased investment in urban arterial roads and urban freeways. (Submissions, vol. 7, p1734) The study conducted on behalf of the Business Council of Australia by JB Cox (*Refocussing Road Reform*, 1994) came to the same conclusion:

"...greatest microeconomic benefits in the road transport sector will come from a re-allocation of existing road expenditure to projects which provide greater economic returns", principally urban roads.

About two thirds of the resources consumed in the roads sector are by business...(so) most of the savings from improved investment effects will flow on to the business sector...

Our National Highway system is much less extensive than other countries and carries about 11% of total Australian travel compared to 40% in the US and France and 26% in Canada. The reason for this is that it is a predominantly rural road system and does not serve economic areas of national interest in urban areas"...

The Commonwealth Government is not well placed to foster intermodal improvements...as its National Highway only rarely ventures into urban areas..."

The AAAs submission to the Inquiry affirms this analysis:

"in recent years, political imperatives related to road investment decisions have meant that the nation has not got the best return from its road investments; we must develop a system which ensures that investment flows to projects which maximise returns to the community, and which establishes an explicit link between the costs of road use, revenue collected from road users, and investment in roads..." (Submissions, vol 6, p1339)

The problem for rational development of the road network is that Commonwealth governments, whether of Coalition or ALP persuasion, have an almost irresistible incentive to manipulate road funding to shore up support in regional and rural areas.

As noted by Cox, the national highway system, by virtue of the size of the Australian continent, already has a geographical bias in favour of rural road expenditure. The population and hence road use centres, however, are overwhelmingly located in the urban and metropolitan areas. If the Commonwealth would vacate the roads field altogether, there would, therefore, be a much a better prospect of getting road dollars to the people who need them most, and the areas that would deliver maximum economic benefit to the nation as a whole.

Conclusion

The Commonwealth should now vacate the field of roads management and funding. Present arrangements are irredeemably flawed and their continuance will see a continuance in duplication, cost-shifting, politicisation of funding decisions and electoral cynicism. The national highway, Black Spot funding and Roads of National Importance should each be handed back to the States and Territories to administer in the context of their wider road and non-road priorities.

Present defects in road funding arrangements reflect wider problems in Commonwealth State financial relations which are in urgent need of attention. The Commonwealth should restore the dialogue established by Prime Minister Hawke to return to the States and Territories the capacity to raise whatever revenues they require to discharge their constitutional responsibilities.

PRIVATE SECTOR INVOLVEMENT

Introduction

This section considers the sixth item in the Inquiry's terms of reference:

Assess the scope to supplement Government funding through innovative arrangements for private sector involvement in the provision and maintenance of roads infrastructure and the scope for pricing of road services to reflect full resource costs.

In particular, this section is critical of the Majority Report's conclusions that *"BOOT schemes are unlikely to be the best method of delivering Commonwealth road projects...The Committee considers that BOOT schemes are unlikely to the best method of delivering State/Territory and local road projects"*(Majority Report p.115).

The Majority Report's opposition to BOOT road projects is largely based on the conclusion that the private sector gets the benefit of profit from its investment in roads without sharing adequately in the commercial risks. This conclusion is not supported by the evidence before the Committee and the evidence itself is incomplete.

The Majority Report's ten criticisms of BOOT projects

The Majority Report cites ten objections and counter-arguments to the claimed benefits of infrastructure delivery through BOOT structures:

1. *"Experience of private sector investment and operation of road infrastructure suggest much of the commercial risk has remained with the public sector and not with the private sector"* (Majority Report p.102).

2. *"Competitive tendering and contracting out under public ownership can offer the same benefits as BOOT schemes"*(Industry Commission at p.115).

3. *Private sector investment in the provision of road infrastructure may involve increased costs where the cost of capital is greater for the private sector than for government. This argument is usually put forward on the basis that government generally faces a lower rate of interest on borrowing than the private sector due to government's higher credit rating.* (Majority Report p104)

4. *"A BOOT agreement for a road project may prevent the government from developing public transport services that would compete with the road or require the government to compensate the road operator in such circumstances"* (Commonwealth Bank of Australia's at p.114).

5. *"It may be inefficient to use toll financing when a road is new and uncongested and to remove the tolls when the road is older and more congested...*(Prof Quiggin at p114). *The costs of using direct tolls may be avoided by financing projects through government expenditure"* (Majority Report p.115).

6. The Majority Report also appears to endorse the Industry Commission's finding that the benefits resulting from accelerated delivery of road projects through BOOT schemes cannot properly be considered an advantage of private sector investment since - in theory at least - it is always open for government to relax any binding fiscal constraints and allow the public sector to construct the projects (Majority Report p.114).

