The Members of the Legislative Assembly
Parliament House
SYDNEY NSW 2000

In compliance with Section 38E of the *Public Finance and Audit Act 1983,* I present a report to the Legislative Assembly titled **Review of Eastern Distributor.**

The Report is very similar to the Draft Report I forwarded to the Minister for Roads on 27 May 1997, and which the Minister himself tabled in Parliament that same day. Alterations which have been made in finalising this Report are:

- grammatical and formatting changes to conform to The Audit Office's standards for published reports
- an updated cost for the audit, including final costs of publication.

The changes do not alter the findings, conclusions or recommendations of the Report.

A C HARRIS

Sydney
July 1997

Performance Audit Report

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Executive Summary

Executive Summary

The Audit

Following a resolution of the Legislative Council, The Audit Office has undertaken a performance audit of the Eastern Distributor. The full resolution is at Appendix 1. In carrying out the audit not all of the elements of the resolution were able to be satisfied.

For a number of reasons, The Audit Office is not in the position to determine “whether the proposed toll and concession period represents the best deal”. In part this is the result of time constraints which do not allow a careful analysis of many toll and concession options. Similarly, the audit does not answer “whether the current proposal represents the best environmental outcome”. But each of these issues (toll and concession and environmental consequences) is discussed in the audit report.

The audit also does not examine whether or not the Eastern Distributor is needed. The Government has been advised that, without it, the traffic difficulties during the Olympics 2000 will be severe. And in one form or another, the project has been in the planning documents (such as they are) for Sydney’s roads since 1951. This approach is consistent with the Legislative Council’s resolution.

This report does closely examine the processes that have so far been applied by the Roads and Traffic Authority (**RTA**) to deliver an “Eastern Distributor”.

A Tollway

In 1995, the current Government confirmed (it was not a foregone conclusion) that the project would be a tollway. The evidence that urban toll roads are not as effective as other options is very strong. But this issue seems not yet to have been considered by either the previous or the current Government.

The performance audit report on the M2 in 1995 recommended that the Government properly consider the limitations and weaknesses of urban tollways for effectiveness and economy. The recommendation was accepted but there is no evidence that this consideration occurred.

One of the reasons might be that the current Government has a stated policy of reducing net debt of the general government sector. It also had until recently a policy of no new taxes. Under current structures this makes it very hard for the RTA to use the most effective and economical revenue raising measures to fund all new, major, urban roads that are planned.

There needs to be a major examination about financing urban motorways. The Government has already stated its concerns about the costs of inherited general government debt. It should also be aware of the stated concerns about urban tollways.

The Government's policy guidelines issued in 1995 state that private sector involvement must offer a more cost effective solution, if it is to be favoured above the traditional public sector approach. There is no evidence to show this comparison was seriously pursued.

Such evidence as was provided on this matter shows that an analysis carried out by RTA in November 1995, using the same scenarios as those proposed by the private consortia, indicated that:

> *a government funded toll road would provide a marginally higher return than the two private toll road proposals.*

It might be that this Government's policy on private sector participation in the provision of public infrastructure conflicted with the Government's policy on debt reduction and no new taxes.

During the course of this audit, however, the Government advised that, in future, it will endeavour to fund fully all roadwork without resorting to private toll roads. This allows the possibility of future private toll roads if public funding is not available.

Concerns with Procedures

The Audit Office has concern with a number of aspects of procedures used to implement the project.

Selection Process

Some question marks exist about the selection process of the preferred proponent.

The panel to select the preferred tender consisted of three officers from the RTA and one from Public Works and Services, assisted by financial, legal and technical consultants.

After the Panel advised the RTA management of its intended recommendation, but before the Panel formally concluded its work, the RTA recommended that the Minister accept the intended outcome.

Because of questions pursued by the new RTA chief executive, the Panel reassessed the position and recommended another proponent as the preferred tenderer. This was ultimately accepted.

The Audit Office agrees that the reassessment was warranted and, depending on the risk RTA was willing to accept, the reversal of the decision was appropriate. That another decision was nearly made suggests important weaknesses existed in the selection process.

Lack of Financial Modelling and Advice

One of these weaknesses is that the Panel did not have adequate financial skills. It did obtain financial advice on the relative merits of the tenders. But it is not apparent that the RTA, at least at the initial selection stages, was sufficiently aware of and conversant with the full consequences of, for example, the RTA's exposure to interest rate movements. It is also a concern to The Audit Office that a selection of a preferred proponent for a major project, for which there was a financial adviser, could be reversed so readily and in a short time frame. The Audit Office was not able to make a conclusive judgement about all of the factors that might have contributed to this selection weakness.

The provision of financial advice was commented on by audit consultants engaged to help with this report. In respect of the preferred tenderer's model they commented that:

> *There has been no independent financial modelling to verify the financial outcomes presented by the proponent.*

The Audit Office concurs with the views expressed by the audit consultants, that "*the financial packages by the tenderers were a critical - probably at the end, the most critical - component of their overall bids*."

Sensitivity analyses were undertaken of the important features of the model and of the integrity of the model to produce given results with given assumptions.

But testing the financial model against an alternative model to determine if it were optimal for the specific project was not undertaken. It would have been an expensive exercise. In urban toll road projects where there is so much uncertainty about traffic and revenue flows, this was a risk. If it ever were acceptable to rely only on competitive tendering for the delivery of the best deal for the State, it became less acceptable when large negotiated changes to the project arose from the subsequent environmental impact statement (EIS) process.

On the other hand, it does appear that the RTA managed its financial exposure to interest rate movements (before agreements are executed and the exposure accepted by the proponent) rather better than in the past. This was also necessary because the size of the "at risk" surplus was an important reason in its recommending its preferred proponent.

The Audit Office has continuing concerns about the selection process. These are based on the wide uncertainty that exists in these types of projects and the wide variations that can arise in the tender process. They are also based on the view that the RTA has to look after both the State's financial interests and the interests of the motorists - these need not be the same.

The Audit Office recommends that the RTA, for any further major project of this type, ensures that it establishes a process which allows all decision makers to have a thorough understanding of the reasonableness of the proponents' offers and their implications for the State and for the public.

The Audit Office also recommends that the RTA should at the outset consult with TCorp in respect of each major project put to tender.

Scheduling

There is a question mark as to the overall scheduling of the project.

There is evidence that the Government considered that completion of the project was vital for the Sydney 2000 Olympics. Notwithstanding such a clear objective, there are signs that time could have been better utilised so as to avoid the substantial pressure that the RTA now faces.

Delays

The selection Panel for the Eastern Distributor tender completed its task on 23 November 1995. Although the Federal Government announced on 15 December 1995 that it will no longer allow tax advantaged infrastructure borrowing for urban roads, which directly affected the proposal at hand, the preferred proponent was not endorsed until 13 August 1996.

The Audit Office recognises that the Government took steps to clarify the position relating to the Eastern Distributor following the Federal Government's December announcement on infrastructure bonds. But, perhaps with the benefit of hindsight, these steps were half-hearted.

For instance, the State Treasurer wrote to the Federal Treasurer on the 22 January 1996 requesting clarification as to whether the announcement affected the Eastern Distributor. The RTA has no evidence to suggest that a written response was received. File notes relating to a telephone conversation made on 2 February 1996 between officers of the RTA and Federal Allowance Authority indicate that oral assurance was given that tax benefits would be still available for the Eastern Distributor project. But this assurance, and remedies available to proponents under law, was not vigorously pursued to finality.

The resulting delay has had severe repercussions that could have, and still can, jeopardise the project.

Timing of EIS

This was the first project undertaken by the RTA where the EIS was scheduled to be considered after the selection of the preferred proponent.

By undertaking the EIS after the consideration of the proposals from the various tenderers, RTA hoped to capitalise on the knowledge it gained from the tendering process. The Audit Office sees merit in this concept: it provides the opportunity to maximise the project's value.

It also brings the risk that changes required from the EIS processes may be so substantial as to require the 'proposal and evaluation' stage of a project to be extended. (This is what happened to a certain extent.) It can also lead to a new tender, if the EIS-induced changes to original tender specifications are substantial.

In this case, the scheduling adopted - which is based on a required start to the project in July 1997 if it is to be finished before the Olympics causes its own traffic problems - does not allow for further protracted processes, let alone for a new tender.

Modifications arising from EIS

The EIS was put on exhibition on 15 November 1996 and closed on 24 December 1996. The proposal put forward was that of the preferred proponent.

The EIS resulted in four significant modifications announced by the Minister for Roads on 9 April 1997. The costs of those modifications to the RTA and to the public were settled by negotiation.

The Audit Office has two observations with that process.

Referral to Probity Auditor or ICAC

Because the announcement of the preferred proponent was delayed some nine months, RTA approached both ICAC and the Probity Auditor to clarify whether there was a need to call fresh tenders. The delay was considered to be sufficiently significant to be raised with ICAC and the Probity Auditor.

However, when the EIS processes led to four significant modifications to the project, the approaches to the ICAC and the Probity Auditor to determine whether a fresh tender was considered necessary were only done at a very late stage of the process. The ICAC advised in writing on 20 May 1997 of its viewpoint that a further tender is not required. The RTA advises that this was also the (oral) view of its probity adviser.

No Fresh Tender Considered

The cost implications of these changes for the project were settled, outside of a fiercely contracted tender, by negotiation.

The changes increased project costs by about $132m (24%); increased the toll starting in 2000 from $2.50 to $3.00; and increased the concession period from 38 to 48 years.

Any decision to re-tender the project would have meant its abandonment until after the Olympics - a half-finished Eastern Distributor is worse than none. There might also have been adverse tax consequences.

Because the proponents' financial model had not been verified, RTA did not have access to all of the financial advice during these negotiations that might have been helpful.

Cost Escalation

If RTA is to sign the contract it must do so by 10 June 1997. If it does not, RTA is liable to pay $2.4m as at 11 June 1997, and $0.4m for every week thereafter in respect of cost penalties.

Referral to DUAP

Notwithstanding such a condition, RTA was unable to forward the EIS to the Department of Urban Affairs and Planning (DUAP) until 18 April 1997. The Department and the Minister for Urban Affairs and Planning has up to almost four months to respond, and the RTA cannot carry out any development for the proposed Eastern Distributor before approval by the Minister.

The existence of cost escalation payments and the late forwarding of material to the Department is just another pressure on the scheduling processes that can give rise to criticism. The rule of law means that these pressures cannot be taken into account by DUAP, the Minister or others exercising a statutory function even if they allow the appearance that they will have an influence on the Department's analysis and the Minister's decision.

Referral to EPA

The project also needs to obtain noise and air pollution licences from EPA. Whilst EPA's approval is not required for the project to commence, the granting of the licence with deliverable conditions, as has been seen in the case of the Luna Park, is critical for a continued operation.

The RTA should consider, in light of the experience gained from this project, whether the benefits from a delayed EIS are sufficient to outweigh the risks.

Other Issues

There are other issues that relate both to the extent of modifications and the concessional period.

The process of determining the scope of the Distributor project was unusual for a number of reasons.

Changes to the Project

In its original specification the proposed Eastern Distributor was a far less ambitious project. The construction cost was estimated to be $180m, it involved a construction time of 3 years and the envisaged concession was for a term of 20 years.

At least one of the Preliminary Proposals included a three-lane tunnel with no additional cost to the RTA and a "surplus" for the RTA which could be used as part of an expanded scheme to upgrade the whole link to the M5. This higher capacity option was allowed for in a request for detailed proposals in May 1995 (the request did not specify any number of lanes). But the alteration was permitted without an adequate review against wider transport and environment priorities of the alternatives.

The prospect of a substantial surplus for related road projects appears to have been a paramount consideration in the RTA's selection of the preferred tenderer. But when modifications arising from submissions to the EIS eliminated the "surplus", there was no reconsideration of the expanded scheme. Instead, project funds were increased through the agreements to a higher toll and a longer concession period. Some essential modifications from an expanded project, such as those to the Southern Cross Drive, became an RTA obligation.

The ultimate effect of pursuing the expanded project is that the current proposal envisages 48 years of toll with a ‘starting’ toll of $3.

The audit consultant reports that there were, and still are, alternatives to the extent of modifications and to the method of financing but that there is no evidence that they have been considered.

In particular, the extension of the concession by 10 years to 48 years only provides a net present value of $9m to the RTA but is likely to impose considerable costs on road users. The audit consultant suggests:

> *It is surprising that out of a project costing in excess of $580 million ... it has not been possible to find $9 million worth of savings.*

The RTA’s decision to pursue an expanded Eastern Distributor stems in part from the surplus that, pre-EIS, was to have been available from a $2.50 toll. It suggests that the Government’s transport strategies lack the detail that is necessary to guide decisions about priorities.

The Audit Office recommends that the following planning improvements should be considered:

- **a clearer definition of transport policy**
- **a better integrated transport plan which clarifies and reconciles strategic and policy objectives and so provides an agreed framework within which individual agencies, and individual schemes, can proceed with more certainty**
- **applying the EIS process to transport policies and plans as well as specific proposals**
- **promoting improvements in the methods used to assess local and regional impacts on traffic and the environment.**

Setting of Future Tolls

The proposed setting of the future tolls is unusual and differs from those applicable to other tolled roads.

The formula that is being considered incorporates the growth in average weekly earnings (AWE) as well as the consumer price index (CPI). Some borrowing will be indexed by the CPI, some by AWE. Other private sector road tolls for future increases take into account the CPI, they do not seek to capture growth from AWE.

For a number of reasons, but particularly because workers share productivity gains in the economy, AWE grows faster that CPI. Because the current formula for future increase in tolls is designated to capture 37.5% of the CPI and 62.5% of the AWE for each quarter, it can be expected that the toll will increase at a faster rate than the CPI and those of the other tolls. In a 48 years context the differences will likely be significant.

The Audit Office does not believe that the RTA is adequately aware of the likely impact of that difference on future tolls.

Any commitment to a 48 year concession term is very significant. As observed by the audit consultant:

> *Very long concession periods may involve contingencies which have not been envisaged at the outset. This sets a greater premium on the careful drafting of the contract between private infrastructure providers and the governments. The public interest is not obviously protected by arrangements which exceed the easily foreseeable future.*

Conclusion

If there is to be a private sector Eastern Distributor before the Sydney Olympics, there is now little scope to consider other options than the particular scheme being advanced by the Government.

There is still scope for the Government to reconsider the term of the 48 year concession currently being advanced, and the indices used to inflate the toll from the $3.00 set for the year 2000 remain a concern.

Other features of the proposal suggest it represents another advance on agreements for private sector urban tolls.

But these advances cannot overcome the critical weaknesses of private urban toll roads and public urban toll roads. As a former Commonwealth Treasurer said, the Commonwealth Government's view is that State Government ownership of State roads is in the State taxpayers' interests.

It is a concern that notwithstanding argued weaknesses for urban toll roads, and notwithstanding governmental agreement to consider these weaknesses, no NSW agency has critically considered them or their long-term implications for sound transport and environmental strategy. And although the issue has not been seriously considered, private sector owners have been given effective long-term rights over important road network issues of concern to Sydney.

These rights allowing the private sector a legal say in important road network issues, will be extended under the terms of the proposed agreements for a privately owned Eastern Distributor.

Summary of Recommendations

Tollways — **The Government should conduct a major examination about financing urban motorways. The Government has stated its concerns about the costs of inherited general government debt. It should also be aware of the stated inefficiencies of urban tollways.**

Planning — **The Government should consider the following planning improvements:**

- **a clearer definition of transport policy**
- **a better integrated transport plan which clarifies and reconciles strategic and policy objectives and so provides an agreed framework within which individual agencies, and individual schemes, can proceed with more certainty**
- **applying the EIS process to transport policies and plans as well as specific proposals**
- **promoting improvements in the methods used to assess local and regional impacts on traffic and the environment.**

Concession — **The Government should reconsider the term of the 48 year concession currently being advanced and the indices used to inflate the toll from the $3.00 set for the year 2000.**

Assessment Process — **The RTA, for any further major project of this type should ensure that it establishes a process which allows all decision makers to have a thorough understanding of the reasonableness of the proponents' offers and their implications for the State and for the public.**

The RTA should at the outset consult with TCorp in respect of each major project put to tender.

Delayed EIS — **The RTA should consider, in light of the experience gained from this project, whether the benefits from a delayed EIS are sufficient to outweigh the risks.**

1. The Audit

1.1 Resolution

On 17 April 1997 the Legislative Council passed a resolution requesting the Auditor General to review urgently the Government's proposals in relation to the Eastern Distributor, and to report as soon as practicable. The full text of the resolution is included as Appendix 1.

1.2 Scope, Criteria and Timing

Audit Scope

In the course of this audit not all the elements of the resolution have been taken to form the audit scope. Some are outside the legislative limits imposed on audit by the Public Finance and Audit Act, while others would have required considerably more time than was available. The audit did not address "whether the proposed toll and concession period represents the best deal", or whether the current proposal represents the best environmental outcome". Nevertheless, the audit has provided brief comments on each of the points of the Resolution at Appendix 2 of this report.

The audit was more concerned with the assessment of procedures adopted by the RTA in developing the proposal for the Eastern Distributor. As such, the audit:-

- identified past events
- compared and /or evaluated actions taken against normative criteria
- made observations and comments on those actions.

The audit also examined the efficacy and propriety of those actions. It also examined the extent to which those actions complied with stated requirements.

Criteria

In particular the audit examines whether due process has been followed in each area, and whether the results demonstrate efficiency and effectiveness. The criteria used in this examination were:

- the content of transport proposals should conform with agreed strategies
- the planning process should conform with guidelines
- the proposed sharing of costs, benefits and risks should demonstrate efficiency and effectiveness

- an efficient and effective process was followed in seeking and assessing proposals from the private sector
- probity issues during the assessment and selection process were identified and addressed
- an efficient and effective process has been adopted for economic and environmental assessment, and for the modifications made as a result to the design of the Eastern Distributor.

Audit Timetable

At the request of the Legislative Council, The Audit Office agreed to complete a draft report within six weeks of the resolution being passed. This has been achieved, although it has limited the depth of analysis possible on some issues.

1.3 Consultants and Report Structure

In preparing this report The Audit Office, after a selection process, retained the services of Kinhill Engineers on technical issues and Gilbert & Tobin on legal issues.

The report is structured in two parts. The report from Kinhill Engineers forms part 2. The Audit Office summary in relation to all issues forms part 1. A summary of the advice provided by Gilbert and Tobin is included as Appendix 3 to the latter.

1.4 Costs

The total cost of the audit is estimated at:

Staff Costs	$125,200
Technical Consultants	38,600
Legal Consultants	29,500
Printing and Other Costs	10,000
Total	**$203,300**

The above figures include 287 hours of unpaid overtime valued at $38,700**.** They also include the costs incurred since the initial tabling of the draft report by the Minister for Roads on 27 May 1997.

1.5 Acknowledgment

The urgency with which a report was requested by the Legislative Council made considerable demands on The Audit Office, its consultants and the RTA. The Audit Office and its consultants wish to express their appreciation to the RTA for its efforts in responding to requests for information.

2. Private Financing, Risks and Benefits

2.1 Background

This report follows a number of examinations by The Audit Office of the involvement of the private sector in the provision of public infrastructure, particularly transport infrastructure.

The M2 Audit

The last, 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. However, it also highlighted the uncertainty that remained over the underlying costs and benefits of such schemes for the State and for the transport network **as a whole**.

While recognising some of the benefits from private sector financing and operation of such schemes, in terms of efficiency, timing and risk-sharing, it suggested that **public ownership** of such schemes might offer the potential for:

- better management of traffic risk over the road network as a whole
- more efficient pricing mechanisms
- a more optimum public transport network.

Further Review Recommended

It concluded:

> *This Audit cannot definitively answer whether from a financial viewpoint private ownership of the M2 is in the State's interest. It suggests that it need not be in the State's interest and it recommends that the Government, with respect to future projects, carefully examine the relative economic benefits of private vs public ownership of urban tollways (and the effects of different revenue raising mechanisms).*

2.2 The Proposed Eastern Distributor Contract

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.

Balance of Risks

- the State has no financial restrictions placed on its development of mass public transport schemes which might compete with the tollway (the most proximate source of such competition, the New Southern Railway, was already well-advanced when proposals for the Eastern Distributor were sought)
- the State is not liable for Commonwealth or State taxation measures that adversely affect the Eastern Distributor's revenues.

State Obligations

However, the State will have obligations:

- to allow the indexed toll throughout the concession period (48 years is currently proposed)
- to allow one North-bound lane on the Cahill Expressway for the concession period
- not to build a juxtaposed competing arterial road
- to "recognise the importance of the Eastern Distributor in the Sydney metropolitan traffic system" in the long-term
- to improve links to the emerging orbital road network without new tolls in the short-term.

Failure to meet any of these obligations will involve damages being paid by the RTA to the proponent or a negotiated restructuring of the project's financing arrangements.

