

29 March 2014

The Chairman
Inquiry into Public Infrastructure
Productivity Commission
LB 2 Collins Street East
Melbourne Victoria 8003

Public Infrastructure

I write to make a submission on the Draft Report. I write in the capacity indicated in the signature block below, not in any other of my other professional capacities.

I would be pleased to give evidence at the hearing in Brisbane on 11 April.

Yours faithfully

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Public Infrastructure
Submission by Geoff Edwards, Independent Scholar

Overview

The Draft Report generally adopts an unsophisticated pro-market review of the complex issues embraced in the terms of reference. In this brief submission I will identify six major issues that require I submit substantial augmentation or editing of the report.

Benefits of privatisation

The Commission's representation of the benefits of privatisation is unduly rosy and its pre-emptive jumping to a conclusion that electricity and ports should be privatised is premature.

Taking just electricity as an example, the partial privatisations and disaggregations around Australia have had two major detrimental systemic effects that are inadequately acknowledged. One is the loss of central coordination: the view that separating out individual functional elements and pitting them against each other is more "efficient" is naive and has not been borne out in practice. For example, retailing companies have increased expenditures on marketing. Risk is transferred to financiers or other parties and is not borne by the managers of the privatised entities. Complexity has increased and new regulators have been erected to further distance the managers from the effects of their decisions.

The other major detrimental effect has been the loss of governments' capacity to frame electricity policy with an eye to the public interest. The rationale for the reforms of the past 15 years has been to reduce costs to consumers. Indirectly, this means *reducing* the cost of burning carbon fuels. But this is not the only relevant public policy objective – the previous Labor national government established a carbon pricing scheme on the advice of economists that *increasing* the price of carbon fuels was the way to manage demand downward. In other words, policy is now evolving in the opposite direction – but the privatised structure is ossified against evolution. The inherent tension between these two positions separated by only a decade should be obvious enough to cause the Commission to think twice about further disaggregating and outsourcing the sector.

Recommendation

That the Commission review its rosy attitude towards privatisation and highlight the waste occasioned by the less-than-ideal privatisations to date. These are on the public record and are well known.

Private sector waste

The Commission at page 61 refers to the Clem 7 tunnel in Queensland as an asset favourable to the community but glosses over a couple of significant considerations. First is the colossal financial waste of capital, private or public, and the enormous opportunity cost of sinking hundreds of millions of dollars into a project that clearly had no prospect of financial success and therefore of economic success. Presumably the losses have been transferred to the other customers of banks who were forced to write down their positions, another deadweight on the economy. It is not just that investors are now more cautious about investing in projects but that enormous benefit could have been gained to Australia by applying those monies to better-conceived projects.

Second the saga of the tunnels exposes so-called private-sector efficiency as very overblown. That a major project can fail in such a spectacular manner (traffic volumes one third of predicted) exposes the so-called prudence of the various interested parties for what it is – self-

interest. The subsequent Airport Link was if anything even worse. By these standards, transport planning as traditionally undertaken by governments is prudent and cautious and carries low risks for construction companies.

A rosy view of private sector projects is again evident at page 61 which praises the “success” of Citylink in Melbourne without highlighting the cost to taxpayers of the tax deductions secured by the proponents of the project.

The overly rosy view of private sector initiative is also evident in Box 3 on page 10. All four of the dot points are just as easily achieved by traditional project management by governments. Large projects have long been constructed by the private sector and indeed, the fourth (risk management) in many of its limbs is more easily taken by government. Private companies will always factor uncertainty into the cost of their bids.

Recommendation

That the report be edited to emphasise the many advantages of traditional design and construct project management led by governments and preceded by government-managed coordinated planning.

Climate change

Given that a large fraction of the economic infrastructure that is the focus of the Commission’s inquiry is transport-related; and given that a large fraction of Australia’s transport is fuelled by carbon emissions-producing fuels, the absence of a serious treatment of the risks to infrastructure investment posed by climate change is noteworthy.

From a technical point of view, the Commission should be asking whether it is prudent for governments and the private sector to be promoting big transport projects which are likely to further entrench dependence upon fossil fuels. Any deeper dependence is likely to make the challenge of meeting emissions targets greater.

From a financial point of view, the private sector construction industry is unlikely to correctly price in the risk of fundamental changes in policy as a result of global warming. This is because many of the major beneficiaries in big projects (facilitators, finance-aggregators, construction companies, legal firms etc) will reap most of their benefits early in a project’s life and are separated from the costs associated with policy changes on a longer – say 10 year – time frame.

Recommendation

That the Commission include a section on climate change and the imperative to factor climate change into transport planning policy.