7. *"Resource allocation may be improved by ensuring that road projects with greater economic benefits are undertaken before projects with smaller economic benefits. […] Private sector investment may fail to meet this objective to the extent that financial returns do not accurately represent economic returns"* (Majority Report p.101*)*

8. *"Private sector involvement in the provision and maintenance of road infrastructure may involve the parties incurring significant transaction costs"* (Majority Report p. 104*).*

9. Professor Gordon Mills argued that the provision of tax concessions to private owners *"may have created an additional distortion in that they were not available to government infrastructure developers. Therefore, the bonds may have distorted the market for providing and maintaining road infrastructure in favour of the private sector"* (Majority Report p.103).

10. BOOT projects often involve governments making physical resources available to the private sector developer, such as use of public land. The Majority Report notes that *"the provision of the land is still a resource that is used by the project, even though it is not a financial cost to the private sector developer"* (Majority Report p.103*).*

Following is an assessment of each of these criticisms.

Dissent One: Inadequate risk transfer

The most frequently cited criticism of road BOOT projects in the Majority Report is that:

> *"Experience of private sector investment and operation of road infrastructure suggest much of the commercial risk has remained with the public sector and not with the private sector"* (Majority Report p.102).

The two examples cited in support of this criticism are the Sydney Harbour Tunnel and the M5 Motorway in Sydney. In both cases, the Majority Report referred to the opinion of the NSW Auditor General (Majority Report p.102). The Majority Report omitted reference to the rebuttals made of these opinions by the Roads and Traffic Authority:

> *"The Auditor-General's report contains factual errors and inaccuracies, the most critical of which are: […]*

- *The suggestion that the Authority bears the majority of risks in relations to the Sydney Harbour Tunnel project, and that, in relation to the M4 and M5 projects, the risks are shared equally between the public and private sectors.*

  On an objective analysis of these arrangements, it is clear that over time as each project has been developed, the majority of risks are borne by the private sector.*"*

  (Addendum: The Roads and Traffic Authority's Response, 1994, p.3; a report written in response to the NSW Auditor General's report titled *Private Participation in the Provision of Public Infrastructure - The Roads and Traffic Authority*, 1994*).*

The Majority Report also overlooks the risk profile of the more recent road BOOT projects such as Sydney's M2 Motorway, the Melbourne City Link and Sydney's Eastern Distributor. The information relied upon below for two of these projects has been published in public prospectus documents.

The conclusion drawn from the two examples cited is false because:

- 'Market first' transactions should not be regarded as the industry standard - particularly when information on more contemporaneous BOOT transactions is readily available and demonstrates *substantially greater* assumption of commercial risks by the private sector.
- The Majority Report does not reflect the clear trend towards greater assumption of commercial risk by the private sector in road BOOT projects. Neither does it acknowledge that in the last three road BOOT projects the relevant State or Territory government shares in the potential commercial upside of the projects while accepting few, if any, of the commercial risks.
- This trend towards greater assumption of commercial risk by the private sector is illustrated by the risk profile of BOOT projects set out in Table 1 below.
- That such an evolution in risk transfer has actually occurred has been acknowledged by the NSW Auditor General in his audit review of the latest road BOOT project - the Eastern Distributor:

  "The report on the M2 motorway, published at the beginning of 1995, noted the improvement (building on experience from previous schemes) in the balance of risks to be borne by the developer and the RTA, in particular contractual arrangements. [...] The arrangements proposed for the contract for the Eastern Distributor continue the improvement in the balance of risks observed in the report on the M2" (NSW Auditor General, 1997, pp.18-19).

While of limited relevance to current practice the Majority Report's discussion of the Sydney Harbour Tunnel project is incomplete. As a matter of natural justice, both sides of the argument should have been considered. The Report endorses the criticisms made by the Auditor-General of the project but

overlooks the comprehensive rebuttal of those criticisms on the public record by the Roads and Traffic Authority in relation to that project:

"An important aspect which does not appear to have been acknowledged by the Auditor-General's Office in its review of the risks of the project is that, had the public sector itself built, funded, owned and operated the infrastructure, then all the risks associated with the project would have been accepted by the public sector. There is a misconception that the private sector often creates additional risks [...] With the introduction of private sector participants, the bulk of the risks have been accepted (in return for rewards) by the private sector. It should have been from this basis that any analysis of the risks in the project was considered."