These obligations continue to give the tollway owners rights to compensation where important future developments materially and adversely affect their interests.

2.3 Implications for the Network

Knock-on Effect

The commitments in relation to completing or upgrading links include the M5 East, General Holmes Drive and Southern Cross Drive at the southern end; and maintaining access to the Cahill expressway and the Sydney Harbour Tunnel at the northern. Thus the knock-on effects on the management of traffic generally extend beyond the Eastern Distributor and its immediate vicinity.

An increasing proportion of the "emerging orbital road network" is tolled, or constrained to be toll-free. The resulting limitations, for example, to the use of remote continuous charging for regional traffic management for the next 40 years or more, including congestion pricing, have not, on the evidence seen by audit, been adequately taken into account in long-term strategies for Sydney's urban roads.

Limited Flexibility

As the Government's "Cashback" scheme for the M4 and M5 shows, the Government's practical flexibility to deal with private tollways is limited. The scheme provides a considerable windfall to the private tollway owners, even if the extent of the windfall cannot be readily measured by The Audit Office (see NSW Auditor General's Report for 1997, Vol 1, p247)

Restrictions on Tolling

The restrictions accepted by the Government on tolling is itself a considerable issue and they deserve to be seriously considered in the future planning for Sydney's roads. If, for example, an urban-based petrol tax were seen to be an efficient way to finance new urban transport systems, the current and possible future proliferation of private sector road tolls might be a major factor in its acceptance.

If a more efficient revenue system cannot be introduced because of tolls, the cost borne by Sydney residents is likely to be large, even though they might never be aware of these costs.

As important as these issues are, there are other factors that should be reflected in road planning:

- the use of tollways means that some motorists who should use them (for example, to avoid increasing pollution in the neighbourhood) will find it cheaper not to
- the efficient future management by the Government of the public transport <u>network</u> is hindered because private ownership of tollways imposes important constraints on the exercise of Government powers

- the toll costs faced by motorists using private tollways are generally higher than equivalent charges raised by the Government because the Government can manage important risks better than the private sector
- there are significant, unearned transfers of benefits from the public sector to private tollway owners when “missing links” or improved access facilities are proposed
- the Government as owner of these motorways is in a better position than the private sector to harness the external benefits and to mitigate the external costs imposed by these motorways/distributors.

In short, there are important characteristics of “networks” which mean that they cannot be ‘traded’ in the same way as, or equated to, normal commodities.

There is no evidence that Government agencies have properly considered these issues in future plans for Sydney’s roads.

Examination of Alternatives Limited

This conclusion is given added weight by the evidence in the audit consultant’s report of doubts internationally about the effectiveness of tollroads in urban areas and the attractiveness of alternative options which still retain the advantages of private sector involvement in design, construction and maintenance.

The Audit Office is not aware of any general governmental examination of the implications of private or public tollways for the transport network as a whole since the audit of the M2 was published. Neither DoT nor the RTA has produced one. RTA’s draft State Road Network Strategy, published in 1994, promised a Road Network Financial Management Plan which might have included such issues, but such a plan has never been developed.

2.4 Assessing Funding Alternatives for the Eastern Distributor

The RTA has pointed out that the previous Government had committed the State to a privately financed Eastern Distributor tollroad in March 1995, before the March 1995 general election and before the new guidelines were issued. That decision, made less than two months after receiving The Audit Office report on the M2, and without a full evaluation of the points raised in that report, is particularly disappointing.

New Guidelines

The current Government did issue revised guidelines on private sector involvement in public infrastructure projects in September 1995 which strengthened the requirement for all such projects to demonstrate that:

- *alternative solutions including non-capital options have been thoroughly researched and do not offer higher net economic benefits*
- *private sector involvement is commercially feasible and offers a more cost-effective solution than the traditional public sector approach.*

However, such ideas had not been applied to the Eastern Distributor when detailed proposals for a privately financed tollroad were issued by the current Government in May 1995. The Treasurer wrote to the then Minister for Roads shortly after saying:

> *I am concerned about proceeding with a request for detailed tenders on this project* [Eastern Distributor] *without the Government resolving its overall policy position in relation to toll roadways ...*

The Minister responded:

> *Unfortunately your letter arrived well after the RTA had requested this formal documentation. This process was locked in by the former Government on 3 March 1995.*

The Government thus acquiesced to a former Government's actions on a matter of substance taken in the month of a general election. That acquiescence overcame the former Opposition's policy of no tolls for the Eastern Distributor.

November 1995 Assessment

Nevertheless, the RTA did undertake a comparison of a publicly-funded tollroad alternative to the private proponents for the Eastern Distributor in November 1995,

> *... to assist in deciding whether the project should proceed as a private or public tollroad...*

The result, on the face of it, indicated that :

> *... a government-funded tollroad would provide a marginally higher return than the two private tollroad proposals.*

This was despite the fact that

> *a premium of $20m was added to these* [government-funded proposal] *costs to allow for the increased efficiency and incentive expected to be displayed by a private venture proponent .*

Had other options been examined (including one where design, construction and maintenance was the subject of tender but ownership remained with the State) the advantages over the present arrangements should have been higher.

The RTA gave the following explanation for not pursuing the options:

> *In coming to its decision to continue with the process which was started by the previous Government to advance the selection of a privately funded toll road proponent, the Government gave considerations to a number of policy issues namely:*
>
> 1. *the Government would need to raise debt in excess of $600m if it was to implement a Government funded toll road strategy. This action would not comply with the intent of the Government's General Government Debt Elimination Act 1995.*
>
> 2. *The Government toll road options considered in the report have an average interest rate cover over the first five operating years of less than one. That is to say, during this period the revenue raised for the toll is inadequate to cover the interest cost of the project. To avoid this problem the Government would need to inject equity funds which would not achieve the Government's policy objective of no cost to Government for the Eastern Distributor.*

> 3. *Under the Government toll road option the Government would take on the traffic risk and interest rate risk. Adverse movements in either of these factors would increase the Government's financial exposure to the project. Under the private toll road option, these risks are taken by the private sector. The returns to toll road projects are very sensitive to movements in interest rates and traffic volumes.*
>
> 4. *It was also considered at the time of the Government's decision that the private sector toll road option provided a financial incentive to complete construction in the most cost efficient manner in order to achieve the earliest possible opening date and therefore earnings of revenue. This decision is consistent with the Government's policy for the project to be completed before the 2000 Olympics.*
>
> 5. *The process had already commenced and resources had been spent by the private sector in response to a previous Government decision to progress the matter with the private sector before the Government came to office in March 1995.*
>
> *Taking all these factors into account, the Government made the decision to continue the process for the project to be a privately funded and operated toll road.*

Not all of these points are persuasive. The identified requirements for equity could have been replaced with larger initial borrowings; the Government need not be exposed to the effects of on-going interest rate changes if it - like the private sector - uses indexed bonds which are supported by indexed tolls; bonuses and penalties can allow speedy construction by the private sector (vide the third runway). This at least shows that the Government should examine private versus public ownership issues thoroughly and carefully.

In the recent past, the Government has:

- agreed to a toll for the Eastern Distributor
- introduced "Cashback" for certain tolls paid for the use of the M4 and M5
- announced that the eastern extension of the M5 would be toll free

contemplated a toll for the underground extension of the Gore Hill freeway in light of demands caused by the completion of the M2.

In the light of these decisions, The Audit Office requested from the Government a statement of its current policy in relation to toll roadways, and in relation to transport developments generally.

The response from the Minister seems to indicate a departure from the policy views contained in the Guidelines for Private Sector Participation in the Provision of Public Infrastructure.

It seems to imply that the relative merits of public and private financing will no longer be used as a basis for decisions on roadworks. Such decisions will depend purely on the level of public funds.

> *The Government will endeavour to fully fund all roadwork without resorting to the use of private toll roads.*
>
> *However in the limited circumstances when this may not be able to be achieved in a timely fashion due to budget constraints, consideration may be given to using private sector capital to bring the roadworks forward.*
>
> *Tollroads funded by the private sector will only proceed if such projects have clear public benefits and are financially viable.*

Conclusion

The Audit Office agrees with its audit consultant when he says, in Section 2 of part 2 of this report:

> *The involvement of private finance and expertise in the improvement and management of roads holds out the prospect of significant gains, but the recourse to private finance for the improvement of Sydney's road network has been essentially opportunistic and ad hoc. There is a need for a broader review of the ways in which it would be possible to improve the efficient use of the road network (taking into account the full environmental costs of road use and the available alternatives) to reduce the costs of road maintenance and management and to involve the private sector more effectively in the provision, financing and operation of road.*

The consultant also says:

> *The issues of the appropriate roles for public and private finance in the funding of urban roads and the scope for involving private sector capital and expertise in innovative ways remain of great significance. But these are general issues which deserve to be addressed generally; and until they are, the conclusions cannot be brought to bear meaningfully on the proposals for specific road improvements and management processes.*

The Audit Office agrees with the need for early resolution of the general issues into a clear framework within which agencies can work with confidence. This applies here in relation to financing and management, and in the next chapter, to translating higher transport planning goals into operation.

Government authorities responsible for advising Ministers on these matters (whether RTA, DoT or Treasury) have failed by not addressing these issues earlier and by continuing not to address them.

The continuation of essentially ad hoc arrangements serve increasingly to limit Government's control of the transport network.

2.5 Proposed Toll Schedule

The current proposal for the Eastern Distributor toll envisages that it will be $3 in the year 2000 and that it will grow by 4% pa or by a rate calculated from a combination of 37.5% consumer price index (CPI) and 62.5% the growth in average weekly earnings (AWE), whichever is the greater.

Differs from M2, M4, M5

This price indexing formula differs from that applicable to the tolls for the M2, M4 and M5, all of which are indexed only by 4% or the CPI.

Over the long term, one could expect that nominal wages will grow faster than nominal prices. This is because wage earners share in the productivity or real growth in the economy, as well as being compensated for nominal price increases.

Productivity growth in the economy varies according to the business cycle and investment cycles but averages out at around 2% pa. (Since 1949 the annual average real increase in male AWE in NSW is 1.9%.) This means that the toll adjusted only by the AWE index will grow over the long term about 2 percentage points pa faster than the toll adjusted only by the CPI.

In its initial financial model, the proponent assumed an annual CPI growth of 4% (which is also the minimum growth allowed) and a growth in AWE of a little over one percentage point higher or 5% per annum. This has been accepted by the RTA as part of the "package".

The Use of AWE

This use of a 1% per annum real increase as a predictor of future movements in AWE may stem from the historical period examined. Using the period from the mid 1980s to-date will produce an artificially low real AWE annual growth. That index was substantially influenced by the seven or so "wage accords", tax trade-offs, Medicare effects that were employed by the Commonwealth Government to dampen AWE growth. A longer timeframe allows a 2% real annual increase to be observed.

As suggested above, if the CPI is to grow by 4% per annum as assumed by the proponent, it would be a better assumption to forecast that AWE will grow by 6% per annum (that is by 2% per annum in real terms).

Using this higher AWE increase means that the annual nominal increase in the Eastern Distributor toll is higher than the proponent suggests, and RTA has accepted, by about two-thirds of a percentage point.

Higher Tolls

The outcome can be shown by comparing a $3 toll in the year 2000 which is adjusted by a 4% CPI and a 5% AWE for each of 47 years (compared to a 4% CPI and a 6% AWE for each of 47 years) of the 48 year concession. In rough terms, the former allows an end toll of $27. The latter provides an end toll approaching $36.

The differences in cash-flow to the private sector proponent are large, notwithstanding the time value of money.

The differences between the toll applying to the Eastern Distributor and those applying to other tollways (M2, M4, M5) will also be large. If each of those tolls are for a further 48 years from the year 2000, and if each is $3 in the year 2000 (two invalid assumptions to help show the differences that can arise) and the CPI is 4% per annum, the applicable toll for those toll-roads would be around $20 in the year 2047.

The use of CPI and AWE as weights in the toll inflator is based on the use of debt (bonds) which are indexed to the CPI and to the AWE. The use of these financing techniques has been accepted by RTA - as noted earlier, no verification of the financial model has been performed.

RTA has also accepted the proponent's assumption that the increase in the AWE over the 48 years of the concession will be 1 percentage point higher than the CPI growth. As noted earlier, The Audit Office considers the RTA should have received more extensive advice on each of these issues. On the latter issue, The Audit Office considers that the accepted assumption is deficient.

Similarly there seems no justification for having a 4% minimum index. Adjusting the toll by a minimum of 4% per annum merely provides the private sector proponent with the prospect of large gains if there is a low inflationary environment. That the previous Government agreed to a minimum inflation for the M2 does not itself justify its application for the Eastern Distributor.

Conclusion

In light of the above, it would be appropriate for the RTA to re-examine the justification for a 4% minimum deflator for the Eastern Distributor toll and the consequences of using the AWE as a toll price inflator.

3. Planning Processes

3.1 The Planning Framework

The Changing Framework

The corridor from the Harbour Bridge/Tunnel to the Airport and Port Botany has been a feature of metropolitan transport strategies for 45 years or more (see Appendix 4 for more details of its evolution). During that time the planning and policy framework has changed considerably. Increasing concerns about the impact of the motor car on the environment and on city living have encouraged efforts to control the growth in traffic as part of a more integrated approach to land use, transport and environment planning.

This has led to a much wider range of strategic objectives that transport schemes now should desirably meet. It has also added more steps in the planning process before such schemes can go ahead. The Eastern Distributor, like all other major road schemes, has had to pass through three major approval stages to satisfy:

- strategic and policy objectives
- economic and financial criteria (Cost-Benefit Analysis, tendering)
- detailed design and environmental standards (Environmental Impact Statement)

The audit has examined the decision-making processes for the Eastern Distributor at each of these stages. The audit highlighted a number of aspects that will require further attention.

3.2 Strategic Planning

Strategy Documents

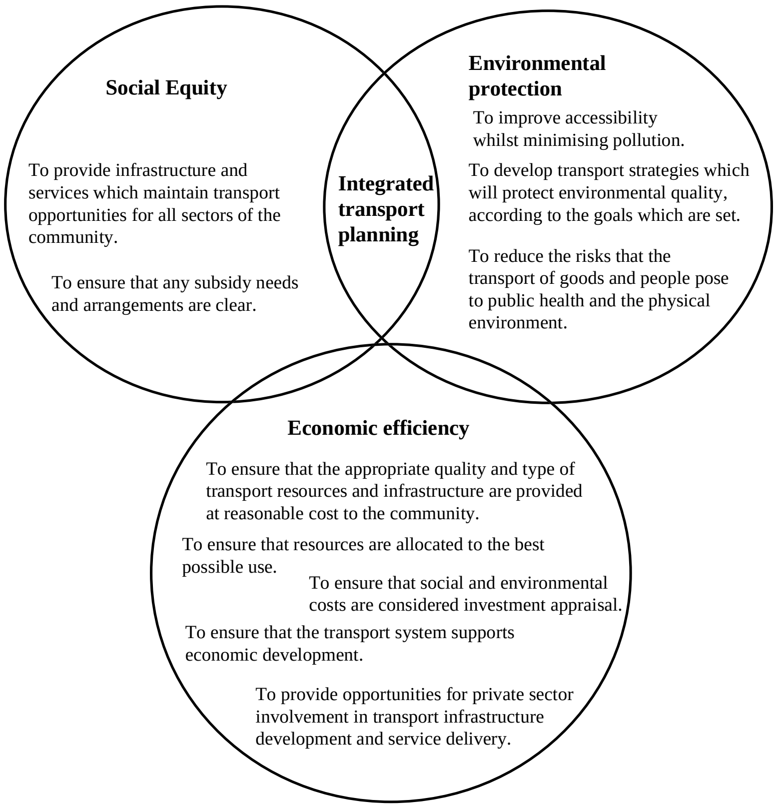
There have been a number of strategy objectives, and strategy documents, for transport and land use planning in metropolitan Sydney. The latest, in 1994-95, were:

- The Integrated Transport Strategy for the Metropolitan Region (Department of Transport)
- The State Road Network Strategy (Roads and Traffic Authority)
- Cities for the 21st Century (Department of Planning)

An Air Quality Management Plan for the region is to be launched shortly (Environmental Planning Authority).

These strategies provide a range of broad objectives for transport. They all stress the need to find a balance between efficiency, equity, environmental protection and safety. The following comes from the Integrated Transport Strategy published by the Department of Transport in 1995.

Figure 1: Strategic Transport Objectives



However, these broad objectives have rarely been translated into a comprehensive set of policies or plans which would reconcile the inevitable trade-offs between these objectives for individual transport developments.

No Comprehensive Transport Policy

As part of this audit, the authorities responsible for Transport and for Roads were asked for details of the transport policies within which the Eastern Distributor is being developed. The responses received focused on specific issues: such as public transport operations; or specific decisions: such as the (previous) Government's decision to approve the construction of the Eastern Distributor as a privately-operated tollway; or financial policies.

None offers a comprehensive policy framework to guide transport planning and development across the region. This would include linked policies for the transport network as a whole on such items as financing; pricing; demand management; reducing traffic pollution; public/private transport integration.

Integrated Transport Plans

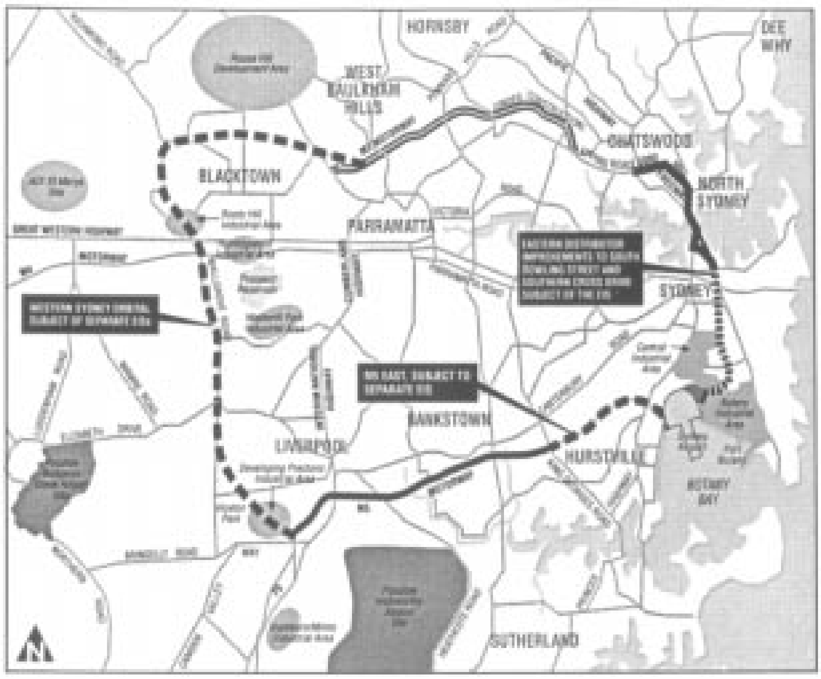
In order to assist Government to formulate and implement its policies, a better process is needed to bring together the agencies with separate responsibilities to agree integrated plans and methods for initiating and funding specific proposals and evaluating them. In the M2 report in 1995, The Audit Office expressed the hope that the Integrated Transport Strategy would generate that process, but it has made little progress.

So, for example, RTA justifies the Eastern Distributor in terms of providing:

> *... a key strategic transport link to support the Government's initiatives and objectives to complete a Sydney Orbital identified in the various strategy documents.*

The map below illustrates this.

Figure 2: The "Sydney Orbital"



However the audit can find no clear Government policy or plan supporting the implementation of the Orbital and no evaluation of the effects of doing so. Certainly, it is not made explicit in the 1994 State Road Network Strategy. And at least one State agency involved in the integrated planning process has questioned the concept in its submission to the EIS. The concept of an Orbital itself needs to be justified if RTA is to rely on it to help justify the Eastern Distributor proposal.

The absence of integrated transport plans is in marked contrast to overseas practice. For example, the California Department of Transportation is required by law to publish a seven year capital improvement program of private and public transport projects funded from the State Highway Account and from other sources on and off the State Highway system.

The Ministry for Urban Infrastructure

The Ministry for Urban Infrastructure (set up in 1996 after the Eastern Distributor was approved) is the latest attempt to develop a more integrated approach in NSW. As its May 1997 Fact Sheet states:

> *The Ministry will develop a five year Urban Infrastructure Management Plan which outlines the Region's infrastructure needs. The plan will assist the UMCC (Urban Management Committee of Cabinet) to implement metropolitan strategies by identifying priorities for expenditure on major infrastructure projects.*

The Ministry has indicated that the first infrastructure plan (which is a much more difficult task than developing an urban transport plan) will be completed later this year.

In the absence of integrated plans, and in response to policies to reduce debt and have no new taxes, an opportunistic approach has been adopted by RTA, and by other agencies. They have sought to take advantage of private debt sources (and private tolls) and match them to specific agency priorities.