Peak oil

Given that a large fraction of the economic infrastructure that is the focus of the Commission’s inquiry is transport-related; and given that a large fraction of Australia’s transport is fuelled by carbon emissions-producing fuels, the absence of a serious treatment of the risks to infrastructure investment posed by peak oil (or in economic terms, rising oil prices) is remarkable.

From a technical point of view, peak oil (or more accurately, plateau oil) is upon us. Estimates of the date vary because the available data are patchy and unreliable. However, the precise date is much less important than the reality that the global rate of production of petroleum is entering a terminal and irreversible decline.

The best official analysis of which I am aware is an unpublished 2009 report by the Bureau of Infrastructure, Transport and Regional Economics. This cautiously worded report avoids doomsday scenarios but points out the geological reality of peak oil. It is unnecessary for me to give further geological evidence as it is included in BITRE 2009 and is also widely available on the Internet.

Orthodox economics does not give much credence to peak oil, as it does not recognise absolute scarcity (that is, scarcity outside the bounds of the market). The orthodox economics viewpoint animated ABARE less than 10 years ago to opine that the long-run price of oil would be in the vicinity of \$20 a barrel. The price is already hovering around \$100 a barrel. Significantly for Australia, domestic production peaked in 2000 and Australia's self-sufficiency is only about 50% of consumption and is falling. The financial cost to Australia of rising prices and declining domestic production is set to add significantly to the current account deficit and also to the fiscal costs of running government operations (including notably the defence forces).

Any analysis that does not caution governments against investing in infrastructure assets that will further entrench the nation's dependence upon foreign countries to power our petroleum-fuelled transport is inadequate.

Recommendation

That the Commission include a section on oil supply and the imperative to reduce Australia's fuel dependence upon a small number of pre-peak producing countries.

Inadequate follow-through on cost benefit analysis

Throughout, the report commendably calls for transparent, rigorous cost-benefit analysis as a foundation for investment decisions. However, it does not follow through by cautioning against using the results of the analyses in an absolute as distinct from a comparative manner. Take, for example, the *National Infrastructure Plan* of June 2013. Multiple billions of dollars of projects in the "Ready to proceed" and "Threshold" categories have a benefit-cost ratio of less than 2:1, which, given the inherent ambiguities in these analyses, is not conclusively greater than 1:1.

The Commission itself in a 2007 study found that the average benefit-cost ratio of research and development projects grants was 40:1. The Commission should in its final report emphasise that unless "economic infrastructure" can demonstrate benefit-costs comparable with other alternative uses of public funds, their proponents should go away.

Many of the shortcomings of benefit-cost analysis are overcome when competing claims on the funds are compared at the same time by the same analyst using the same method. The assumptions then cancel each other out. Tabulation of benefit-costs of alternative uses of project funds at the same time would allow decision-makers to properly assess opportunity cost of investing in big infrastructure projects. An absolute figure by itself is bound to be misleading.

Recommendation

That the Commission edit the report by tabulating some typical benefit-cost ratios of expenditure on non-economic infrastructure so that readers of the report can gauge the extent of the economic subsidy transferred from the rest of the community to the providers of these projects.

Inadequate follow-through on public interest

Laudably, the draft report such as at page 16 and in Draft Recommendation 1 places the notion of the public interest centrally. Unfortunately, the report does not buttress this reference by

describing in clear-sighted terms the threats to the public interest from its privatisation and public-private-partnership (PPP) positions.

The report glosses over the inherent incompatibility between the interest of investors and the public interest. Given that most construction activity is carried out by the private sector anyway, and long has been, (less true for small projects by rural local governments), PPP by its nature means increasing the role of private firms in design, scoping and financing of projects. This shift in role by its nature will create powerful interests which can easily skew public policy.

Victoria, for example, has called for innovative proposals from the private sector that would not otherwise be contemplated by governments. It takes little imagination to foresee that an enterprising company can draw up all kinds of projects, commission analysts to demonstrate a benefit-cost of just over 1:1, then lobby governments to approve. Alternative projects that may be more in the public interest will get scarce attention because there is no procedure by which they can be systematically factored into the decision-making. If the project's benefit-cost analysis comes before a considered analysis by whole of government, a project gains momentum which may be entirely unwarranted from a more strategic viewpoint.

Recommendation

That the Commission edit the report to call for or outline a formalised procedure to ensure that all claims for spending on infrastructure pass through a public interest test (some form of coordinated planning) before they are submitted for benefit-cost analysis.

REFERENCE

Bureau of Infrastructure, Transport and Regional Economics (BITRE), 2009, *Transport energy futures: long-term oil supply trends and projections*, Report 117, Canberra ACT. (Unpublished).

Geoff Edwards
28 March 2014