(Addendum: The Roads and Traffic Authority's Response, 1994, pp.16-17; a report written in response to the NSW Auditor General's report titled *Private Participation in the Provision of Public Infrastructure - The Roads and Traffic Authority*, 1994*).*

The Majority Report's consideration of the Sydney Harbour Tunnel omitted the key fact that it was the NSW Government that insisted on the Ensured Revenue Stream (ERS), because the Government wished to retain an absolute discretion on toll setting. The private sector was always willing to accept full traffic risk on this project. For reasons largely to do with political risks of a new toll road, the NSW Government decided to set the starting toll at $1.00 - a level significantly below that which would have been required to finance the project on a stand alone basis.

The commercial nature of the ERS is testified to by the fact that the NSW Government has since received toll revenue from the Sydney Harbour Tunnel considerably in excess of its ERS commitments, and has therefore enjoyed the benefit of a substantial windfall as reward for its assumption of traffic risk. The implication that the mere existence of an ERS is evidence of an uncommercial deal for government is, therefore, false, as testified to by the Roads and Traffic Authority:

"Currently there is a surplus accruing monthly of total harbour crossing toll revenues over ERS payments, indications are that this will continue and the cumulative deficit will shortly be extinguished. [...]

The Auditor-General is misleading in relation to [the ERS payments]. ... What the Auditor-General fails to point out is that there are also revenues from the Sydney Harbour Bridge which must be taken into consideration in calculating the Authority's surplus concerning the ERS liability. As previously stated, that surplus is estimated, even applying the worst case scenario put forward by the Auditor-General at $284m."

(Addendum: The Roads and Traffic Authority's Response, 1994, pp.3, 16-17; a report written in response to the NSW Auditor General's report titled *Private Participation in the Provision of Public Infrastructure - The Roads and Traffic Authority*, 1994*).*

It is also worth noting - given the seminal nature of the transaction - that the Sydney Harbour Tunnel won international recognition as a landmark infrastructure transaction for its successful involvement of the private sector.

The Majority Report also lacks balance in its consideration of the M5 Motorway transaction in its uncritical endorsement of NSW Auditor General criticisms of that project. According to the Majority Report:

"The NSW Auditor-General identified that the financing risk for the M5 Motorway was primarily carried by the RTA, with other primary responsibility (but less than RTA) being carried by the Commonwealth Bank, and partial risk allocation to Interlink" (Majority Report p. 102).

This conclusion is based on a misunderstanding of the nature of the "M5 extension" project. As the RTA's independent financial advisers - UBS Australia Limited - point out in a letter dated 5 September 1994:

"The [NSW Auditor-General's] Report plays down the fact that RTA, prior to entering into the arrangements with Interlink, retained responsibility for the entire construction and financing of the M5 Western Extension, planning to undertake this in 2000 at an expected public cost exceeding $65m. This was because the RTA had previously determined that this extension would not be tolled, and would therefore not be something that could be put to the private sector for funding.

By entering into the arrangement with Interlink, not only did the RTA reduce its direct financial outlays for the extension by $15m to $50m, it also has every expectation that it will recoup the entire $50m loan together with 7% interest thereon. RTA has also passed the cost and associated risk of maintaining the extension to Interlink for the entire term of the concession period."

(Addendum: The Roads and Traffic Authority's Response, 1994, Appendix 1; a report written in response to the NSW Auditor General's report titled *Private Participation in the Provision of Public Infrastructure - The Roads and Traffic Authority*, 1994*).*

Furthermore, the commercial basis of the credit risk and the interest rate applicable to the RTA loan has been independently attested to by UBS Australia Limited. The Auditor-General's concern that the RTA loan may not be repayable until the end of the project term was unduly alarmist - it has since been rendered academic by the recent repurchasing of the loan by Interlink at its prevailing market price.

The advantages of private sector investment in the M5 extension have been succinctly summarised by the RTA:

"Essentially, the government has received the benefit of a project some 7 years earlier than it would otherwise have been delivered, at a saving of $15m in direct financial outlays, with the probability of obtaining 7% interest on the outlay of $50m. The $50m is fully expected to be repaid, which would not have been the case had the Authority merely constructed the road itself in the year 2000."

(Addendum: The Roads and Traffic Authority's Response, 1994, p.79; a report written in response to the NSW Auditor General's report titled *Private Participation in the Provision of Public Infrastructure - The Roads and Traffic Authority*, 1994*).*

The Majority Report's rejection of BOOT road projects on the grounds of inadequate risk transfer to the private sector is flawed to the extent that risk transfer is now more effective and sophisticated than ever before. In fact *all* project risks (including "network" and "force majeure" risks) are transferable to the private sector provided the government is willing to pay market price for the transfer of those risks. The choice of whether to transfer a given risk is therefore properly a decision for the government of the day.