Such arrangements tend to encourage "insert" schemes, like the Eastern Distributor, which are narrowly defined to developments of private sector interest within an agency's sphere of influence.

Discourages Integration

This makes achieving integrated solutions for the land use and transport system as a whole (both public and private), more difficult. Individual agencies are left to grapple continually with wider issues, and with each other, on individual projects, without a useful framework to resolve them.

The Eastern Distributor in the Strategic Context

The difficulties in this regard faced by the proponents of the Eastern Distributor are well summarised by the audit consultant in section 3 of Part 2 of this report:

> *Many of the problems which appear to arise from the introduction of a new road link such as the Eastern Distributor, or which are seen not to be addressed by the proposal, are in fact of much broader scope than could ever be addressed by works on the scale of the Eastern Distributor. The concern expressed about the specific proposal serves to highlight the inadequacy of the policy framework within which the proposal has been developed and the failure to confront major issues at a much more general level.*

This is not for lack of public, or Government, endorsement for some form of an Eastern Distributor. Community and motorist consultation in 1994 showed a "desire that an Eastern Distributor should be constructed as soon as possible."

The link was specifically mentioned in RTA's Road Network Strategy in 1994:

> *The Gore Hill Freeway, the Sydney Harbour Tunnel and the upgrading of General Holmes Drive have provided a high standard route between the north and Kingsford Smith Airport and Port Botany, with the exception of a short length through East Sydney which is seriously congested in peak periods. The feasibility of a privately funded underground Eastern Distributor to complete this route is now being investigated.*

The Olympics

In 1996, the Government also regarded it as necessary for the Olympics. In announcing the winning tender in August 1996, the then Minister for Roads said:

> *... the construction of the Eastern Distributor road project would commence as one of the Government's undertakings to improve transport facilities for the Sydney 2000 Olympics ...*

Nevertheless such general support has not prevented objections to the specific proposals later in the planning process. The ensuing modifications and delays have prompted the Government to modify its position. In April 1997, during the debate on the Legislative Council resolution that led to this audit, the Treasurer said:

It is not important that this project should be completed by the Olympics. However, it is important that if the project cannot be completed by the Olympics, then it cannot start before the Olympics.

3.3 Cost-Benefit Assessment

For any major public infrastructure project like the Eastern Distributor, an investment appraisal (cost-benefit assessment [CBA]) is required before the project can proceed.

1994 Assessment

For the current Eastern Distributor project, the first of these assessments was conducted in 1994, based on RTA's "concept design" for a short two lane tollroad and tunnel between Cathedral Street in the north and Moore Park (Drivers Triangle) in the south. The initial cost estimate for this design was $180m.

The analysis showed a benefit-to-cost ratio of about 1.25 for the preferred option. With this small but positive benefit, and with the non-quantified benefits expected for the local environment, the then Government gave the go-ahead for the project in September 1994. In line with its desire to promote the use of private financing in public infrastructure, it approved private construction and operation of the Eastern Distributor as a tollway.

Later Assessments

The cost benefit analysis has been updated several times since, after major modifications to the project. The ratios have all been positive, ranging from 1.25 to 6 or more, in response to changing assumptions about traffic flows and construction costs.

Weakness in Methodology

However, as the audit consultant points out, CBA methodology is not sophisticated and it would be dangerous to draw conclusions about the overall "worth" of the project from the precise value of the benefit-cost ratio. This is especially true in the circumstances of the Eastern Distributor where environmental and amenity impacts may be significant factors. Such factors are not easily measured and have not therefore been fully included in the calculation of the ratio, unlike more easily measured benefits like savings in travel time.

Because of this, the audit consultant concludes, in section 8 of Part 2 of the report:

> *The traffic and environmental impacts of the Eastern Distributor in affected areas have not been satisfactorily addressed in the 1996 (revised) cost-benefit assessment. This is unfortunate, given the emphasis of the project on improving the conditions for traffic and residents in the areas most affected.*

The EPA has foreshadowed the need for greater attention to this issue in future, both on a local and regional level.

> *The Government will shortly launch the Air Quality Management Plan for the Metropolitan region and, in this setting, it is likely that a fuller assessment of traffic and transport issues will be required to permit a better assessment of air quality on a regional basis.*

Weakness in Scope

Beyond these methodological weaknesses of the cost benefit analysis used, the audit is also concerned that a more wide ranging assessment was not made of the merits of different options during the evolution of the Eastern Distributor design. It seems to have been sufficient to show that the latest design had a positive benefit-cost ratio rather than undertake a comparative analysis of the alternatives.

The Decision to Expand the Scheme 1995

This is most apparent in two decisions. The first occurred after the Preliminary Proposals had been assessed in 1995 when the option to expand the capacity of the road link was allowed. The detailed proposals issued in May 1995, showed that the RTA's original specification for two two-lane tunnels was replaced with a more general specification, in conjunction with grade separation and widening of roads south to the airport and beyond.

In the revised cost benefit analysis, this extra capacity increased total travel time savings and so increased the benefit-cost ratio, despite higher project costs. For the private sector proponent it also produced a significant increase (40%) in expected toll-revenue over that from the two-lane tunnel, which in turn offered funds for related road improvements.

In this way a "no-frills" solution to alleviate the worst of the traffic problem, had been replaced by a major upgrade to the whole of the strategic link to the M5 East (although these had not been a priority in previous RTA plans), at no cost to Government (though at cost to the public).

The immediate attractions of this "enhancement" are obvious, both to the private sector proponents and to the RTA's financially-constrained road building program. However the wider implications of such increased capacity on the transport network as a whole and on the environment are less clear.

Many EIS submissions, including the questions posed by DUAP and EPA, suggested that this enlarged project would "induce" traffic and have negative effects on the development of public transport and the environment in the region as a whole. They argued that this was contrary to the objectives that the RTA and the State generally had set to reduce the growth in traffic and pollution. Both of these conclusions are disputed by RTA in the EIS Representation Report.

The audit reaches no conclusion on the substance of these claims but considers that the relative merits of the "no frills" approach versus the increased capacity option should have been evaluated more rigorously and publicly in early 1995 before the RTA decided to abandon its original specification for the Eastern Distributor and allow more extensive alternatives when seeking detailed proposals.

The Decision not to Contract the Scheme 1997

The second decision occurred later on after the EIS. Substantial design modifications were then introduced to respond to community concerns. These modifications added to costs (the scheme is now costed at $680m), to an increased toll, and to a longer concession period (48 years).

As the audit consultant points out in section 6 of Part 2 of this report, such long time scales raise intergenerational issues which have not on evidence available to audit been considered. From one perspective, these issues would question the merits of additional works beyond the core value of the project, such as the expansion to three lane tunnels:

> *According to this interpretation, the increase in total cost to cover all the currently proposed works implies a significant and adverse intergenerational transfer whereby additional works now (from which some road user will gain immediate benefit) are being financed by road users in the distant and uncertain future.*

And in relation to the financial evaluation of alternatives to the toll and concession periods now proposed, he says:

> *However, the possibility exists of reducing the scope of works - for example, by eliminating some access ramps or the capacity of tunnel sections - to offset the loss of revenue which maintenance of the $2.00 (1994 value) would imply. There is no evidence that alternatives such as these have been considered.*
>
> *There may be grounds for saying that the final configuration of the Eastern Distributor, as presently proposed, is optimal and that a 7.5% reduction in the scope of works would significantly reduce the overall worth of the project by an amount larger than the cost saving. However, unless these possibilities are addressed, it is difficult to give an assurance that the proposed increase in the road toll and concession period represent good 'value for money'.*

Conclusion on Cost Benefit Assessment

Even though some economic appraisal guidelines have been followed, the process gives the impression of being driven by the private sector's ability to undertake related road improvements on the RTA's behalf, without a cost to the RTA, rather than by the State's wider road-building, transport and environment priorities. The limitations of cost-benefit methodology, and the lack of clarity in the State's agreed strategies and plans to implement these priorities, have contributed to this shortcoming.

3.4 Environmental Impact Assessment Process and Transport Planning

The environmental impact statement (EIS) has been the major new feature of land use and transport planning in the last twenty years.

Timing Dilemma

The EIS is the major point in the planning process at which environmental impacts are assessed and debated. In the absence of integrated plans out of which specific proposals are developed to meet environmental objectives, there is a dilemma for a scheme's proponent as to when to prepare an EIS:

- **too early** and it risks missing key impacts arising from the design and management of schemes

- **too late** and it risks being blocked by strategic environmental concerns that might have been resolved earlier and at lower cost.

This dilemma was recognised in 1995 by the Integrated Transport Strategy:

> *Difficulties which have been experienced in gaining approvals for major road enhancement projects, particularly urban motorways, have tended to occur once the EIS is exhibited. Such problems may indicate that there is not acceptance in the community of the strategic context of the particular project and that the alternatives have not been fully evaluated or explained.*
>
> *This situation is at odds with the intended role of the Part V EIS ... Assessment of alternatives is vitally important but it is properly the role of the strategic planning process rather than the EIS.*

Proposal vs Specific Activity

The NSW Environmental Protection legislation refers in the EIS to a development activity. Policies, plans and concepts are not subjected to the EIS process. This is not the case in all states.

A 1994 report prepared for the Commonwealth Environment Protection Agency, suggests that:

> ... *Limiting the scope of EIA* [Environmental Impact Assessment] *to project-specific factors severely limits the system's compliance with the EIA principles.*

It suggests that EIA should be applied to policies, plans and proposals as well.

Eastern Distributor

The Eastern Distributor was the first project undertaken by the RTA where the EIS was delayed until after the selection of the preferred proponent. RTA explained its reasons for doing so in its submission to the Capital Works Committee in 1994:

> *If an EIS were to be prepared now* [1994], *it is unlikely to contain the most innovative solutions to construction and environmental issues and could require a further EIS being required before work could commence. This would be confusing and seen by the community as time-wasting and possibly duplicitous ...*
>
> *... The possible criticism that expressions of interest should not be invited until a determination has been made to build an Eastern Distributor is expected to be minimal, if at all, because of the extent of exposure of the project to date and community acceptance.*

The Audit Office sees merit in this timing if there is confidence that the modifications required are likely to be limited, as the RTA implied. However in future, if modifications are substantial, it may carry the risk that a supplementary EIS (and wider cost benefit assessment) is required. It could also lead to a costly new tender, if the EIS-induced changes to original tender specifications are substantial.

Conclusions on the EIS Process

In the absence of an appropriate strategic planning process, the EIS is the predominant means by which the public is in the position to consider and comment on a proposal. The Audit Office considers that the EIS for a particular project is not the most appropriate means to gauge public reaction or solicit comments to strategic proposals.

The EIS for a particular project might contain intellectual property rights that would be difficult to disengage from the project and use for the benefit of the public. To a large extent this was the case here.

The methodology for quantifying environmental impacts does not have as long a history as the methodologies for other issues such as traffic forecasting. However, given the imperfections in the latter identified by the consultant, and some improvement in the former, The Audit Office suggests that more explicit consideration of environmental costs should be considered as part of the earlier strategic assessment stages on future projects such as this.

3.5 Planning Process Recommendations

The Audit Office recommends that the following planning improvements should be considered:

- a clearer definition of transport policy
- a better integrated transport plan which clarifies and reconciles strategic and policy objectives and so provides an agreed framework within which individual agencies, and individual schemes, can proceed with more certainty
- applying the EIS process to transport policies and plans as well as specific proposals
- promoting improvements in the methods used to assess local and regional impacts on traffic and the environment.

4. The Tender Assessment Process

4.1 The Assessment of Preliminary Proposals

Preliminary Proposals

The then Government, on 23 May 1994, gave approval to the RTA to invite the private sector to submit Preliminary Proposals to finance, design, construct, operate and maintain the Eastern Distributor Tollroad. The Government requested the RTA to obtain further approvals to proceed after Preliminary Proposals had been evaluated and preferred proponents shortlisted.

In response to a request for clarification, the Premier advised the RTA, on 11 July 1994, that ...

> *The Capital Works Committee did not make a decision with regard to funding. The Committee took the view that it should be left to the private sector to determine the level of toll considered appropriate under a one-way northbound tolling system, and that the private sector proponents should advise the level of Government contribution they considered necessary.*

Preliminary Proposals were invited on 21 September 1994. Guidelines for Proponents were issued. They described the project thus:

> *Twin two lane tunnels and approaches connecting the Cahill Expressway to South Dowling Street, Moore Park Road, as shown on the Plan (Attachment 1), with grade separated interchanges at:*
>
> - *Sir John Young Crescent (north facing ramps as a minimum)*
> - *William Street (north and south facing ramps)*
> - *connection(s) to Anzac Parade and Moore Park Road.*
>
> *A tolling facility located within the length of the project for collection of tolls from northbound traffic using the tunnel (northbound traffic from Sir John Young Crescent was not to be tolled).*

The proponents were also invited to submit a supplementary proposal for improvements to South Dowling Street to provide for interrupted traffic flow.

Included in the Guideline for Proponents was the following statement:

> *Contract forms will be negotiated but proposals should be developed so as to minimise the risks to be borne by the public sector and (without limitation) be on the basis that the successful proponent will bear all design, construction, operation and maintenance risk, and traffic revenue risk.*

Five Preliminary Proposals were received by the closing date of 20 December 1994.

Assessment Criteria

The Guidelines for Proponents provided details of the project assessment criteria and the evaluation process that the RTA was to use:

- technical merit
- project experience
- financing
- financial capacity
- risks and returns.

Assessment of the supplementary proposals was to be considered separately having regard to technical merit, timing of construction and funding arrangements.

The assessment of the Preliminary Proposals was undertaken by a panel of four RTA officers and one Public Works and Services officer. Professional advice was provided to the Panel by Blake Dawson Waldron (legal), UBS Australia Limited (financial) and McLachlan Consultants Pty Limited (technical).

The proponents made presentations on their Preliminary Proposals to the Assessment Panel on 9 January 1995. Some clarification was sought from each of the proponents on 12 January 1995, with replies requested by 16th January.

A further meeting with the proponents was held on 19 January 1995 and clarification of issues from the meeting was received by 23 January. An additional meeting was held with a proponent on 9 February 1995 to clarify several critical technical issues.

Detailed reports were received from the legal, financial and technical advisers which summarised the relevant areas of each proposal and assessed the relative merits of the proposals.

Following a tender process a Probity Auditor from Coopers & Lybrand was appointed to ensure the fairness and equity of the processes followed initially to select a short list of proponents (who were to prepare detailed proposals) and ultimately to select the preferred proponent.

It is understood that the Probity Auditor, while present, did not participate in the evaluation and selection processes. It is a matter of concern, however, that the Probity Auditor signed the Preliminary recommendation as a panel member (22 February 1995).

Panel Recommendation

The Preliminary Panel appears to have evaluated each proposal against the published criteria. The Assessment Panel reported that:

> *Considerable effort has been expended by most of the proponents in developing their Preliminary Proposals. The level of innovation incorporated in the submission is significant and has added value to the process. Innovations include:*
>
> - *the provisions of three lanes between William Street and the southern end of the tunnels*
> - *twin deck tunnels*
> - *various ramp configurations at William Street*
> - *different construction methods and traffic management schemes to minimise the impact of traffic during construction*
> - *solutions to a potential merge problem north of the toll plaza*
> - *differential tolling for cars and trucks, a credit enhancement scheme providing significant up-front equity*
> - *the refinancing of the Sydney Harbour Tunnel bonds in schemes linked to an Eastern Distributor*
> - *the tolling of traffic from William Street heading north.*
>
> *The above features of the Proponents' Proposals presented the Assessment Panel a challenging task in evaluating the proposals.*

And:

> *The invitation to the private sector to submit Preliminary Proposals for an Eastern Distributor tollroad differs from previous invitations such as the tollroad projects, M2, M4 and M5, where an Environmental Impact Study had been completed prior to the invitation. With the Eastern Distributor tollroad proposal, it was decided to invite Preliminary Proposals prior to an Environmental Impact Study being conducted, in order to allow the private sector to advance innovative concepts that considered the community needs.*

The Assessment Panel considered a number of options for shortlisting the proponents including: that only one proponent be invited to submit a detailed proposal; that another one or two proponents be invited; or, that all the proponents with conforming Preliminary Proposals be invited to submit detailed proposals.

In its deliberations the Assessment Panel made the following observation:

> *The disadvantage of appointing only one Proponent is that the Proponent is in a strong position to negotiate the finalisation of the Proposal on terms which may vary from those stated in the Preliminary Proposal, and without exploring opportunities of enhancement which could be of financial advantage to the RTA.*

On 22 February 1995 the Assessment Panel recommended that three proponents be invited to develop and submit Detailed Proposals within three months, based on the Preliminary and Supplementary Proposals submitted, subject to:

- *a scope of works and design criteria*
- *the inclusion of an option to withdraw surplus land from the Detailed Proposal*
- *a single level of toll for both cars and trucks*
- *no tolling of northbound traffic from William Street*
- *the inclusion of options for the grade separation of Sir John Young Crescent as an overbridge at the intersection with the Cahill Expressway and at a location further to the north in cutting*

- *the inclusion of south facing ramps at William Street to provide for entry and exit of east and west traffic, with the option of defer construction*
- *the provision of a solution to the problem of traffic from the toll plaza weaving with traffic from Sir John Young Crescent at an unacceptable level of service*
- *the provision of at least partial grade separation of the Anzac Parade/Moore Park Road intersection to provide for the free flow of southbound traffic exiting the tunnel, without unacceptable adverse impact on the local environment*
- *minimum impact on traffic during construction on the adjoining road network, particularly William Street where the existing grade separation is to be retained until opening of the main tunnels*
- *the upgrading of South Dowling Street to eliminate traffic signals by the construction of under/overpasses as identified by the RTA.*

Approval

On 27 February 1995 the Minister for Roads sought the Premier's approval to invite three private sector proponents to prepare detailed proposals for the Eastern Distributor project. The Premier on 3 March 1995 approved the proposal to invite the three shortlisted proponents to develop and submit Detailed Proposals to finance, design, construct, operate and maintain an Eastern Distributor tollroad. However, this time the approval was subject to:

- *resolution of a number of issues, in consultation with Capital Works Unit and Treasury*
- *consultation with Capital Works Unit and Treasury on the call for Detailed Proposals document*
- *any Government funding contributions be met from within the RTA budget*
- *the RTA seek further approval to proceed with a preferred proponent.*

4.2 The Assessment of Detailed Proposals

Detailed Proposals

Formal invitations to submit Detailed Proposals was sent to the three Proponents on 15 May 1995 accompanied by the Scope of Works and Technical Criteria and Commercial Issues. The Scope of Works differed from the Preliminary Proposal Scope of Works in that no mention was made of the number of lanes for the tunnels and a number of issues in the Supplementary Proposals were now incorporated into the Scope of Works.

The invitation to submit a Detailed Proposal clarified a number of issues raised in various proponents' Preliminary Proposals including the refinancing of the Sydney Harbour Tunnel, which was not to be included in the Detailed Proposal, and differential tolls for cars and heavy vehicles which was to be allowed.

The proponents were invited to develop their Preliminary Proposal into a Detailed Proposal of sufficient detail and certainty as to be capable of forming the basis of negotiation and a binding agreement.

On 14 June 1995 the RTA advised the proponents of five additional matters that needed to be addressed:

- an option that would not require any monetary contribution from the RTA, but may include the tolling of southbound traffic which traverses the Sydney Harbour Bridge or Tunnel toll-free
- the capacity of the Eastern Distributor tollroad must be sufficient to meet the RTA's operational objectives for an orbital route in light of projected long term traffic needs, including:
    - ◊ *the RTA will widen Southern Cross Drive to six lanes prior to the opening of the Eastern Distributor tollroad*
    - ◊ *in the near future the RTA intends to seek the Government's approval to a strategy and timetable to progress the development of the M5 East Motorway including the provision of eight lanes through the General Holmes Drive tunnels*
    - ◊ *the Commonwealth Government is committed to progressing the development of a high quality road link between Sydney and Sydney West Airports*

- that electronic tolling if introduced must be compatible and inter-operable with other such systems operating in Sydney particularly with Harbour crossing systems
- to facilitate the use of the Eastern Distributor by public transport, in particular the requirements of State Transit
- the Sydney City Council's completed Stage 1 feasibility study into a tunnel under Market Street.

On 7 July 1995 the proponents were advised by Blake Dawson Waldron (legal advisers) that the RTA did not require a performance bond as contemplated in the commercial issues document issued with the invitation to submit a Detailed Proposal.

On 21 July 1995 Blake Dawson Waldron advised the proponents that in the invitation to submit a Detailed Proposal, a request was made not to rely on the tax exempt status of the RTA. This qualification was to extend to the tax exempt status of all levels of government, In addition the letter brought to attention an updated Road Safety Audit Manual, provisions for bicycles, Olympic cycling course and noise requirements.

