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Submission to the Senate Economics References Committee inquiry into the operations of existing and proposed toll roads in Australia

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14 July 2017

Introduction

The Grattan Institute is an independent public policy think tank, formed in 2008 in response to a widespread view in government and business that Australia needed a non-partisan think tank providing independent, rigorous and practical solutions to some of the country's most pressing problems.

The Grattan Institute's Transport Program was established in April 2015.

This submission focuses on a current toll road proposal, Melbourne's West Gate Tunnel proposal, to highlight three areas of concern. These concerns may have broader applicability.

The West Gate Tunnel proposal

The Victorian government has accepted an unsolicited bid from Transurban to build the $5.5 billion West Gate Tunnel (previously known as the Western Distributor) project in Melbourne. The government intends to sign contracts by the end of 2017, with the tunnel and freeway due to be completed by 2022.

The funding will come from a combination of:

- tolls on the West Gate Tunnel,
- an extension to Transurban's right to toll CityLink for a further 10 years, and
- state government contributions.

This submission focuses on three particular concerns with this project:

1. That the Victorian government is not sourcing finance for the project in the way that is least expensive to the Victorian public;
2. That the risk of cost overruns on construction and operations – which will be borne by the Victorian public – is understated; and
3. That the lack of transparency surrounding the project is not in the public interest.

The remainder of this submission explains each of these concerns.

1. Private finance costs more than general government borrowing

The West Gate Tunnel, and every other public infrastructure project, is funded by some combination of user charges and tax revenue. In the case of toll roads, typically the road is partially funded by tolls, with the remainder coming from general tax revenue.

When governments establish Public Private Partnerships (PPPs) to involve the private sector in construction and operation of toll roads, the private sector also provides finance for upfront investment costs. This does not mean the private sector funds the project – the funding comes from tolls and general revenue.

But the cheapest form of finance available to state governments is general government borrowing, not private finance. All Australian states have strong credit ratings and can borrow money at historically low rates of interest. The yield on a 10-year Victorian bond was 2.75 per cent in May 2017, and Victoria has a AAA credit rating.

By contrast, an A- or BBB- rated corporate bond, as typically used when a private operator borrows the capital cost of a public infrastructure project, has an interest rate about 1.3 to 2 percentage points higher than government borrowing costs.

The higher cost of private sector finance is only justified if this approach leads to improved allocation of risks to the parties best equipped to manage them.

2. The risk of cost overruns - which is being borne by the Victorian public - is understated

The Victorian public bears the risk of a cost overrun on the construction and operating costs of the West Gate Tunnel project.

The project's business case specifies an additional period over which Transurban has the right to continue collecting tolls on CityLink to help fund the project. (The publicly available version of the business case redacts the actual period.) The business case states,

> *This period [over which Transurban will be authorised to continue collecting tolls on CityLink] is based on the P50 construction and operating costs. If the P90 costs are assumed the analysis indicates that, all else being equal, tolls on the CityLink assets would need to be extended for a further [redacted] to achieve a similar rate.*[1]

In plain English, the P50 cost estimate is the amount the construction and operations will "probably" cost, while the P90 cost estimate could be thought of as a "worst case" cost estimate: 90 per cent of projects should be completed within their P90 cost estimate. The terminology refers to a distribution of cost estimates for many projects; while it is impossible to predict the outcome for one individual project, the reason for making several different cost estimates for an individual project is to better understand and prepare for the fact that over a large number of projects, some will come in on budget, some over, and some under.

But if history is any guide, the West Gate Tunnel business case understates the risk of an overrun.

The P50 cost estimate in the business case is $5.2 billion, and the P90 cost estimate is $5.5 billion. But Grattan Institute analysis has found that, on average, cost estimates described as "P90" estimates could more accurately be described as

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[1] http://economicdevelopment.vic.gov.au/__data/assets/pdf_file/0003/1237269/Western-Distributor-Business-Case-Redacted.pdf, p 241.

"P81" estimates. In other words, the cost estimate that is represented as being able to be met 90 per cent of the time in reality is achieved only 81 per cent of the time.[2] This means that, unless the West Gate Tunnel project is different to the average project over the past 15 years, it is likely to cost more than its "probable" or P50 cost estimate.