As government and the private sector have acquired more experience in infrastructure delivery and management, the market price for the assumption of infrastructure-related risks has declined significance. The resulting increase in value for money has prompted governments to transfer an ever increasing proportion of project risks to the private sector.

Some force majeure risk continues to be absorbed by government because:

- in some circumstances, the government is in a better position to control such risks; and
- since BOOT projects are a form of quasi-ownership, government gains ownership of the asset at termination of the Concession Period (typically at zero cost) and must thus bear some of the residual risks.

The Majority Report also fails to mention that, on the last three road BOOT projects - the M2, Melbourne City Link and the Eastern Distributor - the government participated in the upside commercial risk of the projects without accepting any downside risk:

Road BOOT Project	Year	Government Profit-Sharing Provisions
M2 Motorway	1992	Concession fee of $7m p.a. plus : • 20% of any excess return for each year following IRR ≥ 12.5% p.a Concession term of 45 years reducible to: • 36 years if IRR ≥ 16.5% p.a. • 39 years if IRR ≥ 16.0% p.a. or

		• 42 years if IRR ≥ 16.0% p.a.
Melbourne City Link	1995	Concession fee of $96m p.a. (for first 25 years) and $45m (for remaining 8.5 years) to become payable only after IRR ≥ 10% p.a. Concession term of 33.5 years reducible to: • 25.5 years if IRR ≥ 17.5% p.a. • 27 years if IRR ≥ 17.5% p.a. • 29 years if IRR ≥ 17.5% p.a. • 31 years if IRR ≥ 17.5% p.a. or • 33 years if IRR ≥ 17.5% p.a.
Eastern Distributor	1997	Concession fee of $15m p.a. plus : • 10% of any excess return for each year following IRR ≥ 10% p.a

IRR = After-Tax Real Internal Rate of Return on Private Equity Investment.

It would be regrettable if the outcome of the Majority Report, was to discourage private investment in roads at the very time when the process is beginning to deliver world class outcomes with near complete transfer of risks from government to the private sector.

Table 1: Devolution of commercial risks to the private sector on Australian road BOOT projects.

Project	Year	Construction Risk	Traffic Volume	Tax Risk	Financial Risk	Network Risk	Force Majeure
Gateway Bridge	1983	≈	×	×	×	×	×
Sydney Harbour Tunnel	1986	✓	×	≈	≈	×	×

M5 Motorway	1990	✓	✓	✓	≈	✗	✗
M2 Motorway	1992	✓	✓	✓	✓	✗	≈
Melbourne City Link	1995	✓	✓	✓	✓	≈	≈
Eastern Distributor	1997	✓	✓	✓	✓	≈	≈

✓ full assumption of risk by private sector ≈ partial assumption of risk by private sector
✗ full assumption of risk by government

Dissent Two: Competitive tendering better than BOOT

The Majority Report refers to an Industry Commission opinion that BOOT projects are not desirable because:

"Competitive tendering and contracting out under public ownership can offer the same benefits as BOOT schemes" (Majority Report p.115).

This proposition overlooks the incentive-based efficiency gains that private equity alone is capable of generating. Contracting-out the design and construction (D&C) of a road project does not and cannot provide the private sector with the same incentives to deliver the project on-time and on-budget.

BOOT projects require private sector tenderers to engage in more rigorous assessment of life-cycle costs than would otherwise be the case under D&C tendering. As a consequence, BOOT projects significantly reduce the risk of miscalculation and resulting calls for contract variations.

Contracting-out D&C also fails to maximise the efficiency gains which arise from an owners responsibility for design specifications, the construction program and operating costs. A fixed price D&C contractor has no incentive to select or improve design specifications that will minimise costs over the life-cycle of a project.

It is also dangerous to assume that governments are as proficient as the private sector at administering fixed price construction contracts. The public sector has a notorious record for permitting post-contract variations, cost over-runs and delays. The self-interest of private equity remains the best way of ensuring that market disciplines are applied in the delivery of major infrastructure.

The efficiency of BOOT delivery relative to competitive tendering was acknowledged by EPAC in its *Private Infrastructure Task Force Report*:

"The incentive to dispute contract provisions seems stronger under contracting out than under BOOT structures. […] BOOT-type schemes bring with them generally sharper incentives for efficiency, and synergies from bundling construction and operation with finance. As equity partners, BOOT contractors will have incentives to avoid excessive contract disputation and to better consider the life cycle costs of the project" (EPAC Final Report p.42*)*.