Detailed Proposals were lodged with the RTA by all three proponents on 8 August 1995.

Assessment

Criteria used by the Panel were in accordance with the invitation to prepare Detailed Proposals:

- *conformity with the RTA's Scope of Works and Technical Criteria, including any advantageous technical innovations*
- *commercial benefit to the RTA, Government and Community, measured in terms of*
  - ◊ *the RTA contribution to, or return from, the project*
  - ◊ *tolling regime*
  - ◊ *tollway rental return to the RTA*
  - ◊ *use of surplus land*
  - ◊ *other the RTA revenue from the project*
- *legal aspects*
- *risk exposure to the RTA and Government arising during the negotiation stage of contact development and related to changes in technical, financial or environmental aspects during that phase*
- *the environmental and amenity value.*

The assessment of the Detailed Proposals was undertaken by a panel of three RTA officers and one Public Works and Services officer. Two of the three RTA officers and Public Works and Services officer were on the Preliminary Assessment Panel. Certain professional assistance was provided to the Panel by the same advisers as for the Preliminary Assessment:

Blake Dawson Waldron (legal), UBS Australia Ltd (financial) and Bovis McLachlan Consultants Pty Ltd (technical).

The Probity Auditor appointed to the Preliminary Process continued in that role for the Detailed Assessment.

Detailed Proposals were circulated to the Assessment Panel and the Probity Auditor on 9 August 1995.

The Panel followed, to the extent it could, the NSW Government's February 1995 edition of *Guidelines and Principles for Private Sector Participation in the Provision of Public Infrastructure*. The role of the Panel was to assess the relative merits and benefits of the Detailed Proposal and make a recommendation on the preferred proponent. The Panel was also to identify and report any risks or other issues which the RTA should address during negotiation with the preferred proponent.

Following review of the Detailed Proposal a number of issues from each of the proponents required clarification. Letters of clarification were prepared by Blake Dawson Waldron and sent to the proponents on 28 August 1995. Responses were received on 4 September 1995.

The proponents made presentations on their Detailed Proposals to the Assessment Panel on 11 and 12 September 1995. Clarification of a number of issues raised at the presentations were made in writing by the proponents.

The Assessment Panel papers indicate that at this point assessment of the Detailed Proposal changed to a staged process. The Panel stated that:

> *whilst a staged procedure was not planned at the commencement of the assessment process it was needed to ensure that the best result was achieved in terms of overall benefits to the Government and community and undertaken without impact on the probity of the process.*

The three stages were evolutionary. Before each stage, advice was obtained from the Probity Auditor to help ensure that all probity requirements were satisfied.

Stage 1

This stage consisted of the assessment of the Detailed Proposals as submitted by the proponents, taking identified options for scope change and other project variables into account. This stage as indicated above, consisted of correspondence exchanged between the Panel and the proponent to clarify issues and the formal presentation by the proponents.

Assessment of the Scope of Works and Technical Criteria by the technical advisers indicated that two of the proponents were of a higher standard than the third.

Initial review of the Detailed Proposals found that proponents had adopted significantly different financing strategies, in terms of the concession term, initial payment to Government and future rental.

The initial concession term proposed by the proponents ranged from 27 years to 45 years.

After consultation with the RTA, the Panel determined that the base case to be used for the comparison of the proposals involved:

- no southbound toll
- differential tolling of cars and heavy vehicles
- no joint development of surplus land
- disposal of surplus property by the RTA.

Based on that information, on 22 September 1995 the Panel received reports from the legal, financial and technical advisers. After consideration the Panel was of the opinion that one of the proponents' financial and technical proposal was not as fully developed as the other two. The Panel determined that no further information was required from that proponent because its proposal was considered to be uncompetitive at that point.

After consideration of the information provided by the proponents and the Panel's advisers, the Panel concluded that the financial offer of one proponent provided greater benefits than that of the other. This was subject to traffic forecasts being met, because future rental payments were dependent on traffic flow. The Panel noted that if actual traffic usage was 5% less than the level forecast by the preferred proponent, the other proponent's offer was better in that it provided for an initial contribution.

The Panel also considered the relative merits, both financial and social, of the shorter (27 years) and longer (45 years) concession term proposed. The Panel was of the view that the preferred proponent's proposal offered greater benefits to the community by virtue of the value of the savings to the community through the shorter toll term. The Panel qualified its conclusion by raising doubts over the probability of forecast traffic levels and hence rental returns to the Government.

The Panel considered that if the preferred proponent's proposal was lengthened to 45 years there was potential for the RTA to improve further its return from the project and may realise an increased initial contribution to the cost of ancillary and related works. It would also allow for direct comparison with the other two proponents.

Panel Recommendation

At a meeting held between the Panel and the Chief Executive of the RTA on 26 September 1995, (in attendance was the Probity Auditor and financial adviser), the Panel outlined their findings and recommended that a 45 year term proposal be sought from the preferred proponent.

The Chief Executive, the RTA agreed with the recommendation.

Stage 2

A letter was drafted by the Panel, agreed to by the Probity Auditor, setting out matters that would give the preferred proponent the opportunity to reconsider its financial proposal based on a 45 year concession term. The letter was handed to a representative of the preferred proponent at a meeting attended by two Panel representatives and the Probity Auditor on 27 September 1995.

The revised proposal from the preferred proponent was received on 9 October 1995 and forwarded to the Panel's financial adviser for analysis.

During the period 20 September to 10 October 1995, the other two proponents advised that an additional initial contribution was available due to a recorded reduction in benchmark interest rates. In response to a request from the RTA, the preferred proponent advised on 10 October 1995 that an increase in their initial contribution was possible.

The Panel determined that, because interest rates are volatile and because only the interest rate at financial close was relevant, the proponents' new offers be noted but not be taken into account in the assessment.

A meeting of the Panel on 10 October 1995 considered that, based on the information available to it regarding forecast traffic volumes and toll revenues, the probability of a greater amount of future rental payment being available from the revised preferred proponent's offer made its offer more attractive than the other two proponents' proposals for an equivalent 45 year term.

Panel Recommendation

The Chairman of the Panel reported on 10 October 1995 to the Chief Executive of the RTA that the Assessment Panel recommends the preferred proponent, subject to the underwriting of the debt component of their revised proposal, and the approval of the Budget Committee and Government. The Panel Chairman also noted that a detailed assessment report was being prepared. The report was not signed by the Chairman.

In response to the report, the then Chief Executive of the RTA asked that consideration be given to a 38 year concession period because he considered that a term of 45 years would be unacceptable to the community and that a precedent for a 38 year term had been created by the M2 Motorway.

The RTA (using the information available from all proponents for a 45 year concession term, one proponent's 27 year concession term and from another proponent's 35 year concession term) calculated an estimate of the financial offer of both proponents for a 38 year concession term by extrapolating between the available information.

Chief Executive Recommendation

Based on that information, on 12 October 1995, the Chief Executive forwarded a minute to the Minister for Roads recommending that the Minister

> *approve in principle the selection of ... as the preferred proponent for the Eastern Distributor and authorise the preparation of a submission to the Budget Committee to that effect.*

Apparently the Minister for Roads noted, but did not act on the recommendation pending a review of the assessment by the new RTA Chief Executive. The RTA advises that to the best of its knowledge, the Minister's request for a review was made orally.

Review by new Chief Executive

The incoming Chief Executive was briefed on the project on 16, 17, and 18 October 1995 by the RTA staff and the Panel Chairman.

The Chief Executive provided advice to the Minister for Roads on 18 October 1995 that the estimates of the financial 38 year concession term had been calculated by the RTA and not by the proponents.

After considering all of the issues, the RTA determined that both proponents be asked to prepare a revised financial offer taking into account all of the parameters anticipated by the RTA and based on a 38 year concession term.

The Panel considered that the third proponent not be asked to submit a further offer as it was not as fully developed and at a lower technical standard and that it did not satisfy the Government's stated objective of a no contribution project.

Conclusion

From a review of the papers available to The Audit Office and its consultant, the Assessment Panel and its advisers had the dilemma of comparing the two main proponents' proposals that varied significantly in relation to:

- their assessment of future traffic potential
- the amount and form of the financial return which they offered the RTA
- the length of the concession period.

The RTA realised that the preferred proponent's higher traffic forecast carried with it a higher level of financial risk to the RTA. This was critical because it could affect the financial resilience of the proponent and most importantly, it would affect the likelihood of the RTA receiving the promised rental payments over the life of the project. (At the same time, the other proponent's lower traffic forecast carried the risk that users of the Eastern Distributor might pay more tolls than was warranted, if the higher traffic flows eventuated. This risk to the NSW motorist was not a factor in the RTA's considerations).

At this stage, a very important consideration was lost: namely the benefit of a shorter concession period. No further assessment appears to have been made of the losses involved in rejecting a proposal which proposed a short concession period in favour of one which proposed a longer period.

The Audit Office considers that at this point, when the decision had been made to ask two proponents to revise their financial offer, it would have been reasonable for the RTA to ask that all payments by the proponents to the RTA be made upfront - that is, at least during the construction period and not over the life of the project. This view would have been a logical response to the realisation that most future traffic projections entailed a higher level of risk than the RTA was prepared to bear.

It is unclear why this approach was not adopted. It may have been because the RTA:

- did not want to impose a formal requirement on one bidder at a late stage in the process which it had not previously imposed on the other
- did not want to betray the intellectual property of the other bidder which had proposed most payments upfront (in cash or kind)
- was not advised how to ensure that its own risk preferences could be made to mesh with the very different views of risk clearly manifested by the different proponents.

Stage 3

On 31 October 1995 the Assessment Panel wrote to the two proponents stating that the Panel had been considering a number of alternative scenarios involving options for the concession term, project scope and tolling regime, with an objective of delivering the most beneficial package to Government and the community.

The Panel determined that the financial offers be based on a revised base case including the following project parameters which had been identified by the RTA as the preferred base case:

- *38 year concession term, commencing on the opening of the project to traffic*
- *no tolling of any southbound traffic*
- *a differential toll for heavy vehicles of twice the toll for cars*
- *Interest rates benchmarked at 31 October 1995*
- *all surplus property be disposed of by the RTA*
- *no joint RTA/proponent development of any property*
- *no tolling of public buses*
- *financial close delayed to 31 August 1996*
- *initial contribution based on 'work-in-kind'.*

In addition, the Panel's letters stated that the scope of Eastern Distributor to be used for the preparation of this revised proposal be that as proposed in the proponents' Detailed Proposal. However, the RTA had also identified a number of changes to the scope of the works which it required each proponent to include in their respective base case proposal.

The letters asked the proponents to assess the impact of interest rate sensitivity, traffic sensitivity on three scenarios other than forecast, removal of differential toll on heavy vehicles and an initial cash payment rather than work-in-kind.

Responses were received from the proponents on 6 November 1995 and forwarded to the Panel's financial adviser for analysis and reporting.

On 13 November 1995 the financial advisers concluded that it is apparent that the request for consolidated proposals has resulted in one proponent coming forward with a superior financial offer to the RTA from its previous offer. A follow up letter of 20 November 1995 from the financial advisers stated that:

> *On the assumption that Leightons* [subsequently referred to as AML] *commit to proceeding to financial close without further change to the current assumptions relating to toll escalation (including a minimum toll escalation requirement remaining at 4%), operating costs, the RTA rental arrangements, financing structure and equity return included in their amended proposal of 6 November 1995 and, accordingly, the Initial Contribution proposed can be regarded as fixed other than by reason of interest rate variations or changes to the scope of the project required by the RTA up until financial close, then in our view the Leighton proposal offers to the RTA a better financial outcome than does the* [other proponent's] *proposal.*

The Probity Auditor appointed for the Preliminary Assessment Process continued for the Detailed Assessment Process. A separate report was signed off by the Probity Auditor, as well as signing off the Assessment Panel report that the report was an accurate record of the assessment process.

4.3 Results of Assessment

Panel Recommendation

The Panel considered the two proponent's 38 year term financial proposal and agreed that both proponents had presented the Government with a more attractive proposal in up front payment than previously submitted. At this stage, the Panel also agreed that the future rental payments be disregarded in the assessment, especially because, should there be a 5% reduction in the traffic, the rental payments from one proponent's proposal are eliminated and from the other effectively eliminated.

The Panel after considering all of the information available from each of the proponents agreed that, based on the revised criteria, Airport Motorway Limited (AML) offer contained greater benefits than the previously preferred proponent's proposal in terms of the assessment criteria and the Government's objectives for the Eastern Distributor.

On 23 November 1995 the Assessment Panel signed off the recommendation:

> *After considering all of the information available from each of the proponents the Panel unanimously agrees that the revised proposal of Airport Motorway for a 38 year concession term offers greater benefits than the other proposals in terms of the Government's objectives for the Eastern Distributor as stated in the invitation for Detailed Proposals and subsequent advice to proponents prior to the submission of Detailed Proposals.*
>
> *The Panel recommends that the RTA seek the Government's approval to select Airport Motorway as the preferred proponent for the Eastern Distributor*.
>
> *Furthermore, in the event that negotiations with Airport Motorway are unsuccessful, the Panel recommends that* (the other proponent) *be approached as the preferred proponent. The Panel also recommends that no further consideration be given to the* (third proponent's) *proposal"*.

Chief Executive Recommendation

The Chief Executive, the RTA wrote to the Minister on 24 November 1995 supporting the Assessment Panel's recommendation for AML as the preferred proponent and recommend, that the matter be referred to the Government.

Approval

On 27 November 1995, the Government approved the RTA's recommendation that AML be the preferred proponent for the financing, design, construction, operation and maintenance of the Eastern Distributor tollroad project with a concession term of 38 years; commence preparation of an environmental impact statement; and commence detailed negotiations with AML with a view to execution of a contract by August 1996.

On 13 August 1996 the date of execution of the contract was extended to April 1997. The Minister for Roads announced the decision on the same day, 13 August 1996.

4.4 Nine Month Delay From Recommendation to Announcement

Around nine months elapsed from when the RTA assessed AML on 23 November 1995 as the successful proponent till Cabinet's approval of that selection on 13 August 1996.

The main reason for this delay was an announcement by the Federal Government on 15 November 1995 that it would no longer offer tax benefits in the form of infrastructure borrowing on urban roads.

Although the legislation was never introduced and the restriction did not finally eventuate, the threat was sufficient to halt the progress of the Eastern Distributor project. The threat was not finally removed until 28 June 1996 when the new Federal Government announced that it would reverse the decision.

Technically, the infrastructure bonds remained available during the intervening period. It would appear that the proponents proceeded to lodge applications with the Development Allowance Authority during March and April of 1996. One proponent advised the Government on 31 May 1996 that it had been issued the necessary infrastructure borrowing certificate. AML advised on 4 July that it had been issued a certificate.

Although the State Treasurer had written to his Federal counterpart on 22 January 1996, seeking urgent agreement that the tax benefits be continued for the Eastern Distributor, it seems that no reply was received. The ensuing Federal election led to a change of Government.

4.5 Financial and Other Advice

The financing of a major project, like the Eastern Distributor, requires considerable expertise and sophistication. The intricacies inter-woven in such an arrangement are considerable.

It is thus imperative that, when faced with projects enshrouded in such a financial package, those who evaluate them have expert advice available so that they can come to an informed opinion.

In most instances that informed opinion requires a thorough understanding of how the particular financial package was put together, what are its implications and to what extent the evaluation should or could be relied upon.

It is not apparent to The Audit Office that sufficient expert and sophisticated advice as was necessary for the RTA to perform its function effectively, was commissioned or available to all of RTA's relevant officers at all stages of the project.

The absence of such advice might explain why a recommendation for one preferred proponent was quickly replaced with a recommendation for another.

And as has been seen earlier, the “surplus” payable to the RTA from the project was one, if not the major, factor in the determining the preferred tenderer. The amount of that surplus was affected by interest rate movements. It is not evident to The Audit Office from the papers reviewed as to what extent the connection between the ‘surplus’ and the interest rate movement was taken into account in evaluating the proposals in the early stages of the selection process.

The audit consultant observed that:

> *There has been no independent financial modelling to verify the financial outcomes presented by the* [ultimately successful] *proponent.*

The model was tested for internal consistency, for its sensitivity to risk, but not for its appropriateness as a financial model for the project.

The Audit Office, in discussion with the financial adviser to RTA, was told that they (the financial advisers) saw their role as verifying the results rather than providing alternative solutions or detailed analysis of the consequences of those proposals.

Because there is so much uncertainty about traffic models, the RTA’s relying on competition to deliver the best result might not be prudent. In any event, such reliance was not available for the negotiated changes following the EIS.

The selection and the subsequent announcement of the preferred tenderer on 16 August 1996 was predicated on a “surplus” that was to be available to RTA. But as the “surplus” was affected by the interest rate prevailing at the time, any movement in the interest rate affected that “surplus”. A fall in the interest rate represented an increase and a rise represented an erosion of that surplus.

It was thus important that the RTA manage its exposure to interest rate changes. It received written advice on this from September 1996 and executed hedging arrangements in March 1997.

Detailed Negotiations

On 5 September 1996 the RTA advised AML that it was prepared to enter into detailed negotiations as soon as possible subject to a determination to proceed with the Eastern Distributor project following completion of the environmental assessment process.

The letter emphasised:

- *the Authority's decision to enter into detailed negotiations with the Airport Motorway consortium does not indicate that Airport Motorway has been awarded the project*
- *all outstanding issues between the Authority and the Airport Motorway consortium must be resolved to the Authority's satisfaction and all necessary approvals and consents must be in place before the Authority proceeds to the execution of project documentation.*

Based on evidence to The Audit Office, the issue of the 'risk' attaching to the surplus was actively pursued from around September 1996, when AML advised the RTA about the interest rate risks to which the RTA was exposed. The letter stated that:

> *Whilst our offer is fully underwritten and in line with current market conditions, it remains vulnerable to interest rate variations, changes in the debt and equity markets and changes to taxation or other regulatory matters. This exposure continues until financial closing. Essentially the risk of adverse changes rests with the RTA (as would the gain from market improvement).*
>
> *We are preparing a risk management strategy for your consideration which may permit financial closure as early as December 1996. This will eliminate the RTA's exposure to the factors outlined and facilitate initiation of pre-construction activities to ensure a timely commencement of works. The agreement would allow financial closure with all funds being held on deposit until the completion of the Environmental Assessment and Determination in April 1997.*
>
> *If the determination is* ***not*** *to proceed, a specified "unwinding" process would be automatically triggered. We are negotiating with our financiers to ensure that any unwinding costs to be borne by government would be contained as far as possible. The implementation of a successful strategy would mean that all interest rate variations, changes in the debt and equity markets and changes to taxation or other regulatory matters between*

> *December 1996 and a Determination to proceed in April 1997 would be to the risk of Airport Motorway, not the RTA. The risk would be transferred to the investors.*
>
> *Our legal advice is that provided the implementation of the risk management arrangement is clearly conditional on a Determination to proceed, the integrity of the environmental impact assessment process would not be prejudiced. We acknowledge that the RTA would have to be separately confident of that conclusion.*
>
> *We are preparing discussion papers and draft project documentation to assist consideration by you and your advisers.*

Risk

Following that letter, on 10 October 1996, Macquarie Infrastructure Investment Management Limited, on behalf of AML, forwarded to the RTA a paper on Eastern Distributor - Status and Strategy which discussed amongst other matters: interest rate risk, market conditions risk and early financial closure. The paper was to be discussed at a meeting the next day (11 October 1996) between AML financiers, the RTA and its financial and legal advisers.

The RTA received a letter from AML dated 21 October 1996 which progressed further the earlier observations on financing risks. The letter mentions that a 1% interest rate increase would lead to about a $50m reduction on the surplus payable to the RTA. Conversely, should interest rates fall by 1%, the RTA would benefit by a similar amount.

Following these events, the RTA contacted The Treasury Corporation (TCorp) on 14 November 1996 to assist the RTA to consider the options available to protect RTA from the effect of further interest rate movements.

In a letter 26 November 1996, TCorp advised that

> *Early Financial Close (EFC) as proposed by AM is both politically dangerous and very costly to unwind, and therefore is not a preferred option.*

The letter went on to say that:-

> *Suggested Approach*
>
> *Given the uncertainty surrounding the various aspects of the project, careful consideration must be undertaken before any hedging strategies is implemented. From the RTA's perspective securing the following is essential:-*
>
> 1. *Update of RTA surplus figure, and an agreed methodology for the interest rate sensitivity to this figure.*
>
> 2. *Any advance of the EIS FC helps the RTA's position, particularly if options-based hedging is to be used.*
>
> *Assuming 1. can be secured we would propose a combination of purchased put options and selling of either bond futures or physicals (depending on RTA's logistical preference). A 50/50 split would be sensible, though it may be decided to hedge less than the full exposure. Obviously, any number of permutations exist.*

The EIS for the project was released on 13 November 1996 with a closing date of 24 December 1996.