Another way of representing this risk to the Victorian public is to consider how much money has been allocated for the "worst case" or P90 scenario. The experience of the past 15 years shows that the "worst case" cost estimate should be around 26 per cent higher than the "probable" cost estimate, if it is to truly represent the cost that is achieved 90 per cent of the time.

But this is far from the situation with the West Gate Tunnel project, where the "worst case" cost estimate is just 6.2 per cent higher than its "probable" cost estimate.[3]

The risk of a cost overrun is magnified when a project is more complex or bigger – as is the case with the West Gate Tunnel. While the figures quoted above relate to *all* projects valued at $20 million or more and built in Australia over the past 15 years, in fact larger and more complex projects are at greater risk. A ten per cent increase in project size is associated with a six per cent higher risk of a cost overrun, and those overruns tend on average to be higher.[4]

There is a reasonably foreseeable risk of a cost overrun, such an overrun could be substantial, and this risk is being borne by future Victorian motorists.

3. Secret deals may not be in the public interest

The West Gate Tunnel proposal has been characterised by secrecy. First, the project resulted from an unsolicited bid, which was presented to the then-Opposition before the 2014 election. Second, the government committed to the proposal before the newly-established Infrastructure Victoria was in a position to assess its merits. Third, the publicly released business case has been heavily redacted, limiting scrutiny of its assumptions, including by parliamentarians. Fourth, the consultation period for the 10,000-page Environment Effects Statement was just 30 working days.

In addition to secrecy about the process, the funding mechanism lacks transparency. Instead of making a transparent state government contribution through the budget, the extension of the tolling period outlined above makes it impossible to know the size of the contribution by the Victorian public to Transurban.

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[2] Grattan Institute, unpublished extension of the analysis published in Terrill, M. and Danks, L., 2016, *Cost overruns in transport infrastructure*, Grattan Institute; detail available on request.
[3] https://grattan.edu.au/wp-content/uploads/2016/10/878-Cost-overruns-on-transport-infrastructure.pdf, pp 36-7.
[4] Cost overruns page 30-31

A lack of transparency gives rise to suspicion that the deal may not be in the best interests of the public. The strongest argument for secrecy – that secrecy leads to lower costs to the public – has not been made.

On the contrary, there are indications that the secret deal may not offer the best value deal to the public. The government only made the case for a much smaller road project, the $500 million West Gate Distributor; it did not identify the underlying problem warranting a $5.5 mega-project linking a number of freeways and arterial roads.

Given that the completed project will have few competitors, if any, and given its cost to the Victorian public, the lack of transparency surrounding this project appears to have little justification.

Recommendations

Publish evaluations of new infrastructure commitments

1. The Commonwealth should enable and facilitate better public understanding of infrastructure commitments by:
   a. requiring Infrastructure Australia to publish:
      i. summaries of all transport infrastructure projects funded by the Commonwealth within the previous quarter, completed to the extent that Infrastructure Australia has the information to do so and otherwise left blank; and
      ii. business cases and cost benefit analyses for all transport infrastructure proposals receiving Commonwealth funding during the previous quarter, if these have not already been published by a state government; and
   b. requiring the Productivity Commission to publish reliability ratings of all transport infrastructure business cases within one month of Infrastructure Australia publishing them.

Publish post-completion data

2. To enable learning from past experience, and to improve accountability:
   a. The Commonwealth Department of Infrastructure should be required to publish to data.gov.au the post-completion report it already requires from state governments as a condition of providing final milestone payments for transport infrastructure projects. Reports should detail any scope changes and their justification, agreed and actual construction start and finish dates, actual project costs, reasons for overruns or under-runs, and progress against performance indicators.
   b. Infrastructure Australia should be asked to provide the Joint Committee of Public Accounts and Audit with a post-completion appraisal of the benefits

and costs of each infrastructure project that received Commonwealth funding of $50 million or more.

c. The Council of Australian Governments should add a new category of infrastructure services to the terms of reference for the annual Report on Government Services, produced by the Productivity Commission.

Special arrangements for big projects

3. When the estimated construction cost to a jurisdiction is $1 billion or more, Commonwealth, state or territory governments should be required to introduce standalone legislation for that transport infrastructure.

Fund infrastructure transparently

4. Governments should fund infrastructure projects transparently, by the fairest and most efficient combination of user charges and taxes.

Evaluate before spending

5. Governments should not be able to commit public money to transport infrastructure until a rigorous, independent like-for-like evaluation and the underlying business case have been tabled in the parliament.