This BOOT 'efficiency dividend' has also been noted and confirmed in the Auditor General's *Performance Audit Report - Review of Eastern Distributor*:

"The introduction of private operators into the provision and management of the urban road network has undoubtedly delivered significant efficiency gains. The cost of new road works has fallen significantly and the speed with which they have been delivered has increased. There is undoubtedly scope for further efficiency gains.

The effect of introducing new players into the business of road infrastructure construction has been to encourage the RTA and other State and Territory agencies to improve their efficiency to match that of the private providers. There remains concerns, however, about whether the RTA could manage the provision and maintenance of links in the primary road network with the same efficiency as the private operators" (Review of Eastern Distributor p.158).

As a result of private investment, the M5 motorway was constructed 22 months ahead of the RTA's expectations and the M2 motorway was delivered almost 12 months ahead of schedule.

The Majority Report's conclusion that competitive tendering can secure efficiency benefits equivalent to BOOT structures is directly contradicted by the NSW Auditor General's *Performance Audit Report* on the Eastern Distributor:

"It is doubtful, based on experience, that the RTA would be able to manage the design and construction process, even through outside tenders, with the same efficiency as a private operator facing both responsibility for construction and dependence on a pre-determined level of toll (Review of Eastern Distributor p.158*)."*

Dissent Three: Private sector borrowing costs are higher

The Majority Report conclusions are based on an acceptance of the argument that BOOT projects are uncompetitive because:

"Private sector investment in the provision and maintenance of road infrastructure may involve increased costs where the cost of capital is greater for the private sector than for government " (Majority Report p.104).

The Majority Report concludes that:

> *The committee considers that the question of whether the private sector faces higher borrowing costs than the public sector cannot be resolved from the evidence presented. The committee notes that before rejecting private funding because of higher borrowing costs, all other factors associated with the proposed project would need to be examined."* (Majority Report p.104*).*

The argument that government should undertake infrastructure projects because it has an inherent financing advantage is unsustainable. Evidence received from the DTRD on this subject is correct and provides the basis rational consideration of this issue:

"The reason for the observed difference in borrowing rates is that the risk to the taxpayer is not reflected in the government's borrowing rate. The department observed that the argument that government should finance road infrastructure projects because of its lower borrowing rate is also an argument for government financing of all capital investment projects (sub 482, Submissions, p. 887)

It is an established principle of corporate finance that the cost of capital to be applied to a project ought to reflect the risk of the project's underlying cash flows and not the owner's cost of capital. This ensures projects are evaluated on a stand-alone basis so that true costs are not obscured by cross-subsidisation. The reason why government is

able to finance infrastructure more cheaply is because it effectively subsidises the risk of the project by collateralising its present and future assets through the provision of a government guarantee.

This principle has been acknowledged by the Auditor General's *Performance Audit Report - Review of Eastern Distributor*:

"In effect, tax-payers have to bail out those public projects which fail, so long as there is no provision for government to default on its borrowing. (The NSW Treasury adds a specific charge to the cost of borrowing on behalf of government agencies to cover the implicit guarantee.)"

This argument of cheaper financing costs for government was also examined and rejected by the Economic Planning and Advisory Committee's (EPAC) *Private Infrastructure Task Force Report*:

"A project's exposure to 'systematic risk' is the same whether owned by government or the private sector, but in the former case the risk is pushed onto taxpayers.... Much of the difference between the private and public cost of capital is explained by the taxpayers providing an implicit guarantee of project risks under public ownership "(EPAC Report p.43).

In fairness, it should be noted that the EPAC Report did nonetheless argue that the private sector's borrowing costs would be higher than government's if the road BOOT project was characterised by a significant level of "network" risk. This concern is addressed in the following section.

Dissent Four: Network risk and government compensation

The Majority Report cites criticisms of BOOT projects by the Commonwealth Bank of Australia on the grounds that:

"A BOOT agreement for a road project may prevent the government from developing public transport services that would compete with the road or require the government to compensate the road operator in such circumstances" (Majority Report p.114).

The above proposition is flawed on several counts.

No road BOOT project in Australia has stopped present or succeeding governments from developing a competing public transport service.

Modern experience suggests that - far from being substitutes - road and rail projects are almost always complimentary. This is because rail networks tend to become prime corridors for both commercial and residential development. This in turn increases population density and hence road usage.