Alternative Proposals

On 13 March 1997 AML offered a number of alternatives to its proposal. Included were the following:

- *to pay the RTA a concession fee in the amount of $23m, $5m to be paid 6 months after financial close and the balance at toll commencement*
- *the RTA to gain any benefit and bear all risk of the financial impact of interest rate movement between the interest rates applicable on 17 January 1997 (as advised in the financial model dated 27 February 1997) and the date on which the project sets interest rates on the project debt*
- *in the event of an adverse movement in rates from 17 January Airport Motorway will reimburse the RTA from any revenue above base case received in the first three years after opening to traffic up to a maximum of $12m dollars. This was equivalent to the impact of the adverse interest rate movement experienced between 17 January 1997 and 12 March 1997.*

The RTA replied on 18 March 1997 and included the following:

- *Could you provide us with your understanding of relevant interest rates applicable to the project at 17 January 1997 and could you confirm that the movement of interest rates to trigger the payment of revenue to the RTA above your base case is calculated on rates at 17 January 1997.*

and

- *Our reading of your offers of 3 and 13 March 1997 indicate that with current interest rates the project requires a Government contribution during the construction period, whereas your offer of 13 March concludes that "this offer now meets your objective for the project to be delivered without cost of Government". Could you please explain how this offer achieves the no cost to Government objective.*

and

- *Notwithstanding the above, the RTA requires total assurance regarding the methods to be used by your underwriters in placing the indexed bonds onto the market. The RTA's acceptance of an offer from Airport Motorway will be subject to a satisfactory arrangement being entered into with your underwriters so that the RTA is not exposed to interest rate movements caused by the actions of your underwriters in the sale of indexed bonds. The RTA cannot sustain market related expenses post agreement.*

AML responded on 20 March 1997 that they had arranged a meeting with RTA staff, RTA financial advisers, Treasury and TCorp personnel on 21 March 1997 to address the management of the interest rate risk until financial close. The letter also stated:

> *Your desire to better control the RTA interest rate risk exposure is welcomed.*

TCorp forwarded a letter to the RTA dated 21 March 1997 reflecting a number of issues to be addressed in regard to underwriting the financial risks.

Recommendation to Hedge

The RTA wrote to the Minister for Roads, 26 March 1997 recommending:

- that the RTA progress negotiations with Airport Motorway to agree to project details by way of exchange of letters
- that an interest rate hedge be put in place to be supervised by TCorp to protect the project from a further increase on interest rates.

The RTA's submission to arrange for hedging stated that the surplus of $156.9m as at 17 January 1997 had, as a consequence of increases in interest rates, 'declined' by $26.0m. Taken from the date of the announcement of the preferred tenderer on 16 August 1996, when the surplus was $163.1m, the decline or opportunity loss to the RTA represented $32.2m.

The Treasurer on 27 March 1997 approved the RTA:

> *effecting financial adjustments as defined in Section 5 of the Public Authorities (Financial Arrangements) Act 1987 to hedge against interest rises in real yields in respect of the issue of bonds for the Eastern Distributor Project and in management of the Authority's debt portfolio.*

The result is that the 'surplus', effective from 2 April 1997, is now 'locked in'.

In essence, while the selection of the preferred tenderer was made largely on the basis of surplus, that surplus was at risk until it was able to be secured by some means.

The RTA advised The Audit Office that it did not proceed to hedging earlier because of the uncertainty arising from the EIS process. (This offers another issue to consider when - as is recommended - the timing of the EIS process for other projects is reconsidered.)

While The Audit Office agrees that the EIS process may have contributed to the uncertainty of the project, the project is still subject to determination by the Minister for Urban Affairs and Planning and the passing of the bill relating to Centennial Park and Moore Park Trust land acquisition by Parliament.

The Audit Office considers that given the importance attached to "surplus", the RTA should have retained greater documentary evidence as to their assessment and consideration of the strategy that was to be adopted to protect the desired outcome. The evidence available to The Audit Office, especially as it relates to the initial selection, when following a re-consideration of the issues the selection of initial proponent was reversed, does not suggest that the RTA was then adequately conversant with the intricacies of the financial package and its implications for the RTA.

Conclusion

The Audit Office considers that the RTA should ensure that it secures expert financial advice commensurate to the size and financial complexity of the project; and that it involves TCorp from the start in each major project to protect RTA's and motorists' and taxpayers' interests.

4.6 Financial Consultancy

The RTA on 26 September 1994 did invite a number of consultants to provide submissions so that the RTA could appoint an independent financial consultant to assist on the assessment of the Preliminary and Detailed Proposals for the Eastern Distributor Project.

On 9 November 1994 a financial adviser was engaged to provide financial advice on the Preliminary and Detailed Proposals for a fee of $30,000. Fees quoted by 3 other consultants ranged from $95,000 to $250,000.

The RTA on 1 September 1995 approved of an upper fee limit of $95,000 for the project. Reasons for the increase were:

- *The scope and advanced level of development of the Preliminary Proposals exceeded that which was anticipated*
- *Additional meetings and requests for information to seek clarification were required*
- *Certain unusual features such as a credit enhancement structure and Sydney Harbour Bridge refinancing proposals required special attention.*

Again because of the advanced level of development of the Detailed Proposals, it is anticipated that completion of the assessment will similarly involve additional work.

The RTA on 17 November 1996 approved an increase to $150,000 for the consultancy as a result of:

> *... from the need to progressively analyse the information supplied by proponents at the request of the Assessment Panel and to attend meetings to discuss these analyses.*

On 24 December 1996, the RTA approved to extend the services of the adviser to an upper fee limit of $300,000. Reasons for the extension and increases included: rates have increased from the initial appointment; inefficiency in appointing another adviser in the very tight timeframe available to achieve financial close; and the adviser has a detailed understanding of the complex financial structure for this project.

Conclusion

The initial process of selecting a financial adviser for a $30,000 fee suggests that the RTA did not consider the complexity of the issues it would be facing or its dependence on advice throughout a complex and extended process. (That process also contemplated changes would need to be made because of the EIS, the cost of which change would need to be negotiated).

4.7 Specific Probity Issues

A senior executive of the RTA who had been a key player in the preparation of the documents for the Preliminary Proposal left three weeks before the issue of the invitation of Preliminary Proposals. The ex-RTA officer within days became a director of a firm which was making a bid for the Eastern Distributor project.

The propensity for RTA personnel to resign from the RTA and to deal in the private sector with issues they were dealing with in the RTA has been a matter of public record since 1994. It was pointed out in the report of the performance audit "Private Participation in the Provision of Public Infrastructure: The Roads and Traffic Authority" tabled in that year.

On 29 December 1994 the RTA sought advice from ICAC on the action that they had taken to "... overcome any perception that [the separated officer] ... could unduly influence the Assessment Panel because of [a] prior association with the Authority." The measures taken by the RTA at this stage were to:

- appoint a Probity Auditor who was to report direct to the Chief Executive

- include an independent member on the Assessment Panel
- counsel staff still involved in the tender process "... against being unduly influenced by their past relationship with ... [their former supervisor]".

In its advice of 17 January 1995, ICAC stated that both the RTA and the firm involved needed to take further actions to ensure that probity was exercised. The ICAC advice also stated that the RTA should consider replacing the two subordinates who had remained on the tender Assessment Panel or, alternatively, to ensure that all dealing between the RTA employees and their former supervisor were recorded and conducted in the presence of an independent person. ICAC further suggested that the RTA should consider asking all tender panel members ... to sign statements of conduct that outline their obligations to act in good faith.

Conclusion

Based on the documentation provided, it appears to The Audit Office that the subsequent action taken by the RTA was adequate.

The actions taken included:

- the RTA's writing to the firm concerned highlighting the need to monitor communications between their director and the RTA
- the RTA's replacing one of the two affected panel members
- the RTA's putting into place practices that should ensure that all dealings between the affected panel member and the tendering firm's director were recorded and conducted in the presence of a third person
- all panel members signing a Confidentiality Deed Poll in December 1994.

Such situations as the one above are contemplated in ICAC's April 1997 discussion paper titled "Managing Post Separation Employment". The paper has reference to cases referred to ICAC and practices within Australia and overseas. The paper also provides a series of suggestions that might form the basis of formal government action to address the associated risks to public sector integrity and provide a degree of conformity to solutions.

ICAC has called for responses to its paper, following which it is expected to recommend to the Government ways to manage post separation employment risks.

Preferred Proponent

Advice was provided by ICAC on 12 July 1996 following representation by the then Minister for Roads. The two matters of concern were changes made to assessment criteria and the lengthy duration between selection and announcement of the preferred tenderer.

ICAC's advice was supportive of the RTA's actions, finding that the process of selecting the preferred tenderer "... was not tainted although complicated and protracted for a variety of reasons ..."

In ICAC's view, while selection criteria had changed, the RTA "... went to considerable lengths to be fair to the bidders, to the extent of requiring them to submit a number of bids that could be brought to parity for consideration by the panel."

The Assessment Panel had provided its final advice to the Minister on the preferred tenderer in November 1995. However, because of foreshadowed changes to the Commonwealth's tax policy on infrastructure bonds the ratification and announcement of this decision were delayed. They were made in August 1996. In relation to this, ICAC advised the RTA that any period following the close of tenders is a matter for the "... Government to determine." The RTA had also been advised by the Probity Auditor that there had been no material change in the technical specification since the recommendation by the Assessment Panel of the preferred tenderer.

EIS Changes

Advice was provided by ICAC on 20 May 1997 following representations by the RTA dated 12 May 1997. The RTA's concern was whether its proposal to continue with the process advised to proponents in May 1995, to negotiate with the successful proponent changes required to the project as a result of the Environmental Impact Statement (EIS), was acceptable from the viewpoint of probity.

ICAC's advice was that "..the fact that extensive modifications result from an EIS process does not automatically change fundamentally the nature of the project. In this case the need for modifications was anticipated from the outset and is the direct result of the EIS process".

ICAC stated that "...the only factors that should prevent RTA from negotiating the proposed changes with AML from a probity viewpoint, would be if its failure to act impartially or to seek an outcome that represents value for money for the Government".

ICAC concluded that the RTA had acted impartially throughout the project.

On the question of value for money ICAC understood that RTA had received technical advice from its adviser Evans and Peck Management that RTA will be obtaining value for money for the proposed modifications. ICAC also stated that it understood that RTA regards AML's bid as representing best value for money.

ICAC's overall conclusion was that:

> *... the RTA's proposal is consistent with its original intention to modify the works as a result of the EIS, as advised to the preferred proponents. As the course of action we have reviewed shows a commitment to obtaining value for money through an impartial process, we consider that the RTA is entitled to take the view that it should proceed, without further competition.*

Conclusion

The audit consultant advice is that, if it were possible to re-tender the complete project, including the modifications, a lower overall tendered design and construction price would be achieved. The consultant recognised that there are major barriers to this possibility and that re-tendering would itself have costs - including the possibility of litigation by the proponent in relation to their intellectual property - which have to be weighed against any possible savings in the direct construction costs.

5. EIS and Modifications

5.1 The EIS Process and Timing

Requirements of the Environmental Planning and Assessment Act

The Eastern Distributor project is an activity subject to Part 5 of the Environmental Planning and Assessment Act (the Act). As a result of criticism of earlier schemes, particularly the M5 Motorway, the Act was amended in November 1993 to require that such activities be referred to the Minister for Planning for approval. The provisions of the Act now require the approval of the Minister for Urban Affairs and Planning to be obtained, prior to the RTA carrying out the activity.

The Act requires:

- the RTA to examine and take into account to the fullest extent possible, all matters affecting or likely to affect the environment
- the preparation and consideration of an EIS
- the notification and exhibition of the EIS and receipt and consideration of representations
- the RTA to consider all representations and furnish a report to the Director-General of the Department of Urban Affairs and Planning.
- the Director-General to prepare a report for the Minister within three months and the Minister to then make a decision within 21 days.

Audit Approach

The audit did not evaluate the merits of the EIS, of the submissions or the representations made by the RTA in response. The audit was concerned to establish that the above processes had been followed and that the EIS timing/information/methodology offered an appropriate decision making framework.

The EIS for the Eastern Distributor

The EIS process does appear to have been followed by the RTA and its agents:

- Shortly after 13 August 1996, when Cabinet approved the selection of Airport Motorways as the successful proponent, the RTA engaged a consultant to prepare the EIS.
- On 19 September 1996 the Director-General provided the RTA with a list of key issues, principally relating to environmental and social impacts, required to be specifically addressed in the EIS.

- The EIS was exhibited during the period 15 November 1996 to 16 December 1996. The period for acceptance of submissions was extended until 24 December 1996.

Representations

The exhibition attracted widespread public attention and resulted in:

- 475 original representations
- 7 petitions
- 2280 form letters
- representations from government agencies

Whilst the closing date for representations was 24 December 1996, late representations were accepted until 14 January 1997. The RTA appears to have responded to each issue in its Representation Report.

Significant concerns were raised by the submissions, particularly in relation to:

- the impact of the road on the Art Gallery
- the severance between Woolloomooloo and the City created by a widened Palmer Street
- severance, noise and visual problems along a widened South Dowling Street
- the impact on Moore Park.

The RTA Response

The RTA responded quickly and positively to the community concerns. An urban designer was engaged to work with the RTA's technical advisers to examine 'affordable' improvements to address those concerns. A number of proposals were formulated and discussions with Airport Motorway commenced during January 1997. Additionally, the RTA engaged a consultant to check the prices quoted by Airport Motorway.

The Audit Office's own consultant is satisfied that the estimation process was reasonable, given the limited time and the limited design information available. The consultant also considers that the estimated costs are likely to be higher than would be experienced from actual construction. This reflects the limited time in which AML were required to make an offer and the necessarily conservative estimates made in such circumstances.

The following modifications have been proposed by the RTA to address the concerns raised by the community:

- an extensive (approximately one hectare) landscaped cover over the road to the north of the Art Gallery
- tunnel portals being located north of Cathedral Street
- lowering of motorway lanes to 4-5 metres below the existing road level and extensive landscaping along the interface between Moore Park and the residential area of Surry Hills.

The total costs of $132m - including design, construction, operating and maintenance costs - appear in the RTA's Representation Report as follows:

Cover adjacent to Art Gallery	$41.3m
Tunnel extension to north of Cathedral St	$21.7m
Parkway Option	$60.5m
Underpass extension near Todman Ave	$8.7m

These modifications were announced by the Minister for Roads on 8 and 9 April 1997.

Observation

Whilst the RTA has moved quickly to address the concerns raised by the EIS process, the extent of the modifications and the time needed to develop the RTA's latest proposals raise two questions.

The first is whether re-tendering should have taken place. The RTA sought advice from ICAC on this issue. (The ICAC advised on 20 May 1997 that from its view a new tender was not required.) The project increased in cost from around $552m to $684m representing a 24% increase. As indicated elsewhere in the report, the increase was not subject to tender. The audit consultants have expressed the view that if it were possible to re-tender the complete project, including the modifications, a lower overall design and construction cost would likely be achieved. However, it is also accepted that there are major barriers to this process and that re-tendering would itself have costs.

The second question concerns timing. The Eastern Distributor represents the first such major review that DUAP has undertaken. The legislation provides 3 months for DUAP to respond to the RTA's Representation Report, after which the Minister has 21 days to discuss with the Minister for Roads DUAP's conclusions. The legislation thus allows a determination as late as August.

Timing pressures also arise because of the important role which the Eastern Distributor has for the Sydney Olympic Games. The Government had earlier been advised that traffic problems would be acute without an Eastern Distributor. Lately, the Government has advised that, unless the Eastern Distributor commences soon, the project will need to be deferred until after the Olympic Games. The problems caused by an incomplete Eastern Distributor seems to be worse than having no Eastern Distributor. There are also cost-escalation payments that RTA faces on any delayed signing of the contracts with AML.

These pressures ought not influence the work of the Department of Urban Affairs and Planning or the decision making of the Minister. But the appearance of due process are not unaffected by these financial and other consequences that are potentially at play.

5.2 Modifications Not Chosen in Response to the EIS

Main Proposals

The RTA received many suggestions for modifications to the proposed Eastern Distributor. Three proposals, which were not chosen, appeared to encapsulate many of the other proposals. These were:

- **the City of Sydney Council proposal for Woolloomooloo**

the motorway would be built in a tunnel between William Street and the Domain Tunnel - the RTA has estimated total additional costs of $162m.

The RTA does not favour this proposal, principally on the grounds of engineering difficulties and its relatively high cost.

- **South Sydney City Council's proposal - the full tunnel**

the main through traffic lanes would be placed in a full tunnel from the Cahill Expressway to Southern Cross Drive - the RTA has estimated total additional costs of $436m.

The RTA does not favour this proposal, primarily due to the additional cost, which could not be supported without considerable government funding.

- **the 1985 option**

  the original two lane tunnel scheme under Darlinghurst.

The RTA no longer favours this option, principally on the grounds of the greater road user economic benefits attainable from the modified proposal (although the ratio of benefits to costs is lower).

Other Tunnel Options

In response to the more general request by the Legislative Council for tunnelling costs, The audit consultants have provided a series of costs, as shown in Table 5.1 and discussed in sections 5 and 6 of the consultant's report in Part 2 of this Report.

Table 5.1: Estimated costs for further tunnel options

A landscaped "canopy" type cover from Macquarie Street to Art Gallery canopy. Note, ramps from Macquarie Street would still partly separate the Domain from the Botanical Gardens.	$58m total
Extension of the Art Gallery canopy over the toll plaza and grading to a cut and cover tunnel along Palmer Street to current proposed tunnels at Cathedral Street	$64m total
Cut and cover tunnel from Driver's Triangle to Cleveland Street to replace Parkway option.	$73m total
Cut and cover tunnel from Cleveland Street to join current proposed tunnel under Dacey Avenue.	$109m total
Cut and cover tunnel from Todman Avenue to Link Road.	$47m total
TOTALS: **Tunnel South Dowling / Dowling Streets** **Canopy/Tunnel Macquarie Street to William Street**	 $229m $184m*

Note: * Includes Art Gallery canopy and extension to tunnels under Cathedral Street as estimated (at $62m) by EPM.

The audit consultant reports in section 6 of part 2 of the report as follows:

> *... that* [the extra tunnelling] *could not be financed by a marginal increase in either the proposed toll or the concession period.*
>
> *The implied cost of the Eastern Distributor with full tunnelling from Southern Cross Drive to Macquarie Street / Cahill Tunnel ... would be over $900m. The level of toll required to fund this level of expenditure over, say, 50 years would have a very significant impact on the likely traffic flow.*
>
> *Full tunnelling would probably require a return to the original specification of a two-lane tunnel throughout. For example, if the total cost could be held to $650m, the required toll could perhaps be set in the $4.00 - $4.50 range with a loss of traffic (compared to the original $2.00 toll proposal) of about one quarter. (The higher toll would apply to a trip all the way from Southern Cross Drive to the Harbour Tunnel; lower tolls might be feasible at intermediate exit points).*

Observations

The audit draws the following conclusion from the consultants analysis:

- the audit consultant’s tunnelling costs are of the same order as those provided by the RTA
- the costs of additional tunnelling do not appear bearable by the toll.

6. Other Matters

6.1 Project and Associated Costs

The Legislative Council raised the issue of the full cost of the government contribution to the project in terms of necessary associated roadworks and other expenses.

Project Costs

The proposed financing of the Eastern Distributor, including the modifications following the EIS, is outlined in Table 6.1 of part 2 of this report. This is based on the latest information to hand (as at 12 May 1997) and represents an estimated reconciliation of the available data, taking into account:

- changes in the cost of the base project
- enhancements proposed following the EIS
- additional expenses incurred by the RTA.

The overall capital cost of the project has increased by about $166m. In addition, there are increases in operating and maintenance expenses of about $23m. The cost of the project has also been extended to cover $11.2m of works to Southern Cross Drive.

The total increase in cost is therefore estimated to be about $200m.

Recent changes in interest rates and the need to hedge against future interest rate changes have effectively added about $33m to the cost of the project.

The original proposal, without the modifications incorporated following the EIS, as put forward by the proponent, would have generated a surplus for the RTA of $163m (on an equivalent nominal basis).

This is no longer sufficient to cover all the costs now proposed. The difference is being financed as follows:

	($ million)
Costs above basic project	$200
Additional financing charges	$33
ADDITIONAL OUTGOINGS	**$233**
Previous surplus	$163
Increased revenue	
due to increased toll	$34
due to longer concession	$9
Provision for conditional payments	
by proponent to RTA	$15
RTA shortfall after meeting	
proponent's overall deficit	$12
AVAILABLE SOURCES OF FINANCE	**$233**

The conditional payments by the proponent to the RTA will occur if the traffic in the first three years following the opening of the Eastern Distributor (as currently planned) exceeds the proponent's current estimates. If it does not, the RTA will not receive $15 million; but since the proponent's expected deficit will be eliminated, it is possible that the RTA's consequent increase in expenditure could be contained. This will depend on as yet incomplete negotiations.