Although earlier road BOOT projects involved a compensation clause to cover the possible adverse effect of a competing new rail service, this 'risk' was fully borne by the private sector in the latest road BOOT project - the Eastern Distributor. As the Table below demonstrates, assumption of network risk has increasingly devolved to the private:

Road BOOT Project	Year	Network Risk Borne by Government
M2 Motorway	1992	New competing road or rail service.
Melbourne City Link	1995	New competing road or light rail service (with no provision for compensation for heavy rail).
Eastern Distributor	1997	New competing road (with no provision for compensation for either light or heavy rail).

In view of the above developments, it is unlikely that future road BOOT projects will include compensation clauses for new competing rail services.

The criticism is based on an assumption that a toll road is more valuable to government because, as the owner of a new competing rail service, government can better absorb the associated network risk. This is thought to involve a smaller overall economic loss in the event of an adverse effect on road usage. In other words, although the government would suffer a loss in toll revenue, it would also enjoy a compensating increase in returns from rail.

The logic embodied in this reasoning is defective. To the extent that a competing rail network adversely effects traffic volumes of a tolled road (prior to toll revenues repaying the road's costs), the economic consequences for government are *identical* whether the government retains ownership of the tolled road or agrees to pay appropriate compensation to a private operator. The additional government revenue from increased rail patronage is enjoyed in both cases, as is the loss in toll revenue resulting from the reduction in traffic volumes.

Dissent Five: Tolls create economic inefficiencies

The Majority Report cites Prof Quiggin's criticisms of BOOT projects on the grounds that tolls cause economic inefficiencies:

"It may be inefficient to use toll financing when a road is new and uncongested and to remove the tolls when the road is older and more congested...(Prof Quiggin at p114). *The costs of using direct tolls may be avoided by financing projects through government expenditure"* (Majority Report p.115).

The basis of this view is explained more fully elsewhere in the Majority Report:

"Also, there may be disadvantages in using road tolls on BOOT projects in a network of otherwise untolled roads. Such tolls may encourage motorists to use older, more congested roads rather than the newer BOOT road" (Majority Report p. 113).

"Professor Quiggin also supported the argument that it may be inefficient to use toll financing when a road is new and uncongested and to remove the tolls when the road is older and more congested" (Majority Report p.114*).*

These criticisms are unsustainable because:

- Tolls are not an essential feature of BOOT projects. BOOT projects can be financed through 'shadow tolls' - an arrangement under which the government agrees to pay the private operator a toll for all vehicles using the road. In this way, users can continue to enjoy free access, while the private sector absorbs full traffic risk.

- It is implicit in this criticism that government-owned motorways will not be similarly tolled. This begs the question: how does government propose to service the project debt? All forms of ad valorem taxation - including progressive income tax - are distortionary. Increasing petrol excise, for example, will lead to even greater allocative inefficiency than a tolled road in a "free" network. And to the extent that toll roads are 'voluntary' - in the sense that a free alternative route is always available - tolls are a more equitable revenue-raising device.

- By definition, tolled roads will be used by those road users for whom the economic value of the time-saving offered is at least as great as the toll imposed on the road's use. As there is no element of coercion, the toll road is delivering a net economic or social benefit to every road user.

- Tolled roads reduce traffic and congestion on the free public network, thereby increasing the value and utility of the network, as well as reducing its maintenance and operating costs. This is a benefit which accrues to government without the need for any government expenditure or the assumption by government of any project risk.

- The comment by Professor Quiggin merely raises an issue regarding the optimal toll profile for road infrastructure. As such, it does not represent a criticism of BOOT projects. From an economic efficiency perspective tolls should be driven by demand. BOOT projects can accommodate such a structure by stipulating a peak-pricing formula under the project's contractual arrangements.

Dissent Six: Accelerated delivery and government borrowing capacity

The Majority Report also appears to endorse the Industry Commission's finding that the benefits resulting from accelerated delivery of road projects through BOOT schemes cannot properly be considered an advantage of private sector investment since - in theory at least - it is always open for government to relax fiscal constraints and allow the public sector to construct viable infrastructure projects (Majority Report p.99).

This implies that governments have a limitless borrowing capacity for viable infrastructure - a proposition which any informed observer would reject.

As the world's capital markets have become increasingly integrated, Australian governments - along with other sovereign and provincial governments - are increasingly being subjected to the scrutiny and disciplines of international capital markets and international rating agencies.

International rating agencies often regard government debt-funded infrastructure with a measure of suspicion because:

(i) there is a consensus on both sides of Australian politics that the electorate - in the foreseeable future at least - will not tolerate an increase in the overall tax take of governments. This effectively limits the ability of Australian governments to fund major infrastructure projects, even if such projects are viable and necessary; and

(ii) Australian governments do not have the constitutional power to bind future governments to a pre-determined toll rate over the economic life of a commercially-viable road project. The temptation for successive governments to promise premature cancellation of the toll is often too great to resist in the lead-up to an election.

Road BOOT projects are preferred by international capital markets because they successfully circumvent the concerns expressed above:

(i) The Australian electorate's resistance to increased taxation is, implicitly, also an endorsement of the user-pay principle embodied in tolled motorways; and

(ii) By contractually committing successive governments to a pre-determined toll structure and an explicit compensation provision in the event of toll cancellation, road BOOT projects limit the political temptation for future governments to cancel the toll since:

- on equity grounds, governments are generally more reluctant to interfere with arrangements involving a private third party than they are with purely public funded projects; and
- cancellation of tolls on a BOOT motorway ensures that the annual economic cost of such a decision is made visible and transparent.

The *de facto* ceiling placed by the Australian electorate on government tax revenue means that - if Australia's total infrastructure requirements are to be met - governments must prioritise their infrastructure spending in favour of social infrastructure projects and resort to the private sector investment to meet remaining demands for commercially viable economic infrastructure.

Dissent Seven: Positive externalities

The Majority Report is also critical of BOOT projects because they fail to properly account for any external benefits or costs associated with a project:

"Resource allocation may be improved by ensuring that road projects with greater economic benefits are undertaken before projects with smaller economic benefits. […] Private sector investment may fail to meet this objective to the extent that financial returns do not accurately represent economic return" (Majority Report p.101).

The pertinence of this criticism is unclear since, in Australia at least, project selection remains almost entirely a public sector function. This fact in no way limits or interferes with private sector investment in road infrastructure.

Furthermore, since the externalities associated with a road project are almost always "net positive" (ie. external benefits exceed external costs) - it follows that, where a project is commercially viable, it will also be socio-economically viable. For this reason, the concern expressed in the Majority Report is more theoretical than real.

External benefits and costs are notoriously difficult to measure and the process is usually best conducted by the public sector since it frequently requires the application of normative judgements. However, once the public sector has satisfied itself as to the priority of a given project, then - where the project is commercially viable - it is often the case that the most efficient form of delivery is through the BOOT structure.

In the event that a road project is socio-economically viable but not financially viable, the benefits of private investment through BOOT structures can still be harnessed by governments through a CSO (community service obligation) tender. Under a CSO tender, the right to own the toll road for the term of the Concession Period is awarded to the bid requiring the lowest CSO contribution from government.

Dissent Eight: Transaction costs

The Majority Report also argues against BOOT projects on the grounds that such arrangements often give rise to exorbitant transaction costs:

"Private sector involvement in the provision and maintenance of road infrastructure may involve the parties incurring significant transaction costs" (Majority Report p.91).

Whilst it is true that road BOOT projects give rise to significant transaction costs, it must always be borne in mind that:

- The critical question is whether the total cost of private sector delivery of infrastructure (including transaction costs) exceeds the total cost of public sector delivery (including any hidden transaction costs).
- The transaction costs of a road BOOT projects are one-off, and are placed in perspective when - as is properly the case - they are capitalised as an asset cost and amortised over the economic life of the project.
- BOOT transaction costs will continue to decline over time as the private sector gains more experience with road infrastructure. It is unhelpful to treat 'market first' transactions such as the Sydney Harbour Tunnel and the M2 motorway as the benchmark for all future road BOOT projects.

The current float of one third of Telstra is likely to involve similar transaction costs (as a proportion of asset size) to those encountered in road BOOT projects, yet no commentator has seriously suggested that the float should not proceed because such costs are inordinate.

1. A significant portion of private sector transaction cost is consumed in the research, market testing and feasibility studies which are undertaken to make the project "bankable". Bankability may properly be regarded as one of the indicia of social utility, as it ensures that a proposed asset is responding a real, rather than an imagined or claimed community need. This work should be undertaken by government on its own projects and its absence ought not to be regarded as a measure of efficiency.

   BOOT transaction costs are indispensable to establishing a framework necessary for private sector investment. As such, the magnitude of transaction costs should always be discussed relative to the economic benefits of private sector investment - namely, accelerated and more efficient delivery of infrastructure.

Dissent Nine: Tax concessions

The Majority Report also appears to oppose tax concessions for BOOT projects:

"Professor Gordon Mills argued that the provision of tax concessions to private owners of infrastructure, and not to government owners, may bias the financing choice" (Majority Report p.97).