Associated Works

The audit consultant confirms that all necessary roadworks associated with the project are included, with one minor exception - the re-phasing of the traffic signals surrounding the Eastern Distributor. To satisfy substantially changed traffic patterns approximately thirty sets of signals will require re-phasing. Some signals may also require some reconstruction. This additional cost has been estimated at approximately $150,000.

In the longer term, the implementation of an Eastern Distributor will change the need for, and scope of, the works (e.g. maintenance and minor modifications) required on surrounding roads. Reduced traffic volumes on some roads may reduce the works that would otherwise be required. Similarly, increased traffic on feeder roads may increase the works needed there. The calculation of these costs is not possible within the scope of the present investigation. Such a calculation would require substantial traffic modelling and would, at best, be only indicative.

6.2 Light Rail Costs

The Legislative Council raised the question of the cost of light rail to the Showground, Sportsground and Fox Studio complex and to Kensington to cater for transport needs.

Cost to Kensington

The Department of Transport (DoT) has supplied indicative capital costs for a light rail line from the City to the Showground (Fox studios) and Kensington. The DoT estimated the total cost to be $125m to provide vehicles, tracks both at street level and on a dedicated right of way, stops and a depot/maintenance facility for a five kilometre route. The suggested route would travel from Pitt/Castlereagh Streets in the city to the University of New South Wales via Oxford Street, Flinders Street, the Moore Park bus roadway and Anzac Parade.

Audit Conclusion

Whilst a light rail line might represent a worthwhile project in its own right, it is not likely to offer a successful alternative to the Eastern Distributor. As discussed more fully in section 4 of Part 2 of this Report:

> *Light rail is most effective where it offers relatively frequent stops and serves higher density residential and commercial areas. These characteristics are not presently shared by the (southern part of the) Eastern Distributor-Dowling Street-Southern Cross route.*

6.3 Costing Environmental Impacts

The Legislative Council has requested an estimate of the total cost associated with the air and noise pollution generated by the Eastern Distributor and of the open space which will be lost.

As outlined in Part 2, section 7, of this report, neither the NSW Treasury nor the EPA nor the RTA recommend ‘official’ methods for the evaluation of environmental costs or disbenefits.

The Audit consultant reports:

> *The reviews highlight the limited amount of information that is available about the ‘true economic cost’ of air and noise pollution. Indeed even the concept is open to more than one interpretation.*

As the reviews indicate, in these circumstances the practice of analysts has been to take a cautious view about the conversion of estimates of physical noise and air pollution emissions into economic values. The attitude of those involved in the appraisal of projects for public investment and for EIS assessments contrasts with the approach taken by advocates who may be inclined to adopt measures which most strongly support their point of view.

Air and Noise Costs

The audit consultants have prepared an approximate estimate of air and noise emission costs, included as Table 7.3 in Part 2 of this report. The results suggest that:

> *... the Eastern Distributor will generate some economic disbenefit from the related air and noise pollution impacts but that the changes specifically attributable to the Eastern Distributor will be minuscule.*

Over a 36 year period these impacts, based on the limited knowledge and methodologies currently available, may cost in net present value terms around $1m in noise pollution and $1m in air pollution. If costs assumed to be associated with green-house effects are also included, the air pollution costs increase to $25m.

Open Space Costs

The principal loss of open space is associated with the loss of part of Moore Park. The audit consultants have examined best practice in this area, included as Appendix A2 of Part 2 of this report. The subject of Moore Park is examined below.

6.4 Centennial Park and Moore Park Trust Compensation

Proposed Compensation Package

The proposed works for the Eastern Distributor would result in a loss of recreational park land administered by the Centennial Park and Moore Park Trust. In particular, the ‘Parkway’ proposal has doubled the amount of land required by the RTA from one hectare to two hectares.

It is anticipated that the Trust’s final agreement with the RTA will be submitted to the Government, prior to the Government’s final decision to proceed with the project.

As a guide to the valuation of the land:

- the Valuer-General noted:

  The 8 metre wide strip to be acquired by the Roads and Traffic Authority is considered to have no residential potential whatsoever

  *Hypothetically, however, a two (2) hectare site in this location with residential potential and with all services connected would be worth in the order of **Twelve Million Five Hundred Thousand Dollars ($12,500,000).***

- the audit consultants report in section 7 of part 2 of the report:

  In theory the land adjacent to the proposed Parkway could be sold for high density residential development. If this were permitted, the land would undoubtedly command a very high value, offering both accessibility benefits and proximity to the park

  Since this is inconceivable, a more realistic valuation would be based on the estimated recreational and non-user value attributed to Centennial Park On this basis the 2.2 hectares of Moore Park required for the Eastern Distributor would be worth about $6.8 million (at 1997 prices). This assumes that the cost of restoring landscaping and natural vegetation, and the cost of ensuring that the boundary between the land required for the Parkway and Moore Park was appropriately treated, were fully borne by the proponent.

- the Trust prepared a financial impact study in February 1997 which summarised cost implications for the Park as follows:

Cost implications if the ‘Parkway’ alternative concept is adopted	
Description	**Value**
Valuation	$5,831,795
Financial Impact on business activities*	$2,105,000
Miscellaneous costs for the Trust*	$ 14,840

** Incomplete valuations, not fully determined*

At the time of writing, the Trust and the RTA had not yet reached final agreement on compensation arrangements.

In exchange for the acquisition of one hectare, plus the licensed use of one hectare, the RTA and the Trust have been negotiating compensation arrangements which, based on information available at 12 May 1997, included:

- $12m for improvements to Moore Park
- $0.5m of "work in kind" from AML to restore playing fields after the construction of the Eastern Distributor
- landscaping of South Dowling Street by AML as part of the Eastern Distributor project
- inclusion in the RTA forward works program of a number of traffic management improvement works (including some additional traffic lights and improved pedestrian access).

Additionally, it is intended that:

- the Trust will liaise with the RTA to develop a strategy for the staged removal of surface car parking from Moore Park
- the RTA will liaise with South Sydney Council to remove the County Road reservation from the various planning instruments relating to the Moore Park precinct
- the RTA will use its best endeavours to have certain sections of unmade road re-proclaimed as parklands dedicated to the Trust.

Planned Use

The Trust's proposed plan for the use of $12m available for improvements is as follows:

- $5m contribution to the cost of an underground car park
- $1.25m for the relocation and construction of the Frank Saywell kindergarten
- $1.38m allowance for fees (project management, design/documentation, legal and supervision)
- $4.37m for improvements to the playing areas and general landscaping to the standard of Centennial Park.

Audit Observations

Allowing for the fact that, at the time this report was drafted, the Trust had not completed its negotiations with the RTA, the audit makes the following observations:

- there is no available Government policy or guidance with which to value parkland, particularly when that land is subject to recreational use by the public
- the Trust's claim for compensation has been based on a financial impact study, dealing principally with the value of assets lost and the impact on business activities
- the losses identified in the impact study appear to be of the same order as the compensation figure the Trust has negotiated
- the $12m amount is not due to be fully paid until 30 June 2000
- whilst half of the compensation package is intended to be allocated towards an underground car park, such a development cannot proceed until the Government allocates / finds the additional funds needed to cover the cost.

Appendices

Appendix 1 - Legislative Council Resolution

17 April 1997

1. That this House calls on the Auditor-General to immediately and urgently review the terms and conditions of any project deeds, contracts, agreements, Preliminary agreements or variations reached, or proposed to be reached, between the New South Wales Government and the Airport Motorway Consortium concerning the proposed Eastern Distributor.

2. That in conducting any review, the Auditor-General obtain independent engineering, environmental and all other necessary advice on all matters relating to the Government's proposal, including, but not restricted to, the following matters:

   (a) whether the proposed toll and concession period represents the best deal for the New South Wales taxpayer;

   (b) whether:
   (i) a full tunnel along South Dowling Street and Dowling Street; or
   (ii) a full tunnel from Macquarie Street as originally planned; or
   (iii) both (i) and (ii); or
   (iv) an option that involves substantially more tunnelling than is currently proposed, is affordable given the currently proposed toll and concession period;

   (c) the cost of air, noise pollution and loss of open space, when the project is operating at full capacity;

   (d) the adequacy of the strategic transport planning framework for the distributor at this time;

   (e) the cost of light rail to the Showground, Sportsground and Fox Studio complex and to Kensington to cater for transport needs;

   (f) whether the current proposal represents the best environmental outcome;

(g) the full cost of the government contribution to the project in terms of necessary associated roadworks and other expenses; and

(h) the arrangements made for Centennial Park and Moore Park Trust concerning compensation for the use/transfer of land to/for the RTA-airport motorway consortium.

3. That this House calls upon the Government to make all documents, including Cabinet and legal documents and submissions to the Environmental Impact Statement, available to the Auditor-General to ensure a full and indepth inquiry under the terms of this resolution.

4. That this House calls on the Auditor-General to examine the contracts, project deed and/or agreements to determine whether compensation is payable to the consortium in the event that competing public transport routes are built.

5. That this House calls on the Government to allocate any additional funds to the Auditor-General that the Auditor-General considers necessary to properly complete the enquiry.

6. That the Auditor-General report to Parliament as soon as practicable after the passing of this resolution.

Appendix 2 - Comment on Resolution

Resolution 1

That this House calls on the Auditor-General to immediately and urgently review the terms and conditions of any project deeds, contracts, agreements, Preliminary agreements or variations reached, or proposed to be reached, between the New South Wales Government and the Airport Motorway Consortium concerning the proposed Eastern Distributor.

Comment

A review, subject to the limitations outlined in the Executive Summary, of issues relating to the proposed Eastern Distributor has been carried out. To assist in the review, The Audit Office employed the assistance of Kinhill Engineering Pty Ltd, to assist with some of the technical evaluation of the proposed project. Then consultant's report is attached in full as part of this report.

The Audit Office also contracted Gilbert & Tobin Lawyers to assist with the review of the legal documents. As the contract between RTA and Airport Motorway Limited (AML) has not been finalised, The Audit Office did not consider it to be appropriate to incorporate the full report from the lawyers. It may contain references that could be prejudicial to the negotiation currently under way between RTA and AML. While the full report has been provided to RTA, only a shortened version of the lawyers' report forms part of this report.

The report contains all the observations, comments and recommendations of The Audit Office arising out of this performance audit.

Resolution 2

That in conducting any review, the Auditor-General obtain independent engineering, environmental and all other necessary advice on all matters relating to the Government's proposal, including, but not restricted to, the following matters:

(a) ***whether the proposed toll and concession period represents the best deal for the New South Wales taxpayer***;

Comment

As stated in the Executive Summary, The Audit Office, for a number of reasons, is not in the position to determine "whether the proposed toll and concession period represents the best deal". It has, however, evaluated and compared some elements of the proposals and evaluated the procedures adopted in determining the proposed outcome.

The audit indicates some shortcomings in the evaluation process by RTA, particularly the lack of rigorous financial analysis and advice. It also indicates the lack of evaluation of alternatives arising out of the EIS as they impact on the concessional period and the toll.

(b) whether:
- ***(i) a full tunnel along South Dowling Street and Dowling Street; or***
- ***(ii) a full tunnel from Macquarie Street as originally planned; or***
- ***(iii) both (i) and (ii); or***
- ***(iv) an option that involves substantially more tunnelling than is currently proposed,***

is affordable given the currently proposed toll and concession period;

Comments

The Audit Office contracted Kinhill Engineers to provide advice on a number of technical issues. These matters are addressed in section 5 of Part 1 and sections 5 and 6 of Part 2 of the report.

The audit highlights the relatively high cost of additional tunnelling and the relatively poor capacity of the current toll arrangement to fund such works. The audit consultant has estimated the approximate costs of particular options and comments on the likely affordability of such options. These are dealt with in more detail in section 5 of Part 2 of the report.

(c) the cost of air, noise pollution and loss of open space, when the project is operating at full capacity;

Comments

The Audit Office asked its consultant to investigate best practice in this area and to advise approximate costs, where this was possible. The subject is discussed in section 6.3 of Part 1 and section 7 of Part 2 of the report.

The Audit Office notes the absence of ‘official’ methods for the evaluation of environmental costs or disbenefits. Approximate costs are developed by the consultants as a guide.

(d) the adequacy of the strategic transport planning framework for the distributor at this time;

Comments

The Audit Office has reviewed the strategic transport planning framework, as it exists, in relation to the Eastern Distributor. A number of documents have been produced in draft form by the Department of Transport and RTA with broad policy objectives and indicative strategic planning goals for the system as a whole and for the metropolitan road network in particular.

The planning framework is examined in section 3.1 of Part 1 and section 3 of Part 2 of the report. The report identifies the inadequacy of the framework and the inappropriate role now accorded the EIS in the absence of a satisfactory strategic assessment earlier in the process.

(e) the cost of light rail to the Showground, Sportsground and Fox Studio complex and to Kensington to cater for transport needs;

Comments

The Department of Transport has provided costs and The Audit Office has included comment on the extent to which light rail represents a factor in planning for an Eastern Distributor.

The cost and relevance to the Eastern Distributor proposal of light rail is discussed in section 6.2 of Part 1 and sections 4 and 5 of Part 2 of the report.

(f) whether the current proposal represents the best environmental outcome;

Comments

The audit examined the assessment of the proposal and the valuation of disbenefits associated with air, noise and open space. Environmental issues are included in sections 3 and 5 of Part 1 and 3,7 and 8 of Part 2.

As indicated in the Executive Summary, The Audit Office is not in a position to draw any conclusions in relation to this issue, which is properly the responsibility of DUAP.

(g) the full cost of the government contribution to the project in terms of necessary associated roadworks and other expenses; and

Comments

The Audit Office arranged a brief, detailed review of the engineering costs associated with the project and a review of the risks to RTA associated with the proposed Project Deed. This is covered in section 6.1 of Part 1 and section 5 of Part 2.

The Audit consultant has identified only minor works, additional to the project, which will be required at commencement. Attention is drawn to longer term impacts on surrounding roads and longer term risks to RTA, under the terms of the proposed agreement with Airport Motorway.

(h) the arrangements made for Centennial Park and Moore Park Trust concerning compensation for the use/transfer of land to/for the RTA-airport motorway consortium.

Comments

The Audit Office has reviewed a draft Memorandum of Understanding and examined the Trust's justification for compensation and its plans for use of the amount in question. The matter is addressed in section 6.4 of the report.

The examination notes that the Trust had not, as at the time this report was drafted, completed its negotiations and highlights the absence of Government policy or guidance with which to value recreational parkland.

Resolution 3

That this House calls upon the Government to make all documents, including Cabinet and legal documents and submissions to the Environmental Impact Statement, available to the Auditor-General to ensure a full and indepth inquiry under the terms of this resolution.

Comments

Material provided.

Resolution 4

That this House calls on the Auditor-General to examine the contracts, project deed and/or agreements to determine whether compensation is payable to the consortium in the event that competing public transport routes are built.

Comments

The Audit Office contracted Gilbert and Tobin to examine and advise on this issue based on a review of the draft Project Deed between the RTA and the consortium associated with Airport Motorway (AML). The advice is that compensation is not payable to AML in the event that competing public transport routes are built. This is addressed in section 2 of part 1 of the report.

Appendix 3

LEGAL REPORT RELATING TO THE REVIEW OF THE EASTERN DISTRIBUTOR PROJECT

(Summary Report)

GILBERT TOBIN

50 Carrington Street Sydney NSW 2000 Australia GPO 3810 Sydney 2001
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1. Requested Advice

The NSW Legislative Council passed a resolution on 17 April 1997 referring a number of questions relating to the proposed Eastern Distributor Project to the Auditor-General. The Audit Office has engaged us to advise on certain legal matters to contribute to the Auditor-General's review of aspects of the proposed Eastern Distributor Project. We have been asked to perform the following tasks to assist the Auditor-General in his review:

(a) A review of the draft Project Deed between Roads and Traffic Authority of New South Wales (RTA) and the consortium associated with Airport Motorway Limited (AML) in order to respond to the resolution of the Legislative Council: "*That this House calls on the Auditor-General to examine the contracts, Project Deed and/or agreements to determine whether compensation is payable to the consortium in the event that competing public transport routes are built*".

(b) A review of the draft memorandum of understanding between RTA and Centennial Park and Moore Park Trust in order to respond to the resolution of the Legislative Council: "*That in conducting any review, the Auditor-General obtain independent engineering, environmental and all other necessary advice on all matters relating to the Government's proposal, including, but not restricted to, the following matters...the arrangements made for Centennial Park and Moore Park Trust concerning compensation for the use/transfer of land to/for the RTA-airport motorway consortium*".

(c) A review of the draft Project Deed and supporting documents to establish the costs, liabilities and risks likely to be faced over the life of the Project by the NSW Government and taxpayers if the Eastern Distributor Project is approved by 10 June without significant amendment, in order to contribute to the Auditor-General's review of: "*the full cost of the government contribution to the Project in terms of necessary roadworks and other expenses*".

(d) A review of the agreements currently in place between RTA and AML to determine the costs, liabilities and risks faced by the NSW Government should significant changes be required in the current proposal and/or:

- the Project start is delayed by less than 3 months;
- the Project start is delayed by up to a year; or
- the Project is delayed until after 2000,

in order to contribute to the Auditor-General's review of: "*the full cost of the government contribution to the Project in terms of necessary roadworks and other expenses*".

(e) A review of the draft Project Deed to establish whether the following changes in policy could be accommodated, and the implications for the NSW Government and its taxpayers if it could:

- a variable toll (by time of day) to reflect congestion pricing;
- removing or increasing tolls on other parts of the road network (eg Sydney Harbour Bridge/Tunnel, M5, across the network);
- the introduction of an automatic/ electronic toll system on the Eastern Distributor and elsewhere on the road network (that might not require tollbooths, at least in the same number, and might allow tolling in both directions);
- the non-completion of road links or improvements (eg M5 east, General Holmes Drive widening, removal of Cahill Expressway) and the building of new roads (eg East-West tunnel).

(f) A review of the draft Project documents to consider the effect on the RTA of changes in interest rates and traffic flows.

2. Basis of our Advice

We note the following matters in relation to our advice:

(a) The questions referred to us by The Audit Office refer to the NSW Government and taxpayers. For the purposes of our advice we have treated the costs, risks and liabilities of the RTA as being the costs, risks and liabilities of the NSW Government and taxpayers.

(b) Unless mentioned otherwise, our advice is limited to answering the questions referred to us. We have not investigated the legality or validity of other matters which may arise in relation to the documents, for example whether the process to date has complied with the provisions of the Environmental Planning and Assessment Act.

(c) We have not addressed the commerciality of the proposed arrangements between the RTA and AML apart from where issues arose as a result of our analysis of the costs, risks and liabilities to the NSW Government and taxpayers.

(d) We have not been provided with a number of documents relating to the Project, either because they did not appear to be strictly relevant to the questions referred to us or because they have not yet been prepared. In particular, we have not been provided with and therefore have not reviewed the Scope of Works and Technical Criteria associated with the Project Deed.

(e) All the documents we have reviewed have been either:

   (a) drafts of documents which appear to be in the course of negotiation; or

   (b) copies of correspondence dealing with the negotiations and providing information relating to the Project.

Subject to specific instances which will be addressed in our advice, the Project Deed and associated Project documents do not constitute legally binding agreements in relation to the Eastern Distributor Project. Accordingly, our comments must be read subject to the overriding qualifications that:

(a) the positions we describe are not necessarily final in the absence of binding documentation; and

(b) either the RTA or AML could withdraw from participation in the Project at any time up until final documents are signed.

We have not been asked to consider the legal liabilities of the RTA or the NSW Government if the negotiations with AML were to be discontinued.

As the documents we have reviewed are drafts, those documents particularly the Project Deed, are missing Schedules, Exhibits and relevant items of detail, for example, dates and amounts.

(f) In identifying and describing possible costs to the RTA, the NSW Government or taxpayers we have not taken into account whether, and if so to what extent, those costs may be offset by benefits which may be received by the RTA under the Project Deed, principally being the receipt of concession fees from AML.

(g) The majority of the correspondence provided to us is by or to Airport Motorway Limited (AML). The Project Deed and other draft project documents are proposed to be entered into with AML and the (as yet unnamed) trustee of the Airport Motorway Trust. In many cases the rights and obligations of AML and the trustee are identical although the liabilities of the trustee are limited to its capacity as trustee. For ease of reference we will refer to AML and the trustee collectively as AML unless it is important to distinguish between them.