This proposition is difficult to sustain in light of the fact that government-owned toll roads are not subject to Federal or State taxation.

To the extent that equivalent tax payments are required to be made by publicly-owned motorways (in accordance with the Hilmer principles of competitive neutrality) and a private sector operator is eligible for a tax concession under the existing tax rebate scheme, an appropriate adjustment can easily be made to ensure a fair assessment of competing public and private bids.

It is also worth noting that, unlike any other asset class in Australia, a viable infrastructure asset may be in tax loss for the first 15 years of its economic life. This is because of the intense capital costs during the construction phase accompanied by the absence of any revenue during this period. The so called ‘tax concessions’ are merely an attempt to redress the unfairness of applying the existing asymmetrical treatment of tax losses - (designed to apply to profitable going concerns) - to a capital intensive stand-alone, non-recourse asset class which was not contemplated by the original framers of the Income Tax Assessment Act.

Road BOOT projects have always been further disadvantaged by the application of the depreciation provisions of Division 10D of the Income Tax Assessment Act, which limit depreciation of infrastructure assets to 2.5% p.a. on a “straight-line” basis. Since most road BOOT projects involve concession terms of less than 40 years, this means that private operators are denied a full deduction of the construction cost of the road over the term of the concession.

Finally, as the Department of Primary Industries and Energy argued, tax concessions such as the existing “tax loss rebate” can be easily defended as a government concession made by way of partial compensation for the net positive externalities derived by the community from the project:

“… the use of some public resources may be justified as payment for the social benefits that accrue from the development of road infrastructure” (Majority Report p.103).

Dissent Ten: Provision of public resources

The Majority Report notes that BOOT projects often involve governments making physical resources available to the private sector developer, such as use of public land noting that:

“the provision of the land is still a resource that is used by the project, even though it is not a financial cost to the private sector developer” (Majority Report p.103*).*

The observation is correct but the critical question always is whether private sector investment in roads will deliver infrastructure on a more timely and efficient basis relative to the alternative of public sector provision. As the Majority Report rightly recognises: *"the provision of a land corridor to a private sector road developer is not an additional cost to the community if the alternative use of the land would have been a public sector road"* (Majority Report p.103).

Having recognised the logic of that position, the Majority Report proceeds to a contrary inference - namely, that the provision of public resources to private BOOT operators is an unattractive aspect of BOOT projects. The implication is that private operators somehow derive an unfair windfall from receiving free access to valuable public resources.

BOOT projects are subject to competitive tender and are eagerly sought after. The "winner takes all" nature of the tender ensures that all tenderers have an incentive to submit their best possible bid. It is always open to government to stipulate a charge for the use of public resources as a condition of the tender - the result of which would be to increase the starting toll required to provide equity holders with an economic return for their assumption of commercial risk.

1. This would ensure satisfaction of the Majority Report recommendation that:

> *"any arrangements for the use of public resources to encourage private sector investment in road projects should be clearly specified and transparent in order that the full resource cost of projects may be identified and that governments may be accountable for the use of such resources."* (Majority Report p.104)

The point is that it is not the private sector but the government which decides - on public policy grounds - whether the public resources should be priced or not. We should recommend on the same basis that governments cost the use of public resources when undertaking their own infrastructure projects for precisely the same reasons.

In summary, the free use or otherwise of public resources by a competitively-bid BOOT project is irrelevant to the decision of whether or not BOOT projects are desirable from a "net community benefit" perspective.

Conclusion

The Majority Report produced a conclusion with which no-one could disagree:

> *"...where it can be shown that the benefits of private sector investment are greater than the costs, and that the distribution of those benefits and costs is acceptable to the*

community, then private sector investment may be considered desirable. Where this cannot be shown, it may be preferable to retain the provision and maintenance of road infrastructure partly or wholly with the public sector." (Majority Report p.105).

The problem is that the evidence, as interpreted and reported in the Majority Report, prejudices the decision about how we assess costs and benefits. Its analysis of BOOT schemes is defective to the extent that it is largely based on an incomplete consideration of two seminal transactions, the structures of which have since been superseded by more competitive BOOT projects.

Examination of recent experience with road BOOT projects reveals that the community has enjoyed significant economic and social benefits as a result of private sector investment in urban motorways.

Road BOOT projects allow for significantly accelerated provision of important economic infrastructure, while providing powerful incentive signals for innovation and efficiency. The Majority Report mentioned but did not adequately appreciate the importance of such benefits.

Ross Cameron

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