3. Short Answers to Questions

Subject to the reservations stated in paragraph 2 above, our full answers in Section 5 and based on documents we have reviewed, our short answers to matters (a) to (f) in Section 1 above, are as follows:

(a) Under the draft Project documents, compensation would not be payable to AML in the event that competing public transport routes were built. However in certain circumstances the RTA may be required to renegotiate the Project in a manner which may result in extra cost to the RTA or the RTA being exposed to a claim for damages.

(b) Subject to the details and conditions described in our full answer to this question, the compensation currently proposed to be provided to Centennial Park and Moore Park Trust is as follows:

- (i) From the RTA:
  - A. $12 million;
  - B. development of a bus interchange to a maximum cost of $2 million;
  - C. traffic management improvement works;
  - D. assistance in relation to:
    - (i) developing a strategy for the staged removal of surface car parking from Moore Park;
    - (ii) removal of County Road Reservation from Moore Park planning instruments; and
    - (iii) deproclamation of unmade roads and their proclamation as parklands.

(ii) From AML:

A. $500,000 of "work in kind" to restore playing fields after construction of the Eastern Distributor; and

B. landscaping of South Dowling Street as part of the Eastern Distributor Project.

(c) The draft Project documents in their present form, would give rise to some costs, liabilities and risks which would be borne by the NSW Government and taxpayers. Some of these matters would result in a direct and unconditional contribution by the Government to the Project, for example, the cost of specified road works and traffic system management works. Other costs, liabilities and risks are conditional or contingent upon other events occurring.

(d) As binding Project documents have not been signed, the RTA is not liable to pay any costs in relation to changes in the Project or delays in the commencement of the Project.

Certain Preliminary agreements have been entered into which provide for the RTA to bear the following:

(i) reimbursement of certain of AML's pre-construction costs; and

(ii) costs associated with arrangements for hedging pre-documentation interest rate risk. If Project documents are not signed the RTA also bears the risk/gain resulting from interest rate movements.

All of these costs and risks, other than the underwriting fee would become costs of the project and would not be borne by the RTA once the Project documents were signed.

If the draft Project documents were signed in their present form and the RTA required changes to the Project or delays in commencement of the Project occurred, the RTA would face possible costs, liabilities and risks. Specific costs, liabilities and risks cannot be identified at this time because the nature of the costs, liabilities and risks would depend upon the nature and cause of the proposed changes or delays.

Our answers are strictly from a legal viewpoint. We have not examined the possible costs, risks and liabilities to the RTA from a non-legal viewpoint, for example costs, risks and liabilities involved in altering its commercial arrangements with AML from those presently proposed.

(e) The draft Project Deed deals to a limited extent with collection of tolls, both in relation to the Eastern Distributor and other parts of the Sydney road network. Changes to tolls on other parts of the Sydney road network may expose the NSW Government and taxpayers indirectly to costs or liabilities under the Project Deed.

Any changes to the toll arrangements for the Eastern Distributor except for indexation in accordance with the draft Project Deed would have to be agreed between the RTA and AML, at a possible cost to the RTA.

Under the Project documents, the RTA would undertake certain obligations relating to constructing road links or other roadworks and traffic system management requirements. Failure to comply with these obligations would expose the RTA to costs and liabilities which in some cases are specified and in others are unspecified.

(f) After execution of Project documents, the RTA will have no direct exposure to the risk of interest rate changes or change in traffic flows. Some indirect risks exist.

We would be happy to discuss the matter further at your convenience.

Yours faithfully
GILBERT & TOBIN

A J TOBIN

Appendix 4 - A Brief History

This appendix traces the development of the Eastern Distributor, from its conception in 1951 as part of a ring road around the city centre, to its present form as a motorway extending from the Cahill Expressway to the airport. The many changes to its form are apparent.

City Ring Road

When the Eastern Distributor was first considered in the County of Cumberland Scheme of 1951, it was part of a ring road system around the City Centre, designed to collect through traffic from freeways radiating from the centre and “distribute” it in various directions, by-passing City streets.

In the decades that followed, many of the inner urban freeway corridors were abandoned. Whilst the need to “distribute” traffic from freeways was removed, the concept of an Eastern Distributor was retained to provide a by-pass of the congested inner city.

City By-pass

The nature of traffic on the eastern side of the city changed considerably, particularly with the construction of the Cahill Expressway, the expansion of Sydney Airport and Port Botany and the construction of Southern Cross Drive. Pressure to remove through traffic from the inner eastern suburbs increased.

1984 Scheme

In 1984 the Department of Main Roads proposed construction of an Eastern Distributor as a surface freeway with underpasses at William Street and Oxford Street. Following expressions of public concern, the scheme was re-designed to place the Eastern Distributor in a tunnel from north of William Street to the intersections of South Dowling, Moore Park Road and Anzac Parade (known as Drivers Triangle). An EIS was prepared on this scheme in 1985, to be built in three stages. The EIS was subsequently determined and Stage 1, the tunnel under William Street, was built in 1987. (Stages 2 and 3 involved the full length tunnels in each direction).

Stages 2 and 3 were not constructed.

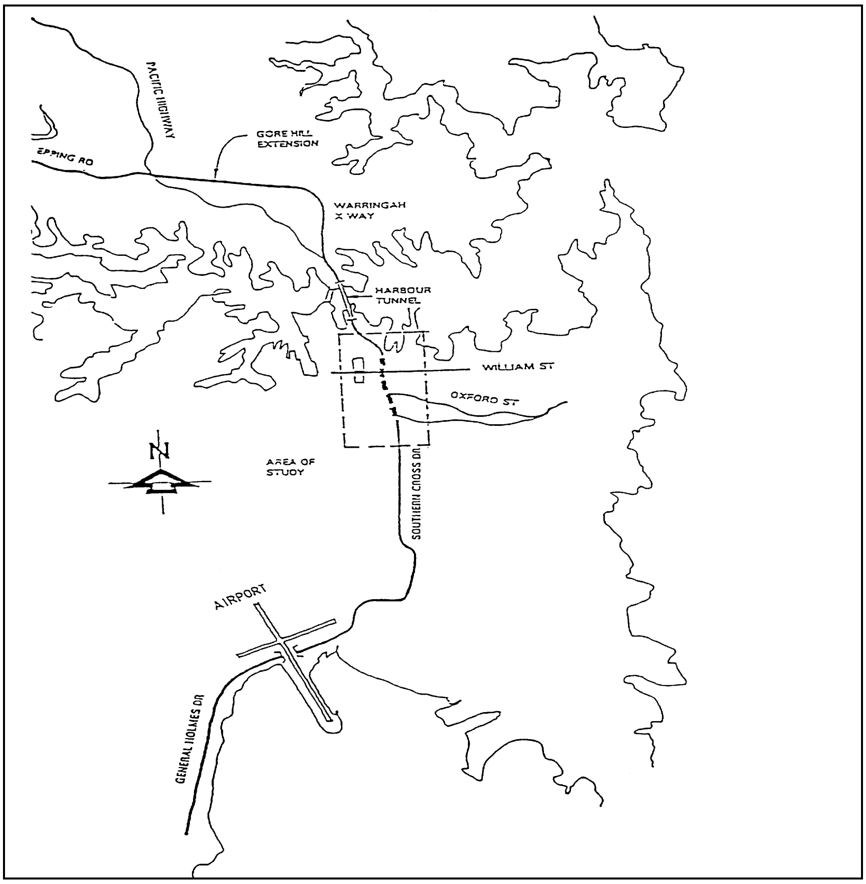
Increasing Need for a By-pass

The completion of the Sydney Harbour Tunnel in 1992 increased the volume of traffic travelling between the Tunnel / Cahill Expressway and the areas south and south east of the inner eastern suburbs. Increasing through-traffic increased the need for a road to by-pass the inner city.

Tollroad proposed 1994

In 1993 the Roads and Traffic Authority (RTA) undertook a program of community consultation to gauge the level of community acceptance of construction of an Eastern Distributor as a toll road. With indications of a high level of community support, the Authority submitted the project to the Government in 1994. The project was based on the re-designed 1984 scheme, employing two, two-lane tunnels in a similar location. It was estimated to cost $180M. On this occasion, the Government approved the RTA proceeding with the project based on there being little cost to the State, calling for proposals from the private sector.

Figure A1: Eastern Distributor 1994



1995 Enlarged Scheme

Expressions of interest from the private sector suggested that a $2 toll would raise far more than the estimated cost of the short two lane twin tunnels. In response, in 1995, the RTA allowed detailed proposals for a larger capacity tunnel at a cost estimated around $250m with options for additional works if funds permitted.

1996 Announcement

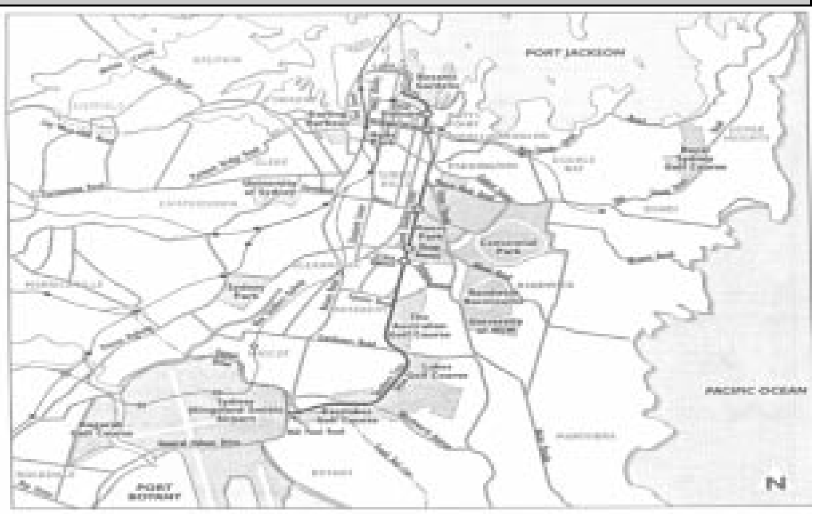
In 1996, following delays in financing, the election and extensive negotiations with the private sector proponents, the new Government announced the selection of Airport Motorway's offer, so extending the scope of the Eastern Distributor to encompass the widening of Southern Cross Drive to 6 lanes and General Holmes Drive to 8 Lanes as part of an emerging orbital network (see map below). The estimated cost now exceeded $500M.

The successful offer was based on a north-bound toll of $2.50 from the year 2000, indexed for a 38 year concession period. This would generate sufficient income to fund:

- an upgraded connection from the Cahill Expressway at the Domain to South Dowling Street, Moore Park including a twin three lane tunnel from William Street to Anzac Parade, Moore Park Road and South Dowling Street
- the widening and upgrading of South Dowling Street
- the widening of Southern Cross Drive from 4 to 6 lanes
- a $65M contribution towards the construction of the M5 East

An Environmental Impact Statement was prepared and placed on exhibition toward the end of the year.

Figure A2: Eastern Distributor 1997



1997 Announcement

In April 1997 the Minister announced that, in response to concerns raised by the Environmental Impact Statement, modifications to the scheme would be incorporated at an estimated cost of $132M. These modifications included a non-load bearing ‘canopy’ over the Cahill Expressway near the Art Gallery and a below ground approach to the works required on South Dowling Street. The total project cost had reached $684M.

The original “surpluses” on the project were now more than fully absorbed in paying for the modifications. Indeed the start toll was increased (to $3) and the concession period extended (to 48 years) as part of the new financial package proposed. The RTA was also now required to fund a widened Southern Cross Drive to 6 lanes by the year 2000, and the RTA would need to ensure the M5 East was constructed and open to traffic by 2004.

Planning Determination

RTA submitted its modified scheme in April 1997 to the Department of Urban Affairs and Planning for planning approval. At the time of preparation of this report, DUAP has yet to make a recommendation to the Minister and no contract has been signed with Airport Motorway.

Appendix 5 - The RTA’s Response and a Rejoinder

Rejoinder

Unfortunately, RTA’s letter which follows does not respond to issues of major importance in the report, such as the inadequacy of planning for Sydney’s roads, and misreads other issues to which it does respond. This requires me to make the following observations:

Availability of Independent Financial Modelling

The Eastern Distributor tender process gave divergent results which stemmed in part from different financial assumptions. This can be expected given the uncertainty of traffic projection and the length of the agreement. Rather than test this thinking with a model developed for the RTA as a benchmark, the RTA accepted one of the tendered models - eventually that of AML - as being preferred.

The audit does not say that the preferred tenderer’s model should not be used. It says that the RTA should have had the capacity to interpret it against its own developed thinking.

Exposure to Interest Rate Risk Hedging Strategy

The report accepts that the RTA understood its exposure to movements in interest rates from late 1995. It also accepts the difficulty, caused by the processes, for the RTA to hedge against these risks.

Availability of Infrastructure Bonds

These bonds were issued under law. The Commonwealth Authority which issued the required certificates had a legal obligation at the time to issue certificates to applicants which met the statutory criteria. No announcement by a Minister could alter these statutory provisions. They could have been pursued more vigorously by the RTA or the proponents.

Use of Average Weekly Earnings

The report already notes that private borrowings to fund the Eastern Distributor are to be indexed against the AWE. Others are to be indexed by the CPI.

The audit points out that this was accepted by the RTA as the result of the tender process. The proponent's assumption of the effects was also accepted by the RTA. In part this occurred because the RTA did not invest adequately in obtaining financial advice.

The audit provides evidence to support its view that the indexing arrangements should not have been merely accepted by the RTA.

Cost Escalation

The audit has no difficulties with the existence of cost penalties. It merely observes that, given the timing problems already facing the project, they add to pressures facing the Government. These pressures in part arise because of the way the project has been scheduled.

Public versus Private Financial of Urban Roads

Rather than quote what the RTA likes in the EPAC report, it should for itself consider the limitations and advantages of private financing of urban roads.

Discussion with Probity Auditor

Audit shows that following the EIS there were extensive changes to the project. The impact of these on the whole process was discussed with the Probity Auditor with no ensuing written report. The ICAC reported on 20 May 1997.

Review of Proposed Modifications to Achieve Cost Savings

The RTA has offered assurances that in a $680m project, savings amounting to 1.5% are not available.

Southern Cross Inclusion

Audit agrees that Southern Cross Drive improvements have always been an RTA responsibility and in the same way, the Eastern Distributor has been an RTA responsibility. Now they are being seen as part of the one project.

The RTA supplied material now follows:

COPY

Chief Executive

Roads and Traffic Authority
New South Wales

26 May 1997

Mr. A. Harris,
Auditor General,
The Audit Office,
Level 11,
234 Sussex Street,
SYDNEY. 2000.

Centennial Plaza
260 Elizabeth Street
SURRY HILLS NSW 2010

PO Box K198
HAYMARKET NSW 2000

Telephone: (02) 218 6316
Facsimile: (02) 218 6999

Dear Mr. Harris,

REVIEW OF THE EASTERN DISTRIBUTOR

Thank you for providing me with a copy of your Performance Audit Report *"Review of the Eastern Distributor"*, and your consultant's report *"Technical Matters Relating to the Eastern Distributor"*.

While I note that the report concludes that the project "represents another advance on agreements for private sector urban tolls", I have a number of concerns regarding the accuracy of certain matters raised in your report.

In summary, my main concerns are:

Availability of Independent Financial Modelling:

♦ The RTA and NSW Treasury are of the view that to develop an independent financial model would not be productive (see letter attached from NSW Treasury). For these types of projects when tenders are submitted they comprise a construction cost and a financing package. The financing package is reflected through the use of a financial model. Negotiations with the proponent must revolve around the proposal as submitted not some artificial financial model that RTA may wish to establish.

NSW Treasury has advised the RTA that *"to achieve a successful financial arrangement both parties need to be using the same computer model. By using the proponents financial model it is possible to identify the significant financial risk parameters for Government and financier. In all of the previous private sector infrastructure arrangements it has been the practice to adopt the financier's model as the basis for negotiations."* In addition, the Eastern Distributor was selected through a competitive tender process, with each proponent offering its own unique financial model.

It is also pointed out that to do otherwise than utilise the proponent's model could subject the RTA to criticism that the offer .that was accepted had been substantially changed to comply with an RTA model which could reflect aspects of an unsuccessful proponent's proposal.

In the case of the Eastern Distributor Road Project, Treasury and the RTA's financial advisers were provided with a copy of the proponents financial model and verified the outcomes associated with interest rate movements, construction cost changes and traffic and toll forecasts.

With reference to your recommendation that the RTA should consult with TCorp in respect of each major project put to tender, the matter has been discussed with TCorp, who have advised that they are prepared to advise on any future structured finance proposal but not on each major project put to tender.

Exposure to Interest Rate Risk:

- ♦ I note that in your Executive Summary you compliment the RTA for managing the interest rate movements better than in the past. Yet Chapter 4 of your report implies that the RTA was not *"adequately conversant with the intricacies of the financial package"*. In addition to financial advice from our private sector consultants, Treasury were actively involved in providing advice on the financial aspects of the proposal and have indicated that *"The issue of exposure to interest rate changes was always known to Treasury and the RTA. When the Minister for Roads announced the decision to proceed with the project on 13 August 1996, the Commonwealth Government 2010 index bond rate had just reached a 12 month peak of about 5.3% in July 1996 and was on a downward trend. Given the economic indicators at the time conservative estimates indicated continued decline in the bond rate which would be to the Governments benefit. Interest rates actually bottomed out in January 1997."* I assure you that the components of the financial package particularly the relationship between interest rates and the "surplus" were clearly understood by the RTA, Treasury and its financial advisers.

  Moreover, the RTA and NSW Treasury, as well as the RTA's financial advisers, have together been aware of the proponent's offer and changes to the offer throughout the entire process. It is not correct to say that the RTA or NSW Treasury is *"not adequately aware of the likely impact"* of aspects of the offer.

Hedging Strategy:

- ♦ Again, NSW Treasury, as well as TCorp, were involved in the hedging decision and have indicated that *"the decision to put in place an interest rate hedge was not taken lightly. In January, 1997, the scope of works was unknown because of the issues raised from the ElS process. Additionally, the direction of forward interest rates was uncertain. In December, 1996, the interest rates were moving in the Government's favour and Treasury was of the view that further falls were expected. The critical issue faced by Treasury and RTA at the time was when would be the optimal time to hedge the rates. Rate hedging does have a cost and a potential downside risk. In addition, the RTA had established a financial management policy of not investing in the futures market. The decision to hedge involved a major policy shift for RTA executive and also required the approval of the Treasurer.*

  To imply that there was an avoidable loss of $26 million implies perfect knowledge of forward interest rate movements in January, 1997, which was not the case. When compared with the bond rate at the 13th August, 1996, which was about 5.0%, the RTA hedged on the 2nd April 1997, at 4.79%, which actually gained about $28 million on the price at 13th August, 1996."

This position regarding the complexities of and risks associated with hedging has been verified by TCorp (see attached correspondence from TCorp), who were retained by the RTA to advise it on a hedging strategy.

The fact is that a hedge was put in place immediately agreement was reached with Airport Motorway about the scope and costs of modifications for the project. Without such agreement the RTA would have incurred considerable costs and risks (see TCorp's letter attached).

Availability of Infrastructure Bonds:

- The report implies that Infrastructure Bonds were available during the period December, 1995, to end June, 1996. This is clearly not correct. A Federal Ministerial directive was given in December, 1995, withdrawing the availability of infrastructure borrowings for urban roads. This decision was not reversed until the 24th June, 1996, (see attached press release issued by the Federal Treasurer). I understand this was pointed out to the Audit Office during your review by the RTA and Treasury.

  NSW Treasury has confirmed this understanding to me and I understand to you during the audit (see attached copy of Treasury correspondence).

  NSW Treasury and RTA officers met with Commonwealth officials immediately after the announcement by the previous Federal Government was made. At those meetings it was patently clear that the Commonwealth would not consider at that time an application for the issuance of Infrastructure Bonds for the Eastern Distributor Project. There was no other reasonable action that the RTA could have taken to resolve this matter.

  The funding of projects are materially affected by Government announcements and any uncertainty regarding Government policy. Surely the Audit Office would have been critical of the RTA if it had proceeded with the process in the light of uncertainty regarding Commonwealth Government policy on Infrastructure Bonds.

Use of Average Weekly Earnings:

- The report questions the use of the average weekly earnings (AWE) index. An examination of the finance plan would reveal that the indexed bonds are issued in two tranches. The first tranche for $150 million is indexed in line with the consumer price index (CPI), whilst the second tranche for $250 million is indexed in line with the AWE. This is a similar financing arrangement to that adopted for the Citylink Road in Melbourne.

  NSW Treasury has advised *"that real wages have been increasing at less than 2.0% over the more recent past. The CPI has been running at less than 4% per annum, and Treasury, forecasts to year 2000 are about 2.5% per annum. On the current trends it would appear that neither the CPI nor the AWE would exceed 4% in the foreseeable future"*. Hence, your calculations of future tolls is questionable.

Moreover, you fail to recognise that the toll formula was accepted as part of a total financial package. The RTA is not in a position to selectively choose one aspect of a complex financial package without considering the trade-offs and benefits to the total deal. In this regard the RTA did consider the trade-offs, in particular its ability to fund the proposed modifications arising out of the ElS process.

Cost Escalation:

- I note under the heading of "Cost Escalation" you incorrectly refer to cost penalties payable by the RTA. It is normal in any tender process for offers put forward by tenderers to contain validity periods. During the validity period costs associated with the offer are frozen. Airport Motorway Ltd. validity period has been extended from the 30th April, 1997, to the 10th June, 1997. The fact that a tenderer cannot indefinitely hold its costs should not be seen as a cost penalty.

State Obligations:

- Your report states that the State will have obligations *"not to build a juxtaposed competing arterial roads."*

This statement is misleading. The network in the vicinity of the Eastern Distributor is already well developed and there are few opportunities to develop competing arterial roads. Nevertheless, as was indicated in your discussions with the Minister for Roads, The Hon. C Scully, MP, the project documents specifically allow the RTA to develop the Arterial Route as an intersection-based road between Cleveland Street and Drive/Qantas Drive. This arterial road offers an alternative toll-free route between the City and the airport.

Public versus Private Financial of Urban Roads:

- The Technical Report quotes the EPAC Taskforce conclusion that:

> *"in the broad, BOOT-type structures are likely to be least advantageous for urban roads".*

However, EPAC went on to say:

> *"this finding does not imply that BOOT-type road projects are undesirable in all circumstances. For example, the BOOT approach may be warranted if there are short term budgetary constraints preventing good projects proceeding in a timely fashion under public ownership. As noted above, lengthy delays under public provision mean that benefits to users are deferred".*

This is precisely the position the RTA finds itself in.

Discussions with Probity Auditor on Competitive Tendering:

- Your suggestion that the RTA was late in taking action to resolve the probity issue regarding competitive tendering of the proposed modifications is incorrect. The RTA discussed this matter with the Probity Auditor on the 11th February, 1997, and again in April before you were asked to undertake the Special Audit.

The Probity Auditor did not raise concerns to the RTA's suggested course of action, nor did ICAC after the RTA referred the matter to them for advice.

Review of Proposed Modifications to Achieve Cost Savings:

- Your report suggests that the RTA could have found cost savings of $9 million to enable a reduction in the proposed term. I can assure you that the RTA, with its technical consultants and its urban designers, examined the scope of the project and the costings in exhaustive detail. Substantial cost savings were made with Airport Motorway, although in order to respond to public comment through the ElS process, the RTA is of the view that the proposed modifications are required to make the project acceptable environmentally.

Southern Cross Drive Inclusion:

- Southern Cross Drive improvements have always been an RTA responsibility, not something that became an RTA obligation after the modifications were added to the project.

Yours sincerely,

R.D. Christie,

Chief Executive.

COPY

MICHAEL KNIGHT
NEWS RELEASE

Minister for the Olympics **New South Wales**
Minister for Roads Friday 15 December 1995

CHANGES TO INFRASTRUCTURE BORROWINGS FOR URBAN ROADS

The State Government is investigating the implications of the Federal Government's decision to no longer offer tax benefits in the form of infrastructure borrowings for urban roads.

The NSW Minister for Roads, Michael Knight, acknowledged that the Commonwealth's decision will have implications on the Eastern Distributor and M5 East projects.

"The Federal Government has clearly changed the rules on infrastructure financing," Mr Knight said.

"The State Government was on the verge of deciding on a preferred proponent for the Eastern Distributor. However, the Commonwealth's decision has put a question mark over the financing of the project.

"The State Government will now be holding immediate talks with the three short-listed proponents to examine what the implications are for their tenders on the Eastern Distributor.

"We will also be seeking urgent discussions with the Federal Government to clarify the implications of their decision and the precise detail of the proposed alternative financing arrangements mentioned in their media statement.

"At this stage, it is too early to determine what effect the Federal Government's decision will have on the future on the Eastern Distributor project," Mr Knight said.

Media contact: Andrew Woodward (w) 02 228 4244 (m) 041 920 2317

Editor's note:
The three proponents for the Eastern Distributor (in alphabetical order) are:
Baulderstone Hornibrook
Airport Motorway (Leightons)
Transfield

COPY

JOINT MEDIA STATEMENT

By Hon Ralph Willis MP
Treasurer
and Hon Laurie Brereton MP
Minister for Transport

T100/95 15 December 1995

CHANGES TO INFRASTRUCTURE BORROWINGS FOR URBAN ROADS

Cabinet has approved significant changes to the way in which major urban road projects can be financed, to avoid a repetition of problems which have recently emerged with such projects.

Effective immediately, the Federal Government will no longer offer tax benefits in the forms of infrastructure borrowings for urban roads.

Instead, the Government will ask the Loan Council to establish a special category for State Government borrowing to develop publicly owned land transport infrastructure - funds which will be available at a lower rate than is available to private developers.

The Federal Government will work with the States to assist them in accessing this category of borrowings to finance nationally significant transport infrastructure.

"It is the Federal Government's view that the development of roads by State Governments themselves will benefit taxpayers considerably. Road users will be the winners, as State rather than private ownership will eliminate the interest premiums, the risk premiums, and the financing profit," Mr Willis and Mr Brereton said.

The taxation changes will only apply from now on. Road projects currently financed with the assistance of infrastructure borrowings such as the M2 in Sydney will not be affected. Melbourne City Link, for which an application is currently being assessed by the Development Allowance Authority (DAA), will remain eligible for infrastructure borrowings.

Urban road projects for which no formal application has been received by the DAA at the time of this announcement will no longer be eligible for infrastructure borrowings.

Today's decision follows the findings of the Economic Planning Advisory Commission (EPAC) Private Infrastructure Taskforce report released in October which stated that privately financed projects are "likely to be least advantageous for urban roads".

Despite its general support for private infrastructure projects, the EPAC Taskforce found that there was little efficiency to be gained from private ownership of roads.

It also concluded that the cost of building private roads was inflated because of legal and financial complexities, and “network risk” where the visibility of the project is affected by decisions on competing roads and public transport.

The Ministers said that the Government’s decision also reflects widespread community concerns about the City Link and M2 projects.

In the case of the City Link project, the Federal Government has already criticised the Kennett Government for corralling traffic onto tollroads to boost the private developer’s revenue, as well as the application of a toll to the currently toll-free Tullamarine Freeway.

The Federal Government is also highly critical of provisions in the Sydney M2 tollway, developed by the Fahey government, which provide for compensation to be paid to the tollway developer in the event of competition from future development of public transport services.

While the taxation benefits in dollar terms of infrastructure borrowings over the life of a project are modest, they have been very important in facilitating private sector financing of such projects because of their ability to lower the cost for financing in the early or construction phase.

For a billion dollar project the net present value of these taxation benefits would typically be less than fifty million dollars.

Media contacts: Luke Lawler, Mr Willis’ office (06) 277 7340 or Sharon McCrohan, Mr Brereton’s office (06) 277 7320

COPY

Treasurer of New South Wales
Australia

M Lambert
228.5440
X35080

The Hon Ralph Willis MP
Treasurer
House of Representatives
CANBERRA ACT 2600

22 January 1996

Dear Treasurer

Financing of Urban Tolls

On 15 December 1995 the Commonwealth announced changes to infrastructure borrowings and tax arrangements for urban roads.

Effective from the date of the announcement, tax benefits are no longer available for infrastructure borrowings undertaken by private sector operators for urban roads.

At the time of the announcement, the State Government was on the verge of announcing its preferred proponent for the Eastern Distributor project that is directed at constructing a tollroad from Sydney Airport linking to the City. Further, planning work was well advanced on the related M5 East project.

Both projects are now in jeopardy. The estimated impact of the change in policy announced by the Commonwealth is to increase the cost of the Eastern Distributor project by between $70 million and $90 million.

It appears rather surprising that the new policy exempts the Melbourne City Link project but adversely impacts on the Eastern Distributor and M5 East, particularly bearing in mind the significant benefits conferred on Sydney Airport by these projects.

In discussion with the Commonwealth Minister for Transport and Commonwealth officers, there would appear to be acceptance of the case for treating the Eastern Distributor and possibly the M5 East as a special case due to the advanced stage reached in the tender process.

The simplest approach would appear to be to allow the Eastern Distributor/M5 East project to proceed under the previous arrangement, as is the case with the Melbourne City Link project. Alternatively, if that is not acceptable, there should be a Commonwealth capital grant to compensate for the financial impact of the change of policy.

I seek your urgent agreement on this matter in order that this vital, strategic project can proceed.

Beyond the specific case of the Eastern Distributor/M5 East project, it is also important that the general approach to apply under the new arrangements be fleshed out. The Commonwealth Media Statement refers to the creation of a special category for State Government borrowings to develop publicly owned land transport infrastructure. No detail of what is proposed has been provided.

In order to allow for effective planning for future vital transport infrastructure, I would urge that you provide information on the proposed approach and an explanation of what financial benefits it will provide to the States relative to the eliminated tax benefits.

Yours sincerely

(Sgd) Michael Egan

Michael Egan
Treasurer

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TREASURER

PRESS RELEASE No. 34

INFRASTRUCTURE BORROWINGS - URBAN ROAD PROJECTS

The Government has decided to reverse the previous Government's plans to remove urban road projects from eligibility for the Infrastructure Borrowings concession.

This decision reverses the decision, announced on 15 December 1995, by the former Treasurer, and the former Transport Minister, the Hon. Laurie Brereton.

Since the legislation to enact the decision of 15 December has not been introduced to Parliament, the effect of today's announcement is that urban road projects have never been excluded from the Infrastructure Borrowings concession.

On the current forward estimates in the budget for the cost of infrastructure borrowings, the decision to reinstate urban road projects is expected to have minimal impact on the budget in 1996-97 and future years.

The Government is announcing this decision to remove uncertainty in the financial markets surrounding the status of the previous Government's decision.

The Government, of course, reserves the right to keep infrastructure borrowings under review to ensure the program is meeting its objectives. There is no basis to arbitrarily remove one kind of project from the program. Those urban road projects that do proceed using infrastructure borrowings are matters for the State Government or the consortium concerned.

CANBERRA
24 June 1996

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Mr Paul Forward 23 May 1997
Director
Road Network Infrastructure
Roads and Traffic Authority of NSW
Level 6, Centennial Plaza
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SURRY HILLS NSW 2010

Dear Paul

RESPONSE TO DRAFT AUDIT REPORT

TCorp's principal concern with the Draft Audit Report is its implicit assumption that full hedging of the "RTA surplus" could have been readily achieved as early as August 1996.

It is important to note the components of risk in implementing a hedging strategy for this project:-

1. Project Uncertainty

Implementing financial hedging incurs both costs and risks. Unwinding financial hedging also incurs costs. As a result it is prudent to hedge <u>only when</u> there is a high degree of confidence that :-

(a) the project will proceed, and
(b) the components of the project (including construction costs, inclusions, repayment dates etc) are no longer subject to substantial alteration.

TCorp made this point to RTA in November 1996 and, as detailed in the letter dated 26th November, advised that RTA should consider financial hedging if they could secure a reasonable degree of certainty on additional works and aggregate project costings given that the scope for these were influenced by the movements in the underlying interest rates for index securities.

2. Performance of the Hedge ("Basis risk")

To explain, a particular feature of the accepted financing proposal is the usage of CPI-linked bonds. As a result, the RTA surplus is most sensitive to movements in CPI interest rates. The main difficulty is that <u>there is no ready market to hedge CPI interest rate exposure.</u> The CPI bond market is relatively small and illiquid, and sensitive to demand/supply imbalances. This factor added to the risk that the market for CPI bonds would move adversely in yield prior to financial close, in light of market anticipation of a large volume of CPI bonds to be issued (Note- This situation did occur in relation to the M2 project).

Therefore, TCorp's proposal for financial hedging focussed on using the more liquid nominal interest rate markets, which results in a "basis risk" (ie. the risk that the CPI market and the nominal market do not move in tandem). The following points should be noted:-

(a) The hedging arrangement that was negotiated in March 1997 with Airport Motorway Ltd (AML) includes AML assuming this basis risk. The $5m fee paid by RTA to AML is compensation for assumption of this risk.

(b) AML's initial proposal for assumption of hedging and basis risks (as per meetings on 24th March 1997) implied a fee for assumption of the basis risk of approx. $20m.

(c) Discussions at the time between TCorp and the bond houses involved in the distribution of the CPI bonds for the project, revealed that the impact of selling the targeted volume of bonds into the market could conceivably cost RTA $20m or more (due to the basis risk, where CPI yields move up and nominal yields remain steady).

(d) Had RTA chosen to implement hedging back in 1996, they would have had to assume this basis risk, and as a result would not have been able to "lock-in" the surplus. The only way of truly locking in the surplus would be to have another party (such as AML) assume this basis risk, which is what ultimately did occur. AML almost certainly would not have entertained the idea of assuming this risk prior to March 1997, whilst there were still various aspects of the project and its inclusions that had not been negotiated.

(e) As a result, it is not accurate to state that the $26m deterioration in RTA surplus between January and March was avoidable, as there was no practical or cost effective way of truly fixing the RTA surplus prior to March.

Yours sincerely

Stephen Knight
General Manager Treasury

COPY

The Treasury

Mr R Christie
Chief Executive
Roads and Traffic Authority
PO Box K198
HAYMARKET NSW 2000

Contact D Graham
Telephone (02) 9228 3213
Our Reference T95/2028
Your Reference

Dear Mr Christie

Eastern Distributor Road - Auditor General's Performance Audit Draft Report

Thank you for forwarding a copy of the Auditor General's draft report on the Eastern Distributor Road. Treasury has reviewed the report and would like to take the opportunity to make a number of comments.

On page 2 of the report the comment is made that there is no evidence to show that a comparison of private versus public sector delivery was seriously pursued. Treasury requested that a full financial analysis report be prepared which compared the alternative delivery options. The financial analysis undertaken by the RTA was fully discussed with Treasury prior to performing the model runs.

Treasury was supportive of the general finding that a government funded tollroad would provide marginally higher returns to Government. This outcome was fully reported to Cabinet at the time of selection of the preferred proponent. Treasury is aware that the benefits of private sector involvement had been established on several previous contracts. The ability of RTA to develop a contract structure that would produce similar outcomes had not been proven. Treasury would maintain that analysis of the public sector delivery option was comprehensive and was seriously considered by RTA and Government at the time.

Page 5 of the report refers to verification by independent financial modelling. Treasury is of the view that to develop an independent financial model would not be productive. For these types of projects when tenders are submitted they comprise a construction cost and a financing package. The financing package is reflected through the use of a financial model. Negotiations with the proponent must revolve around the proposal as submitted not some artificial financial model that RTA may wish to establish. Treasury is of the view that to achieve a successful financial arrangement both parties need to be using the same computer model. By using the proponents financial model it is possible to identify the significant financial risk parameters for

Government and financier. In all of the previous private sector infrastructure arrangements it has been the practice to adopt the financier's model as the basis for negotiations. In the case of the Eastern Distributor Road project Treasury was provided a copy of the proponents financial model and verified the outcomes associated with interest rate movements, construction cost changes and traffic and toll forecasts.
With respect to the general issue of interest rate risk Treasury and the Government were fully aware that interest rate risk was being borne by the Government until financial close. This position has been consistently taken by Government for other projects. On the M2 project the Government took the risk and has to pay for the cost of adverse rate movement. On the Olympic Stadium the same position was taken which was to the Government's benefit. In the submission to Cabinet on the Eastern Distributor Road on 27 November 1995 Treasury identified the financial impact of interest rate movements.

The issue of exposure to interest changes was always known to Treasury and the RTA. When the Minister for Roads announced the decision to proceed with the project on 13 August 1996, the Commonwealth Government 2010 index bond rate had just reached a 12 month peak of about 5.3% in July 1996 and was on a downward trend. Given the economic indicators at the time conservative estimates indicated a continued decline in the bond rate which would be to the Government's benefit. Interest rates actually bottomed out in January 1997.

The decision to put in place an interest rate hedge was not taken lightly. In January 1997 the scope of works was unknown because of the issues raised from the EIS process. Additionally, the direction of forward interest rates was uncertain. In December 1996 the interest rates were moving in the Government's favour and Treasury were of the view that further falls were expected. The critical issue faced by Treasury and RTA at the time was when would be the optimal time to hedge the rates. Rate hedging does have a cost and a potential of not investing in the futures market. The decision to hedge involved a major policy shift for RTA executive and also required the approval of the Treasurer. To imply that there was an avoidable loss of $26 million implies perfect knowledge of forward interest rate movements in January 1997 which was not the case. When compared with the bond rate at 13 August 1996 which was about 5.0% the RTA hedged on 2 April 1997 at 4.79% which actually gained about $28 million on the price at 13 August 1996.

Page 6 indicates that the issue of Infrastructure Bond availability was not vigorously pursued. Contrary to this opinion the Treasury and RTA met with Commonwealth officials immediately after the announcement by the previous Federal Government was made. At those meetings it was made patently clear that the Commonwealth would not consider at that time an application for the issuance of Infrastructure Boards on the Eastern Distributor Road. The discussion on page 57 of the report more closely reflects the actual position.

Page 10 of the report indicates that there is no justification for use of the average weekly earnings (AWE) index. A close examination of the finance plan would reveal that the indexed bonds are issued in two tranches. The first tranche for $150 million is indexed in line with consumer price index (CPI), while the second tranche for $250 million is indexed in line with AWE. This is a similar financing arrangement to that adopted for the Citylink Road in Melbourne. Real wages have been increasing at less than 2.0% over the more recent past. The CPI has been running at less than 4.0% per annum and Treasury forecasts to year 2000 are about 2.5% per annum. On the current trends it would appear that neither the CPI nor the AWE would exceed 4% in the foreseeable future. Statements made on page 25 should be amended.

Yours faithfully

Ian Neale
for Secretary

COPY

The Treasury

Mr T Jambrich
Assistant Auditor General
The Audit Office
GPO Box 12
Sydney NSW 2001

Contact D Graham
Telephone (02) 9228 3213
Our Reference D33658
Your Reference

Dear Mr Jambrich

Eastern Distributor Road - Performance Audit

I refer to your recent letter concerning the supply of information to your office on matters related to the proposed Eastern Distributor Road. Treasury officers have been in regular contact with Mr C Yates regarding Treasury's position on the project and information that we may hold.

I would like to refer specifically to correspondence that Mr Yates forwarded to Treasury regarding Invest Australia's inference that only limited communication took place following the previous Federal Government's policy decision to remove use of infrastructure bonds for urban roads.

The previous Federal Government on 15 December 1995 issued a joint media statement from the Treasurer the Hon R Willis and the Minister for Transport the Hon L Brereton stating:
"Effective immediately, the Federal Government will no longer offer tax benefits in the form of infrastructure borrowings for urban roads." At the time the NSW Government had not announced the preferred proponent for the Eastern Distributor Road. Processing of the Eastern Distributor Road proposal was placed on hold until its status was confirmed, as all proponents has proposed using infrastructure bonds.

Treasury met with officers from Commonwealth Treasury on the 19 and 21 December 1995 to discuss the impact the Commonwealth's policy had on the Eastern Distributor Road. Following those meetings the Treasurer wrote to the Federal Treasurer expressing concern about the adverse impact the policy decision would have on the Eastern Distributor Road and the M5 East projects. No reply was ever received to that letter. I attach copies of documents related to decisions taken at that time.

Because of the Commonwealth's policy position, further work on the project ceased until the new incoming Treasurer Mr P Costello issued a media statement on 24 June 1996 which stated: *"The Government has decided to reverse the previous*

Government's plans to remove urban road projects from eligibility for the Infrastructure Borrowing concession."

Contrary to MR Maxwell's (Invest Australia) advice it is clear from the content of the two media statements and our meetings with Commonwealth Treasury that there was the expressed policy intention that between 15 December 1995 and 24 June 1996 urban roads were excluded from the Infrastructure Borrowing concession.

I also attach a copy of a letter dated 8 February 1996 from Bain & Company, who were representing one of the proponents, which indicates that they shared the view that infrastructure bonds may not be available for the Eastern Distributor Road.

I confirm that a meeting between Mr Yates and Mr Neale and Mr Graham of Treasury that we provided a copy of the economic appraisal for the Eastern Distributor Road. This report was submitted to Treasury as part of the documentation provided by the RTA to support their selection of the preferred proponent. I also attach an extract of RTA's Capital Investment Strategic Plan which is currently being revised to take account of changes contained within the Budget.

I have been advised that RTA have provided to you separately of their financial appraisal comparing government and private financing of the project.

Yours faithfully

Ian Neale
for Secretary

19 May 1997

PART 2

Technical Matters Relating to the Eastern Distributor